College Accounting – Chapter 11 Current Liabilities and Payroll

1. HOW ARE CURRENT LIABILITIES OF KNOWN AMOUNTS ACCOUNTED FOR?

- **Liabilities** are debts that are owned to creditors. Liabilities have 3 main characteristics:
  - They occur because of a past transaction or event.
  - They create a present obligation for future payment of cash or services.
  - They are unavoidable obligations.
- **Current liabilities** must be paid either with cash or with goods and services within one year or within the entity's operating cycle if the cycle is longer than a year.
  - Salaries Payable, Interest Payable, and Unearned Revenue are all current liabilities.
- **Long-term liabilities** are liabilities that do not need to be paid within one year or within the entity's operating cycle, whichever is longer.
  - **Notes payable** is a long-term liability.

a. Accounts Payable

- Amounts owed for products or services purchased on account are accounts payable.
- Because they are typically due in 30 days, they are current liabilities.

b. Sales Tax Payable

- Most states assess sales tax on retail sales.
- Enter: Cash as the debit on the top line. Sales Revenue next and Sales Tax Payable on the 3rd line, both as credits. The Sales Revenue + Sales Tax Payable = Cash amount.

c. Unearned Revenues

- Unearned revenue is also called deferred revenue.
- Unearned revenue arises when a business has received cash in advance of providing goods or performing work and, therefore, has an obligation to provide goods or services to the customer in the future.
- Enter: Cash as the debit and Unearned Revenue as the credit.
- Once part of the work is done, enter: Unearned Revenue as the debit and Service Revenue as the credit.

d. Short-Term Notes Payable

- **Short-term notes payable** are common form of financing. Short-term notes payable represent a written.
- Enter: Merchandise Inventory as the debit and Notes Payable as the credit.
- When the note is due enter: Notes Payable as the debit, Interest Expense is a debit and Cash as the credit. Notes Payable + Interest Expense = Cash.
- Promissory notes are entered as: Cash with a debit amount and Notes Payable with a credit amount.
- The matching principle requires the business to accrue interest expense as: Interest Expense as the debit and Interest Payable as the credit.
- At the end of the year enter: Notes Payable as a debit, Interest Expense as a debit, Interest Payable as a debit and then Cash as a credit. The 1st 3 add to the Cash amount.

e. Current Portion of Long-Term Notes Payable

- The current portion of notes payable is the principal amount that will be paid within one year. The remaining portion of the note will be classified as long-term.

2. HOW DO COMPANIES ACCOUNT FOR AND RECORD PAYROLL?

- There are numerous ways to label an employee's pay:
  - **Salary** is pay stated at an annual, monthly, or weekly rate.
  - **Wages** are pay amounts stated at an hourly rate.
  - **Commission** is pay stated as a percentage of a sale amount, such as a 5% commission on a sale.
  - **Bonus** is a pay over and above base salary (or wage or commission). A bonus is usually paid for exceptional performance – in a single amount after year-end.
  - **Benefits** are extra compensation – items that are not paid directly to the employee.
- Businesses pay employees at a base rate for a set period – called **straight time**. For additional hours – **overtime** – the employee may get a higher pay rate, depending on the job classification and wage and hour laws.

a. Gross Pay and Net (Take-Home) Pay

- **Gross pay** is the total amount of salary, wages, commissions, and bonuses earned by the employee during a pay period, before taxes or other deductions.
- **Net pay** is the amount the employee gets to keep after deductions.

b. Employee Payroll Withholding Deductions

- Amounts withheld from paychecks are called **withholding deductions**. Two categories:
  - Required deductions, such as employee federal and state income tax and Social Security tax.
  - Optional deductions, including insurance premiums, retirement plan contributions, charitable contributions and other amounts that are withheld at the employee's request.
- Withholding for Employee Income Tax
  - The income tax deducted from gross pay is called **income tax payable**. This book uses 20%.
- Withholding for Employee Social Security Tax (FICA)
  - The Federal Insurance Contributions Act (FICA), also known as the Social Security Act, created the social security tax. It has 2 components:
    - OASDI (old age, survivors, and disability insurance) – this provides retirement benefits to individuals based upon age, benefits to survivors of qualified individuals, and disability insurance to individuals who cannot work because of a medical condition. This book uses 4.2%.
    - Medicare (medical benefits) – this provides health insurance to individuals based on age or disability. This book uses 1.45%.
- Optional Withholding Deductions
  - As a convenience to employees, some companies withhold payroll deductions and then pay designated organizations according to employee instructions.
  - Insurance premiums, retirement savings, union dues, and gifts to charities are examples.

c. Payroll Register

- Many companies use a payroll register to help summarize the earnings, withholdings, and net pay for each employee.
- A business's payroll register typically includes the following columns:
  - Employee name
  - Beginning cumulative earnings
  - Current period earnings
  - Ending cumulative earnings

- OASDI
- Medicare
- Income Tax
- Health Insurance
- Other deductions
- Total Withholdings
- Net Pay
- Check Number
- Salaries and Wages Expense

d. Journalizing Employee Payroll

- Enter Salaries and Wages Expense as a debit. This is an amount that all of the following credits add up to equal. Credits are: FICA-OASDI Taxes Payable, FICA-Medicare Taxes Payable, Employee Income Taxes Payable, Employee Health Insurance Payable, United Way Payable, Salaries and Wages Payable.
- On payday, the company makes the following entry: Salaries and Wages Payable as the debit with Cash as the credit.

e. Employer Payroll Taxes

- Employers must pay at least payroll taxes:
    - Employer FICA tax (OASDI and Medicare)
        - The employer portion of OASDI is 6.2% on the first $110,000 of each employee's annual earnings.
        - The employer's tax rate for Medicare is 1.45% on all earnings.
    - State unemployment compensation tax (SUTA)
        - This is a payroll tax paid by employers to the government, which is used to pay unemployment benefits to people who are out of work. This book uses 5.6%.
    - Federal unemployment compensation tax (FUTA)
        - This is a payroll tax paid by employers to the government, which is used to pay unemployment benefits to people who are out of work. This book uses 0.6%.
    - To journalize, enter: Payroll Tax Expense as the debit. Enter the credits as: FICA – OASDI Taxes Payable, FICA-Medicare Taxes Payable, Federal Unemployment Taxes Payable, and State Unemployment Taxes Payable. The debit amount should equal all of the credits added together.

f. Internal Control Over Payroll

- Controls for Efficiency – the payroll data are stored in a file, and the computer makes the calculations, prints paychecks, and updates all records electronically.
- Controls to Safeguard Payroll Disbursements – the owner of a small business can monitor his/her payroll by personal contact with employees. Hiring and firing employees should be separated from accounting and from passing out paychecks.
- 4 departments within a company to help with payroll:
    - The Human Resources Department – hires and fires workers.
    - The Payroll Department – maintains employee earnings records.
    - The Accounting Department – records all transactions.
    - The Treasurer – distributes paychecks to employees.

3. HOW ARE CURRENT LIABILITIES THAT MUST BE ESTIMATED ACCOUNTED FOR?

a. Bonus Plans

- Many companies give bonuses to their employees in addition to their regular wages.
- Bonus = (Bonus % X Net income before bonus) / (1 + Bonus %)
- Journalize as: Employee Bonus Expense as the debit and Employee Bonus Payable as the credit.

b. Vacation, Health, and Pension Benefits

- A **pension plan** provides benefits to retired employees.
- For vacations, journalize: Vacation Benefit Expense as the debit and Vacation Benefits Payable as the credit.

c. Warranties

- Many companies guarantee their products against defects under **warranty** agreements. A warranty is any agreement that guarantees a company's product against defects.
- Journalize: Accounts Receivable as the debit, Sales Revenue as the credit. Cost of Goods Sold as the debit and Merchandise Inventory as the credit. Warranty Expense as the debit and Estimated Warranty Payable as the credit.
- When the company replaces the defective goods, it makes the following entries: Estimated Warranty Payable with a debit and Merchandise Inventory as a credit.

4. HOW ARE CONTINGENT LIABILITIES ACCOUNTED FOR?

- A **contingent liability** is a potential, rather than an actual, liability because it depends on a future event.
- Three types:
    - Remote Contingent Liability – a remote chance of the event occurring in the future.
    - Reasonably Possible Contingent Liability – a reasonably possible chance that the event will occur.
    - Probable Contingent Liability – the event is probable and most likely will happen.

Likelihood of Future Events	**How to Report the Contingency**
Remote	Do not disclose.
Reasonably possible	Describe the situation in a note to the financial statements.
Probable and the amount of the expense cannot be estimated	Describe the situation in a note to the financial statements.
Probable and the amount of the expense can be estimated	Record an expense and a liability based on estimated amounts.

5. HOW DO WE USE THE TIMES-INTEREST-EARNED RATIO TO EVALUATE BUSINESS PERFORMANCE?

- Investors can use the **times-interest-earned ratio** to evaluate a business's ability to pay interest expense.

$$\text{Times-interest-earned ratio} = \frac{(Net\ income + Income\ tax\ expense + Interest\ expense)}{Interest\ expense}$$