Financial Accounting

John J. Wild

Sixth Edition

McGraw-Hill/Irwin

Chapter 09

Reporting and Analyzing Current Liabilities

Conceptual Learning Objectives

C1: Describe current and long-term liabilities and their characteristics.

C2: Identify and describe known current liabilities.

C3: Explain how to account for contingent liabilities.

Analytical Learning Objectives

A1: Compute the times interest earned ratio and use it to analyze liabilities.

Procedural Learning Objectives

P1: Prepare entries to account for short-term notes payable.

P2: Compute and record employee payroll deductions and liabilities.

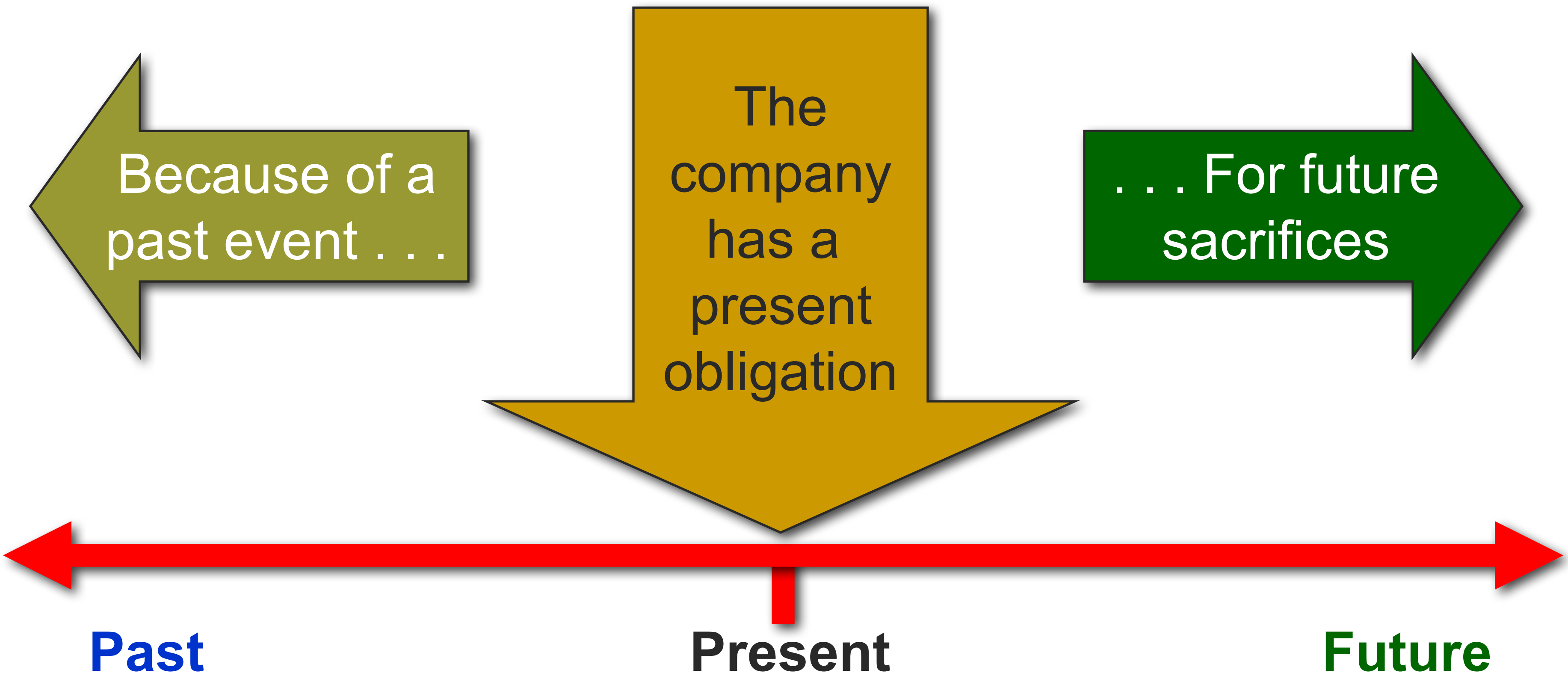
P3: Compute and record employer payroll expenses and liabilities.

P4: Account for estimated liabilities, including warranties and bonuses.

P5: Appendix 9A – Identify and describe the details of payroll reports, records, and procedures (see text for details).

C 1

Defining Liabilities



C 1

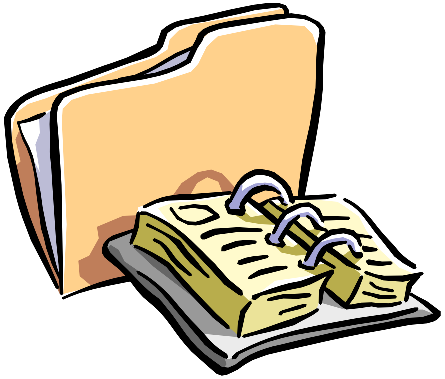
Classifying Liabilities

Current Liabilities	Long-Term Liabilities
Expected to be paid within one year or the company's operating cycle, whichever is longer	Expected not to be paid within one year or the company's operating cycle, whichever is longer

C 1

Uncertainty in Liabilities

Uncertainty in whom to pay



Uncertainty in when to pay

Uncertainty in how much to pay

C 2

Known Liabilities

Accounts Payable

Sales Taxes Payable

Unearned Revenues

Short-Term Notes Payable

Payroll Liabilities

Multi-Period Known Liabilities

P1

Note Given to Extend Credit Period

On August 1, 2011, Matrix, Inc. asked Carter Co. to accept a 90-day, 12% note to replace its existing $5,000 account payable to Carter. Matrix would make the following entry:

		DR	CR
Aug 1	**Accounts Payable - Carter**	**5,000**	
	Notes Payable - Carter		**5,000**
	To replace customer account with note		

C 2

Sales Taxes Payable

On May 15, 2011, Max Hardware sold building materials for $7,500 that are subject to a 6% sales tax.

		DR	CR
May 15	**Cash**	**7,950**	
	Sales		**7,500**
	Sales Taxes Payable		**450**
	To record cash sales and 6% sales tax.		

$7,500 × 6% = $450

C 2

Unearned Revenues

On May 1, 2011, A-1 Catering received $3,000 in advance for catering a wedding party to take place on July 12, 2011.

		DR	CR
May 1	Cash	3,000	
	Unearned Revenue - Catering		3,000
	To record advance payment.		

		DR	CR
Jul 12	Unearned Revenue - Catering	3,000	
	Revenue - Catering		3,000
	To recognize revenue received in advance		

P1

Note Given to Extend Credit Period

On October 30, 2011, Matrix, Inc. pays the note plus interest to Carter.

Oct 30	**Notes payable - Carter**	**5,000**	
	Interest expense	**150**	
	Cash		**5,150**
	To record payment of note and interest		

Interest expense = $5,000 × 12% × (90 ÷ 360) = $150

P1

Note Given to Borrow from Bank

PROMISSORY NOTE

$20,000 — Face Value

Sept. 1, 2011 — Date

Ninety days after date I promise to pay to the order of

American Bank

Nashville, TN

Twenty thousand and no/100 - - - - - - - - - - - - - - - - - - Dollars

plus interest at the annual rate of 6%.

Jackson Smith

P1

Face Value Equals Amount Borrowed

On September 1, 2011, Jackson Smith borrows $20,000 from American Bank. The note bears interest at 6% per year. Principal and interest are due in 90 days (November 30, 2011).

		DR	CR
Sep 1	**Cash**	**20,000**	
	Notes payable		**20,000**
	To record note to American Bank		

P1

Face Value Equals Amount Borrowed

On November 30, 2011, Smith would make the following entry:

	DR	CR
Notes payable	20,000	
Interest expense	300	
Cash		20,300
To record payment of note and interest		

$20,000 × 6% × (90 ÷ 360) = $300

P1

End-of-Period Adjustment to Notes

Note Date

End of Period

Maturity Date

An adjusting entry is required to record interest expense incurred to date.

P1

End-of-Period Adjustment to Notes

Dec. 16, 2011

Dec. 31, 2011

Feb. 14, 2012

Note Date

End of Period

Maturity Date

James Burrows borrowed $8,000 on Dec. 16, 2011, by signing a 12%, 60-day note payable.

P1

End-of-Period Adjustment to Notes

On December 16, 2011, James Burrows would make the following entry:

Dec 16	Cash	8,000	
	Notes payable		8,000
	To record amount borrowed from bank		

On December 31, 2011, the adjustment is:

		DR	CR
Dec 31	Interest expense	40	
	Interest payable		40
	To accrue interest on note		

$8,000 × 12% × (15 ÷ 360) = $40

P1

End-of-Period Adjustment to Notes

On February 14, 2012, James Burrows would make the following entry.

		DR	CR
Feb 14	Notes payable	8,000	
	Interest payable	40	
	Interest expense	120	
	Cash		8,160
	To record payment of note		

$\$8,000 \times 12\% \times (45 \div 360) = \$120$

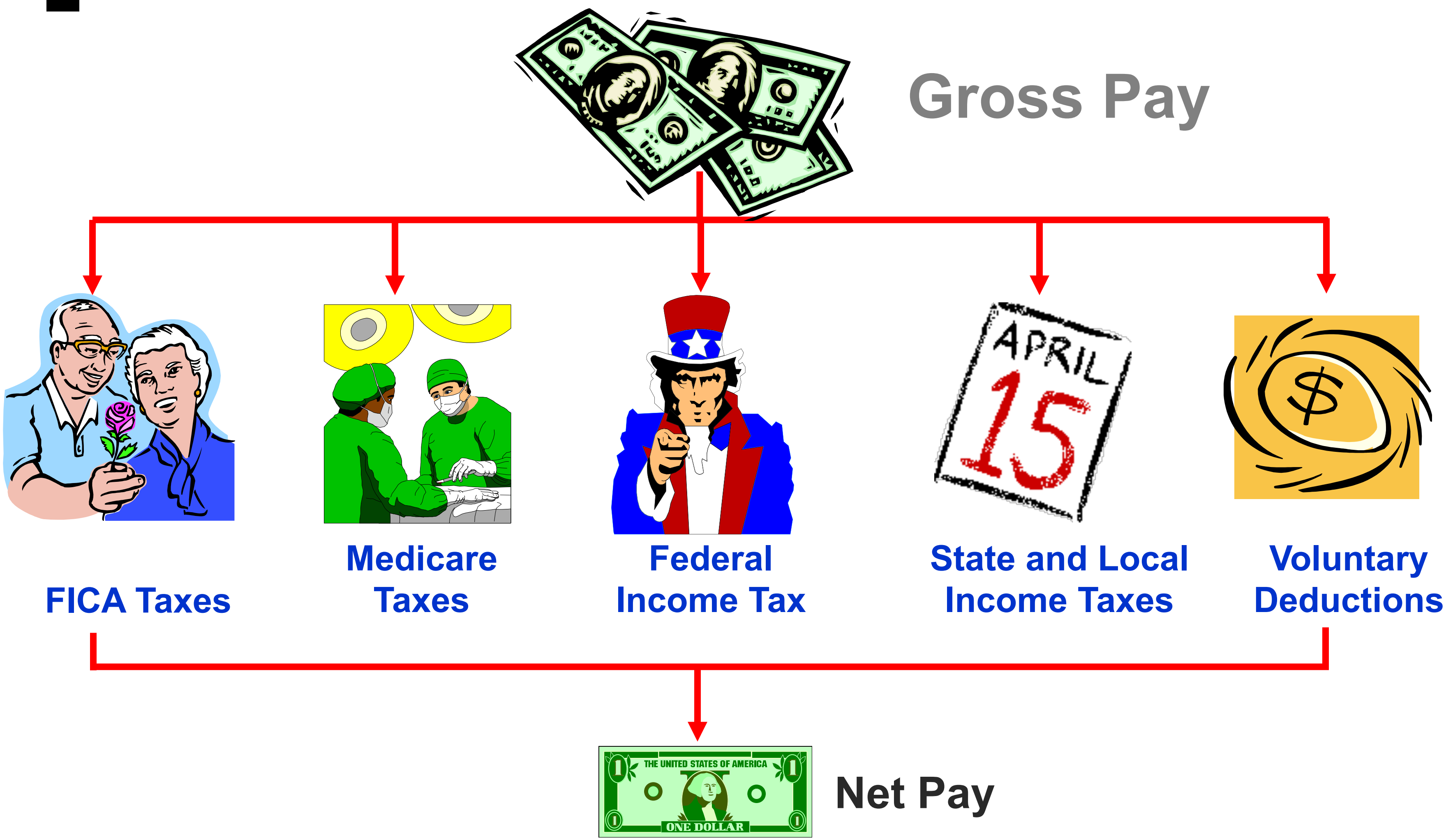
P2

Payroll Liabilities

Employers incur expenses and liabilities from having employees.

P2

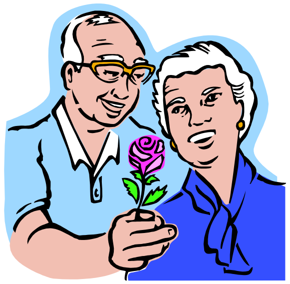
Employee Payroll Deductions



P2

Employee FICA Taxes

Federal Insurance Contributions Act (FICA)



FICA Taxes — Soc. Sec.

2010: 6.2% of the first $106,800 earned in the year (Max = $6,622).

FICA Taxes — Medicare

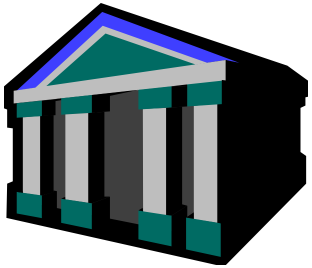
2010: 1.45% of all wages earned in the year.

Employers must pay withheld taxes to the Internal Revenue Service (IRS).

P2

Employee Income Tax

Federal Income Tax



State and Local Income Taxes

Amounts withheld depend on the employee's earnings, tax rates, and number of withholding allowances.

Employers must pay the taxes withheld from employees' gross pay to the appropriate government agency.

Employee Voluntary Deductions

Voluntary Deductions

Amounts withheld depend on the employee’s request.

Examples include union dues, savings accounts, pension contributions, insurance premiums, and charities.

Employers owe voluntary amounts withheld from employees’ gross pay to the designated agency.

P2

Recording Employee Payroll Deductions

The entry to record payroll expenses and deductions for an employee might look like this.

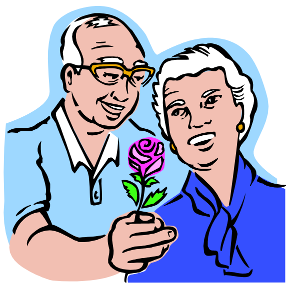
		DR	CR
Jan. 31	Salaries Expense	4,000	
	FICA - Social Security Tax Payable		248
	FICA - Medicare Tax Payable		58
	Employee Federal Income Tax Payable		420
	Employee Medical Insurance Payable		48
	Employee Union Dues Payable		100
	Accrued Salaries Payable		3,126
	To record accrued payroll for January		

$\$4,000 \times 6.2\% = \$248$

$\$4,000 \times 1.45\% = \$58$

P3

Employer Payroll Taxes



FICA Taxes

Medicare Taxes

Federal and State Unemployment Taxes

Employers pay amounts equal to that withheld from the employee's gross pay.

P3

Federal and State Unemployment Taxes

Federal Unemployment Tax (FUTA)	**2010: 6.2% on the first \$7,000 of wages paid to each employee (A credit up to 5.4% is given for SUTA paid, therefore the net rate is .8%.)**
State Unemployment Tax (SUTA)	**2010: Basic rate of 5.4% on the first \$7,000 of wages paid to each employee (Merit ratings may lower SUTA rates.)**

P3

Recording Employer Payroll Taxes

The entry to record the employer payroll taxes for January might look like this:

FICA amounts are the same as that withheld from the employee's gross pay.

SUTA: $4,000 × 5.4% = $216

FUTA: $4,000 × (6.2% - 5.4%) = $32

		DR	CR
Jan. 31	Payroll Taxes expense	554	
	FICA - Social Security Tax Payable		248
	FICA - Medicare Tax Payable		58
	State Unemployment Taxes Payable		216
	Federal Unemployement Taxes Payable		32
	To record employer payroll taxes for January		

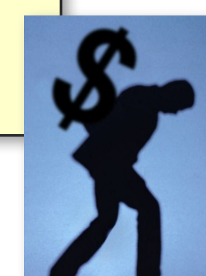
P3

Multi-Period Known Liabilities

Often include unearned revenues and notes payable.

Unearned revenues from magazine subscriptions often cover more than one accounting period. A portion of the earned revenue is recognized each period and the unearned revenue account is reduced.

Notes payable often extend over more than one accounting period. A three-year note payable would be classified as a current liability for one year and a long-term liability for two years.



P4

Estimated Liabilities

An estimated liability is a known obligation of an uncertain amount, but one that can be reasonably estimated.

P4

Health and Pension Benefits

Employer expenses for pensions or medical, dental, life, and disability insurance

Assume an employer agrees to pay an amount for medical insurance equal to $8,000, and contribute an additional 10% of the employees' $120,000 gross salary to a retirement program.

		DR	CR
Jan. 31	Employee Benefits Expense	20,000	
	Employee Medical Insurance Payable		8,000
	Employee Retirement Program Payable		12,000
	To record employee benefit costs		

P4

Vacation Benefits

Employer expenses for paid vacation by employees

Assume an employee earns $62,400 per year and earns two weeks of paid vacation each year.

$62,400	÷	52 weeks	=	$1,200
$62,400	÷	50 weeks	=	$1,248
Weekly vacation benefit				$ 48

Jan. 5	**Vacation Benefits Expense**	**48**	
	Vacation Benefits Payable		**48**
	To record weekly vacation for one employee		

P4

Bonus Plans

Many bonuses paid to employees are based on reported net income.

Assume the annual yearly bonus to the store manager is equal to 10% of the company's annual net income minus the bonus. The store earned $100,000 net income this year.

$$B = 0.10 \times (\$100{,}000 - B)$$

$$B = \$10{,}000 - 0.10B$$

$$1.10B = \$10{,}000$$

$$B = \$9{,}091 \text{ (rounded)}$$

P4

Bonus Plans

Many bonuses paid to employees are based on reported net income.

Assume the annual yearly bonus to the store manager is equal to 10% of the company's annual net income minus the bonus. The store earned $100,000 net income this year.

		DR	CR
Dec. 31	**Employee Bonus Expense**	**9,091**	
	Bonus Payable		**9,091**
	To accrue annual bonus to manager		

P4

Warranty Liabilities

Seller's obligation to replace or correct a product (or service) that fails to perform as expected within a specified period. To conform with the matching principle, the seller reports expected warranty expense in the period when revenue from the sale is reported.

A dealer sells a car for $32,000, on December 1, 2011, with a warranty for parts and labor for 12 months, or 12,000 miles. The dealership experiences an average warranty cost of 3% of the selling price of each car.

P4

Warranty Liabilities

A dealer sells a car for $32,000, on December 1, 2011, with a warranty for parts and labor for 12 months, or 12,000 miles. The dealership experiences an average warranty cost of 3% of the selling price of each car.

		DR	CR
Dec. 1	**Warranty Expense**	**960**	
	Estimated Warranty Liability		**960**
	To accrue estimated warranty expense		

On February 15, 2012, parts of $200 and labor of $250 covered under warranty were incurred.

		DR	CR
Feb. 15	**Estimated Warranty Liability**	**450**	
	Auto Parts Inventory		**200**
	Salaries Payable		**250**
	To record warranty costs		

C3

Contingent Liabilities

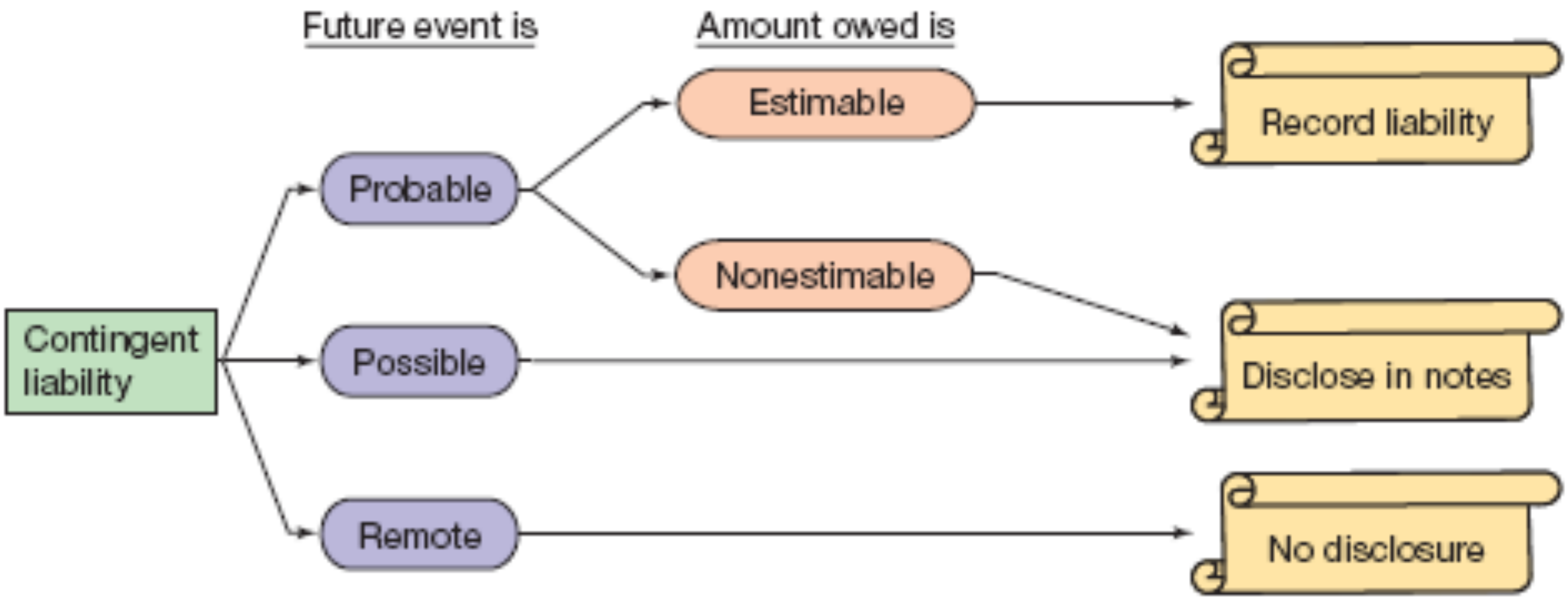
Potential obligation that depends on a future event arising out of a past transaction or event.

Probability of future sacrifice . . .

Amount . . .	Probable	Reasonably Possible	Remote
Can be Estimated	Record the contingent liability.	Disclose the liability in the notes to the financial stmts.	No action.
Cannot be Estimated	Disclose the liability in the notes to the financial stmts.	Disclose the liability in the notes to the financial stmts.	No action.

C3

Accounting for Contingent Liabilities



C3

Reasonably Possible Contingent Liabilities

Potential Legal Claims – A potential claim is recorded if the amount can be reasonably estimated and payment for damages is probable.

Debt Guarantees – The guarantor usually discloses the guarantee in its financial statement notes. If it is probable that the debtor will default, the guarantor should record and report the guarantee as a liability.

A1

Times Interest Earned

$$\text{Times interest earned} = \frac{\text{Income before interest and income taxes}}{\text{Interest expense}}$$

If income before interest and taxes varies greatly from year to year, fixed interest charges can increase the risk that an owner will not earn a positive return and be unable to pay interest charges.

End of Chapter 09