

Introduction to Accounting 2
Modul 4
Current Liabilities and Payroll Accounting

After studying this chapter, you should be able to:

1. Explain a current liability, and identify the major types of current liabilities.
2. Describe the accounting for notes payable.
3. Explain the accounting for other current liabilities.
4. Explain the financial statement presentation and analysis of current liabilities.
5. Describe the accounting and disclosure requirements for contingent liabilities\
6. Discuss the objectives of internal control for payroll.
7. Compute and record the payroll for a pay period.
8. Describe and record employer payroll taxes

ACCOUNTING FOR CURRENT LIABILITIES (STUDY OBJECTIVE 1)

A current liability is a debt with two key features:

1. Expected to be paid from existing current assets or through the creation of other current liabilities
2. Paid within one year or the operating cycle, whichever is longer.

Current liabilities include:

1. Notes payable
2. Accounts payable: arise from purchasing goods or services for use in a company's operations or for purchasing merchandise for resale.
3. Unearned revenues
4. Accrued liabilities

NOTES PAYABLE (STUDY OBJECTIVE 2)

Obligations in the form of written promissory notes are recorded as notes payable.

Those notes due for payment within one year of the balance sheet date are usually classified as current liabilities.

NOTES PAYABLE

General Journal			
Date	Account Titles	Debit	Credit
March 1	Cash	100,000	
	Notes Payable		100,000

When an interest-bearing note is issued, the assets received generally equal the face value of the note. Assume First National Bank agrees to lend \$100,000 on March 1, 2005, if Cole Williams Co. signs a \$100,000, 12%, 4-month note. Cash is debited and Notes Payable is credited.

FORMULA FOR COMPUTING INTEREST

The formula for computing interest and its application to Cole Williams Co. are shown below:

Face Value of Note	Annual Interest Rate	Time in Terms of One Year	Interest
\$100,000	x 12%	x 4/12	= \$4,000

NOTES PAYABLE

General Journal			
Date	Account Titles	Debit	Credit
June 3	Interest Expense	100,000	
	Interest Payable		100,000

Interest accrues over the life of the note and must be recorded periodically. If Cole Williams Co. prepares financial statements semiannually, an adjusting entry is required to recognize interest expense and interest payable of \$4,000 at June 30.

General Journal

Date	Account Titles	Debit	Credit
July 1	Notes Payable	100,000	
	Interest Payable	4,000	
	Cash		104,000

At maturity, Notes Payable is debited for the face value of the note, Interest Payable is debited for the amount of accrued interest, and Cash is credited for the maturity value of the note.

SALES TAXES PAYABLE (STUDY OBJECTIVE 3)

Sales tax is a stated percentage of the sales price on goods sold to customers by a retailer.

The retailer collects the tax from the customer when the sale occurs.

The retailer serves only as a collection agent for the taxing authority.

General Journal			
Date	Account Titles	Debit	Credit
March. 25	Cash	10,600	
	Sales		10,000
	Sales Tax Payable		600

Cash register readings are used to credit Sales and Sales Taxes Payable. If on March 25th cash register readings for Cooley Grocery show sales of \$10,000 and sales taxes of \$600 (sales tax rate is 6%), the entry is a debit to Cash for the total, and a credit to Sales for the actual sales and Sales Taxes Payable for the amount of the sales tax.

- When sales taxes are not rung up separately on the cash register they must be extracted from the total receipts
- If Cooley Grocery “rings up” total receipts, which are \$10,600, and the sales tax percentage is 6%, we can figure sales as follows:

$$\$10,600 \div 1.06 = \$10,000$$

UNEARNED REVENUES

- Unearned revenues (advances from customers)
 - A company receives cash before a service is rendered
- Examples:
 - Airline sells a ticket for future flights
 - Attorney receives legal fees before work is done

UNEARNED REVENUES

General Journal			
Date	Account Titles	Debit	Credit
Aug. 6	Cash	500,000	
	Unearned Football Ticket Revenue		500,000

If Superior University sells 10,000 season football tickets at \$50 each for its five-game home schedule, the entry for the sale of the tickets is a debit to Cash for the advance received, and a credit to Unearned Football Ticket Revenue, a current liability.

General Journal			
Date	Account Titles	Debit	Credit
Sept. 7	Unearned Football Ticket Revenue	100,000	
	Football Ticket Revenue		100,000

As each game is completed, the Unearned Football Ticket Revenue account is debited for 1/5 of the unearned revenue, and the earned revenue, Football Ticket Revenue is credited.

Unearned and earned revenue accounts

Shown below are specific unearned and earned revenue accounts used in selected types of businesses

Account Title

Type of Business	Unearned Revenue	Earned Revenue
Airline	Unearned Passenger Ticket Revenue	Passenger Revenue
Magazine Publisher	Unearned Subscription Revenue	Subscription Revenue
Hotel	Unearned Rental Revenue	Rental Revenue
Insurance Company	Unearned Premium Revenue	Premium Revenue

CURRENT MATURITIES OF LONG-TERM DEBT

Current maturities of long-term debt

- Classified as a current liability
- Long-term debt due within one year

FINANCIAL STATEMENT PRESENTATION (STUDY OBJECTIVE 4)

- Current liabilities
 - first category under liabilities on the balance sheet
 - each of the principal types of current liabilities is listed separately
 - seldom listed in the order of maturity
- Common methods of presenting current liabilities:
 - to list them by order of magnitude, with the largest ones first
 - many companies, as a matter of custom, show notes payable and accounts payable first regardless of amount



WORKING CAPITAL FORMULA AND COMPUTATION

The excess of current assets over current liabilities is working capital. The formula for the computation of Caterpillar, Inc. working capital is shown below.

$$\boxed{\begin{array}{c} \text{Current} \\ \text{Assets} \end{array}} - \boxed{\begin{array}{c} \text{Current} \\ \text{Liabilities} \end{array}} = \boxed{\begin{array}{c} \text{Working} \\ \text{Capital} \end{array}}$$

$$\mathbf{\$14,628 - \$11,344 = \$3,284}$$

CURRENT RATIO AND COMPUTATION

The current ratio permits us to compare the liquidity of different sized companies and of a single company at different times. The current ratio for Caterpillar, Inc. is shown below.

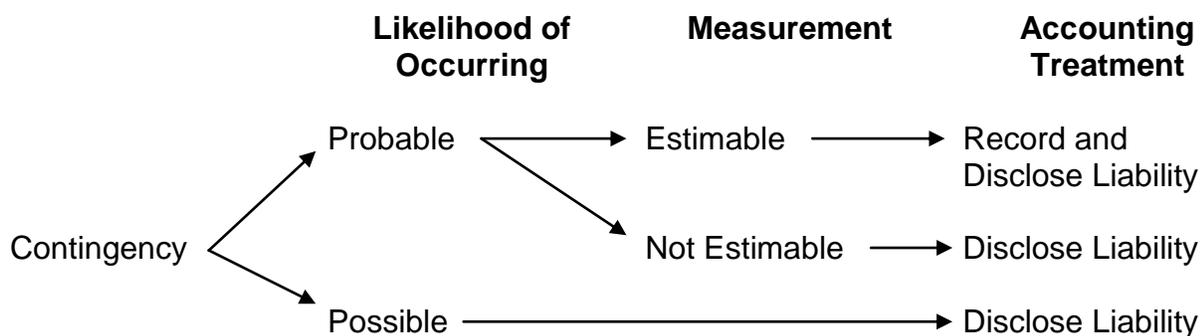
$$\boxed{\begin{array}{c} \text{Current} \\ \text{Assets} \end{array}} / \boxed{\begin{array}{c} \text{Current} \\ \text{Liabilities} \end{array}} = \boxed{\begin{array}{c} \text{Current} \\ \text{Ratio} \end{array}}$$

$$\mathbf{\$14,628 / \$11,344 = 1.29:1}$$

CONTINGENT LIABILITIES (STUDY OBJECTIVE 5)

Contingent liability: A potential liability that may become an actual liability in the future

Accounting Treatment of Contingent Liabilities



PRODUCT WARRANTIES

- Product warranties
 - Example of a contingent liability that should be recorded in the accounts
 - The estimated cost of honoring product warranty contracts should be recognized as an expense in the period in which the sale occurs.
- Warranty expense is reported under selling expenses in the income statement, and estimating warranty liability is classified as a current liability on the balance sheet.

COMPUTATION OF ESTIMATED PRODUCT WARRANTY LIABILITY

In 2005 Denson Manufacturing Company sells 10,000 washers and dryers at an average price of \$600 each. The selling price includes a one-year warranty on parts. It is expected that 500 units (5%) will be defective and that warranty repair costs will average \$80 per unit. The calculation of of estimated product costs on 2005 sales is as follows:

Number of units sold		10,000
Estimated rate of defective units	X	5%

Total estimated defective units		500
Average warranty repair cost	X	\$ 80
Estimated product warranty liability		\$ 40,000

ENTRIES TO RECORD WARRANTY COSTS

General Journal			
Date	Account Titles	Debit	Credit
Dec. 31	Warranty Expense	40,000	
	Estimated Warranty Liability		40,000

Denson Manufacturing Company makes the adjusting entry above to accrue the estimated warranty costs on 2005 sales. Warranty Expense is debited while Estimated Warranty Liability is credited for \$40,000 at December 31.

General Journal			
Date	Account Titles	Debit	Credit
Jan. 1 - Dec. 31	Estimated Warranty Liability	24,000	
	Repair Parts/Wages Payable		24,000

Denson Manufacturing Company makes the \$24,000 (300 X \$80) summary entry above to record repair costs incurred in 2005 to honor warranty contracts on 2005 sales. Estimated Warranty Liability is debited while Repair Parts and Wages Payable are credited by December 31.

General Journal			
Date	Account Titles	Debit	Credit
Jan. 31	Estimated Warranty Liability	1,600	
	Repair Parts/Wages Payable		1,600

--	--	--	--

Denson Manufacturing Company replaced defective units in January 2006 for \$1,600 (20 X \$80) and made the summary entry above. Estimated Warranty Liability is debited while Repair Parts and Wages Payable are credited.

PAYROLL ACCOUNTING (STUDY OBJECTIVE 6)

- Payroll pertains to both salaries and wages.
- Managerial, administrative, and sales personnel are generally paid salaries. Salaries are often expressed in terms of a specified amount per month or year.
- Store clerks, factory employees and manual laborers are normally paid wages based on a rate per hour.
- Payments made to professional individuals who are independent contractors are called fees.
- Government regulations relating to the payment and reporting of payroll taxes apply only to employees.

INTERNAL CONTROLS FOR PAYROLL

- The objectives of internal accounting control concerning payroll are:
 1. To safeguard company assets from unauthorized payments of payrolls and
 2. To ensure the accuracy and reliability of the accounting records pertaining to payrolls.
- Payroll activities involve four functions:
 1. Hiring employees,
 2. Timekeeping,
 3. Preparing the payroll, and
 4. Paying the payroll.

HIRING EMPLOYEES

- The human resources department is responsible for ensuring the accuracy of the personnel authorization form.
- The human resources department is also responsible for authorizing changes in employment status:
 1. Changes in pay rates

2. Termination of employment.

TIMEKEEPING

- Hourly employees are usually required to record time worked by “punching” a time clock. Times of arrival and departure are automatically recorded by the employee by inserting a time card into the clock.
- In large companies time clock procedures are often monitored by a supervisor or security guard to make sure an employee punches only one card.
- The employee’s supervisor:
 1. Approves the hours shown by signing the time card at the end of the pay period and
 2. Authorizes any overtime hours for an employee.

FILING AND REMITTING PAYROLL TAXES

- Preparation of payroll tax returns is the responsibility of the payroll department. Payment of the taxes is made by the treasurer’s department.
- FICA taxes and Federal income taxes (FIT) withheld are combined for reporting and remitting purposes.
- The taxes are reported quarterly – no later than one month after the close of each quarter.
- FUTA taxes are generally filed and remitted annually on or prior to January 31 of the subsequent year.
- SUTA taxes must be filed and paid by the end of the month following each quarter.
- The employer is required to provide each employee with a Wage and Tax Statement (Form W-2) by January 31 following the end of the calendar year.

Appendix Additional Fringe Benefits



ADDITIONAL FRINGE BENEFITS PAID ABSENCES

Employees often are given rights to receive compensation for absences when certain conditions of employment are met. Such compensation may relate to 1) paid vacations, 2) sick pay benefits, and 3) paid holidays. A liability should be accrued for paid future absences if 1) its payment is probable and 2) the amount can be reasonably estimated. Academy Company employees are entitled to one day’s vacation for each

month worked. If 30 employees earn an average of \$110 per day in a given month, the accrual for vacation benefits for January is \$3,300 ($\110×30). The liability is recognized at January 31 by the following adjusting entry:

General Journal			
Date	Account Titles	Debit	Credit
Jan. 31	Vacation Benefits Expense	3,300	
	Repair Parts/Wages Payable		3,300

When vacation benefits are paid, Vacation Benefits Payable is debited and Cash is credited. If Academy Company pays such benefits for 10 employees in July, the journal entry to record the payment is for \$1,100 ($\110×10).

General Journal			
Date	Account Titles	Debit	Credit
Jan. 31	Vacation Benefits Pay	1,100	
	Cash		1,100

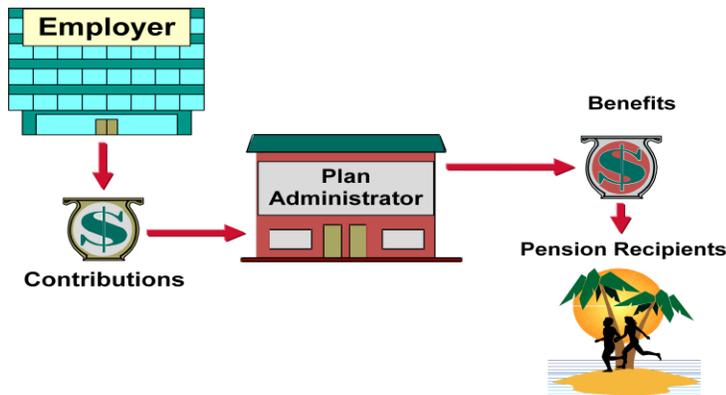
POSTRETIREMENT BENEFITS

- Postretirement benefits are benefits provided by employers to retired employees for:
 1. health care and life insurance
 2. pensions
- Both types of postretirement benefits are accounted for on the accrual basis.

PENSION PLANS

- A pension plan is an agreement whereby an employer provides benefits to employees after they retire.
- Three parties are generally involved in a pension plan.
 1. The employer sponsors the pension plan.
 2. The plan administrator receives the contributions from the employer, invests the pension assets, and makes the benefit payments.
 3. The retired employees receive the pension payments.

PARTIES IN A PENSION PLAN



REVIEW

REVIEW

1. The time period for classifying a liability as current is one year or the operating cycle, whichever is:
 - a. longer.
 - b. shorter.
 - c. probable.
 - d. Possible

2. The department that should pay the payroll is the:
 - a. Timekeeping department.
 - b. Human resources department.
 - c. Payroll department.
 - d. Treasurer's department.

3. Selected transactions of PT Tabita, completed during the fiscal year ended December 31, as follows:

Mar. 1	Purchased merchandise on account from CV Kurnia Rp20.000.000,00
Apr. 10	Issued a 60-day, 12% note for Rp20.000.000,00 to CV Kurnia on account
June 9	Paid CV Kurnia the amount owed on the note of April 10
Aug. 1	Issued Rp50.000.000,00, a 90-day note CV Hana in change for building. CV Hana discounted the note at 15%
Oct. 30	Paid CV Hana the amount due on the note of August 1

Instruction:

Journalize the preceding transactions

Reference

Weigandt, Jerry J., Donald E. Kieso, Paul D. Kimmel *Accounting Principle*, 8th Ed. New York: John Willey and Sons, Inc. (W)

Reeve, James M, Caarl S. Waren and Jonathan E. Duchac.
Principles of Accounting. Singapore: Cengage Learning Asia Pte Ltd. (R)