

ACCOUNTING 101

CHAPTER 9: CURRENT LIABILITIES

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Defining Liabilities

Liability accounts represent amounts owed to others. Although usually paid in cash, liabilities may also be satisfied by rendering services. Liabilities may only be recorded as a result of a past transaction or event. Liabilities must be a present obligation, and must require payment of assets (such as cash), or services.

Classifying Liabilities on the Balance Sheet

Liabilities classified as current liabilities are usually due within one year from the balance sheet date. Exceptions are made for companies with an operating cycle of longer than one year, such as certain construction companies, but these exceptions are rare. Liabilities classified as long-term liabilities are due after one year from the balance sheet date or the company's operating cycle, whichever is longer.

Characteristics of Liabilities

Liabilities can be described as

1. Known liabilities,
2. Estimated liabilities, or
3. Contingent liabilities.

Known liabilities

Most liabilities are known liabilities. They result from agreements, contracts, or laws, and are easily measurable. Known liabilities include the following:

- Accounts Payable
- Sales Tax Payable
- Unearned Revenues
- Notes Payable
- Payroll Liabilities

As Accounts Payable, Sales Tax Payable, and Unearned Revenues were discussed in earlier chapters, these notes will focus on accounting for notes payable and payroll liabilities.

Short-Term Notes Payable

Notes payable arise when money is borrowed or credit extended. Notes payable are usually evidenced by written documentation, and bear interest.

An example of the journal entries required when a note is issued from credit extension follows.

Example: Hatfield Company has a \$1,000 account payable to McCoy Corp. On June 15, McCoy Corp. agrees to accept \$100 cash and a \$900 note from Hatfield Company. The note will become due 60 days from June 15, and bears interest at 6%.

The entry to record the payment of \$100 and issuance of the note on Hatfield Company's books is:

June 15	Accounts Payable – McCoy Corp.	1,000	
	Cash		100
	Notes Payable – McCoy Corp.		900

The entry to record payment of the note plus interest on August 14 is:

August 14	Notes Payable – McCoy Corp.	900	
	Interest Expense		9**
	Cash		909

** $\$900 * 6\% * 60/360$

An example of the journal entries required when monies are borrowed from a bank, including a required adjusting entry for interest owed, follow.

Example: A company borrows \$10,000 from a bank on December 1, 2010. The interest rate is 9% and the note is repayable in 120 days (March 31, 2011).

The entry to record the borrowing is:

2010

Dec. 1	Cash	10,000	
	Notes Payable		10,000

The adjusting entry to record interest owed on this note at December 31, 2010 is:

2010

Dec. 31	Interest Expense	75	
	Interest Payable (\$10,000 * 9% * 30/360)		75

The entry to record payment of the note plus interest on March 31, 2011 is:

2011

March 31	Notes Payable	10,000	
	Interest Payable	75	
	Interest Expense	825**	
	Cash		10,900

**\$10,000 * 9% * 90/360

Payroll liabilities

Gross pay

Gross pay can include several types of compensation, including, but not limited to:

- Salary (same pay each pay period)
- Wages (a pay rate per hour worked)
- Overtime (paid at time and one-half the regular wage rate, for hours worked in excess of 40/week; or, in some instances, double-time for holidays/Sundays)
- Commissions, for salespersons
- Bonuses
- Tips, for waiters/waitresses or other personal service providers

Example: Mr. Evans earns \$20 per hour. He is paid weekly. During the week ended January 31, he worked 44 hours. What is his gross pay?

Answer: \$920, computed as follows:

Regular pay: 40 hours @ \$20 per hour	\$800.00
Overtime pay: 4 hours @ \$30* per hour	<u>120.00</u>
Gross pay	<u>\$920.00</u>

* The overtime pay rate was computed as: \$20 regular pay * 1.5 = \$30 per hour

Deductions

As any of us who have worked is well aware, we do not take home what we earn. This is due to payroll deductions. These deductions fall into three categories: (1) Federal and state income taxes; (2) Employee FICA (social security and Medicare) taxes; and (3) voluntary deductions, including those for savings plans, health insurance, union dues, and charitable giving. These are withheld from our paycheck by the employer. To the employer, these monies withheld from employee paychecks are classified as liabilities, as they must be paid by the employer to various governmental and other entities at a future date.

Example: Mr. Evans earned total pay of \$920.00 (see above) during the week ended January 31. His various taxes and voluntary deductions for that pay period were:

- Social Security, 6.2%
- Medicare, 1.45%
- Federal income taxes withheld, \$100.00
- Health insurance premiums, \$50.00
- Charitable contributions, \$25.00

Assuming all wages were subject to the Social Security tax, what were the total deductions from Mr. Evans' paycheck?

Answer: \$245.38, calculated as follows:

Social Security: 6.2% (or .062) * \$920.00 =	\$57.04
Medicare: 1.45% (or .0145) * \$920.00 =	13.34
Federal income taxes	100.00
Health insurance premiums	50.00
Charitable contributions	<u>25.00</u>
Total deductions	<u>\$245.38</u>

Net Pay

Net pay is simply gross pay less total deductions. This is our “take-home” pay. It is the amount on our paycheck. Remember, the employer has withheld several items from our paycheck and must remit those items to the various governmental and other entities at a later date.

Example: Mr. Evans earned \$920.00 during the pay period ended January 31, and had \$245.38 withheld from his check (see examples above). What is his net pay?

Answer: \$674.62, computed as follows:

Gross pay	\$920.00
Less total deductions	<u>245.38</u>
Net pay	<u>\$674.62</u>

Journalizing the Payroll

Now that we have computed Mr. Evans’ net pay, we must record it in the accounting records using a journal entry. For simplicity sake, let us assume (1) he is our only employee, and (2) he is paid his net pay on January 31, the end of that payroll period. Using numbers calculated in previous examples, the journal entry to record his pay would be as follows:

<u>Date</u>	<u>Description</u>	<u>Debit</u>	<u>Credit</u>
Jan. 31	Wages and Salaries Expense	924.00	
	Employee Income Tax Payable		100.00
	Social Security Tax Payable		57.04
	Medicare Tax Payable		13.34
	Health Insurance Premiums Payable		50.00
	Charitable Contributions Payable		25.00
	Cash		674.62

Note that we:

- Debited Wages and Salaries Expense for the gross pay;
- Credited liability accounts for each employee deduction; and,
- Credited Cash for the net pay.

What if Mr. Evans had been paid in February for amounts he earned through January 31? This is a common practice among many employers, and is due to the time needed to process the payroll. In this case, the above entry would still have been recorded on January 31, except that Salaries and Wages Payable would be credited for \$674.62 instead of Cash.

Payroll Taxes

The following table summarizes both employee payroll taxes and employer payroll taxes:

PAYROLL TAXES

EMPLOYEE

Social Security *

Medicare

Federal income taxes

State/local income taxes

EMPLOYER

Social Security

Medicare

Federal unemployment tax (FUTA) *

State unemployment tax (SUTA) *

* This tax has a payroll “ceiling”, or maximum, per year. The Social Security tax stops when the employee earns a certain amount in any calendar year. This amount is \$102,000 for 2009. Both FUTA and SUTA taxes stop when the employee earns \$7,000 in any calendar year.

Note that Social Security and Medicare are both employer and employee taxes. The amounts withheld from the employee pay are matched by the employer.

The FUTA and SUTA taxes are paid by the employer only.

Calculating Employer Payroll Taxes

Example: Recall that Mr. Evans earned gross pay of \$920.00 during the payroll period covering the week ended January 31. Let's assume his entire gross pay is taxable. If the FUTA tax rate is .8% (.008), and the SUTA tax rate is 5.4% (.054), what is the amount of the employer payroll taxes on his gross wages for the payroll period ended January 31?

Answer: \$127.42, calculated as follows:

Social Security: 6.2% (or .062) * \$920.00	=	\$57.04
Medicare: 1.45% (or .0145) * \$920.00	=	13.34
FUTA: .8% (or .008) * \$920.00	=	7.36
SUTA: 5.4% (or .054) * \$920.00	=	<u>49.68</u>
Total employer payroll taxes		<u>\$127.42</u>

Journalizing Employer Payroll Taxes

Example: using the data in the example above, record the employer payroll taxes for the period ending January 31. Assume Mr. Evans is the company's only employee.

Answer:

<u>Date</u>	<u>Description</u>	<u>Debit</u>	<u>Credit</u>
Jan. 31	Payroll Taxes Expense	127.42	
	FICA - Social Security Tax Payable		57.04
	FICA - Medicare Tax Payable		13.34
	FUTA Tax Payable		7.36
	SUTA Tax Payable		49.68

When these taxes are paid to the respective governmental agencies, the payments will be recorded by debiting the "Payable" accounts and crediting the "Cash" account.

Multi-Period Known Liabilities

The repayment period for certain liabilities, such as car loans and mortgages, require monthly payments that extend beyond one year. In this case, the principal amount due on the debt in the following year is classified as a current liability on the balance sheet. The principal due after one year is classified as a long-term liability on the balance sheet.

Estimated Liabilities

GAAP requires expenses to be recorded when incurred, not paid. Sometimes, the amount of liability to record must be estimated.

As an example, when an auto manufacturer sells a new car, the revenue from the sale is recorded in the period the car was sold. When that car was sold, the manufacturer assumed a liability to fix any defects in the warranty period. It is impossible for the auto manufacturer to know the exact amount of future repairs under warranty. However, GAAP requires the auto manufacturer to estimate future repairs and record that estimate as a liability in the same period the car was sold. This complies with the matching principle.

Other examples of estimated liabilities are:

- Vacation Benefits
- Bonus Plans
- Health and Pension Benefits

Contingent Liabilities

A contingent liability is a potential liability that depends on a future event arising from a past transaction or event. Examples of contingent liabilities are lawsuits and government investigations. The accounting for contingent liabilities depends on the likelihood that a future event, such as losing a lawsuit, will occur. Such likelihoods and the related accounting are summarized below.

Likelihood

Accounting Treatment

The future event is probable and the amount owed can be reasonably estimated.	A liability should be recorded for the amount of loss estimated. The details of the loss should be disclosed in the notes to the financial statements.
The future event is reasonably possible. Or, the future event is probable but the amount of loss cannot be reasonably estimated.	Information about the contingent liability should be disclosed in the notes to the financial statements.
The future event is remote.	Do nothing.