chapter 9

accounting for Current Liabilities

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| Chapter Outline | |
| **I. Known Liabilities**—Set by agreements, contracts, or laws and are  measurable (also called *definitely determinable liabilities)*.  A.Characteristics of Liabilities | |
| 1. Defining Liabilities Probable future payments of assets or services that a company is presently obligated to make as a result of past transactions or events. Note three factors: | |
| a. Due to past transaction or event  b. Present obligation  c. Future payment of assets or services | |
| 2. Classifying Liabilities | |
| a. Current liabilities (*short-term liabilities*)—Liabilities due within one year (or the company’s operating cycle if longer). Expected to be paid using current assets or by creating other current liabilities.  b. Long‑term liabilities—Liabilities due after one year (or the company’s operating cycle if longer). | |
| 3. Uncertainty in Liabilities—requires answering three important questions that are sometime uncertain at the time liability is incurred: | |
| a. Whom to pay? (Ex. A note “Payable to Bearer”)  b. When to pay? (Ex. Unearned revenues—may not know when service will be provided to satisfy)  c. How much to pay? (Ex. Accrued expense that needed to be estimated prior to receipt of bill) | |
| Examples of known liabilities in the *current* classification include: | |
| B. Accounts Payable Amounts owed to suppliers (also called vendors) for products or services purchased with credit.  C. Sales Taxes Payable Amounts the retailer (seller) collects as sales taxes from customers when sales occur, and currently owes to the government until remitted.  D. Unearned Revenues— also known as *deferred revenues*. Amounts received in advance from customers for future products or services.  When cash is received: (*Dr* Cash, *Cr* Unearned Revenue).  When earned: (*Dr* Unearned Revenue, *Cr* Revenue). | |
| E. Short-Term Notes Payable Written promise to pay a specified amount on a definite future date within one year. Can arise from many transactions; two common examples: | |
| 1. Note Given to Extend Credit Period—creditor requires an interest-bearing note for an overdue account payable that does not bear interest. (*Dr* Accounts Payable, *Cr* Notes Payable) | |
| 2. Note Given to Borrow from Bank—face value equals amount borrowed (*principal*) and at maturity a larger amount is repaid. The difference between amount borrowed and repaid is the *interest*. The note is recorded at and reported at face value.  ( *Dr* Cash, *Cr* Notes Payable) In both examples above, interest is recorded as incurred. This may be when paid with note or as end-of -period accrued interest adjustment.  (*Dr* Interest Expense and Note Payable, *Cr* Cash)  3. When Note Extends over Two Periods— (*Dr* Interest Expense and *Cr* Interest Payable) if accrued interest is being recorded at end-of-period adjustment. | |
| **II. Payroll Liabilities**—arise from salaries and wages, employee benefits, and payroll taxes levied on the employer.  A**.** Employee Payroll and Deductions—amounts withheld from an employee’s gross pay, either involuntary or voluntary; also called *withholdings.* Each is recorded as a separate *liability* (*Cr*). | |
| * Gross pay—total compensation an employee earns, including wages, salaries, commissions, and bonuses. Gross pay amount is recorded as Salaries *Expense (Dr)*. * Net pay—gross pay minus all deductions; also called *take-home pay*. Net pay is recorded as Salaries *Payable* (*Cr*)*.*   1. Employee FICA Taxes—FICA (Federal Insurance Contributions Act) taxes can be separated into two groups: Social Security and Medicare taxes. FICA tax is computed as current rate multiplied by gross wages *subject to tax.* For year 2020,Social Security tax is 6.2% of the *first* $137,700 earned by the employee in the calendar year and Medicare tax is 1.45% of *all* wages earned by the employee. *A* *0.9% additional Medicare tax* is imposed on the employee for pay in excess of $200,000 – this additional tax is not imposed on the employer. | |
| 2. Employee Income Tax is determined from chart based on their gross pay, pay period, marital status and number of withholding allowances the employee claims. | |
| 3. Employee Voluntary Deductions (charitable contributions, health insurance premiums, ***union*** dues) result in various payables. **Note: *All* the payroll components, gross pay, each deduction, and net pay, are recorded in one journal entry.**  4. Employee Payroll Recording | |
| B. Employer Payroll Taxes—payroll taxes in addition to those required of employees. These taxes result in expenses (*Dr*) and current liabilities (*Cr*). | |
| 1. Employer FICA Tax—employers must pay an amount equal to employee contribution. The taxes are credited to the same FICA taxes payable account used to record the amounts withheld from the employees.  2. Employer Unemployment Taxes—(state and federal) current tax rate multiplied by wages subject to tax. The total rate is up to 6.0% of the first $7,000 earned by each employee (the dollar level varies by state). The federal rate can be reduced by a credit of up to 5.4% for taxes paid to a state program—as a result a net FUTA rate is often only 0.6%.  3. Recording Employer Payroll Taxes—additional expense beyond Wages and Salaries Expense. Debit Payroll Tax Expense for the Total and Credit the individual liability accounts for the individual taxes.  C. Internal Control of Payroll—Four key areas of payroll activities that should be separate and monitored include:  1. Employee hiring  2. Payroll preparation  3. Timekeeping  4. Payroll payment | |
| D.Multi-Period Known Liabilities—known liabilities that extend over many periods; for example, Unearned Revenues and Notes Payable. Classification is based upon the period in which they will be satisfied. | |
| 1.Current liability—portion that will be due in the next year.  2.Long-term liability—portion that will be due after the next year. | |
| 1. **Estimated Liabilities—**Known obligations of uncertain amounts that can be reasonably estimated. Recorded as expenses (*Dr*) and payables (*Cr*). Examples include: | |
| A. Health and Pension Benefits—benefits provided by a business, including benefits such as medical, dental, life. and disability insurance. Appropriate proportion accrued at time of each payroll.  B. Vacation Benefits—also called *paid absences*. These are estimated and recorded by the employer in the period when employees earn them. Appropriate proportion accrued at time of each payroll. | |
| C.Bonus Plans—employee bonuses must be estimated and recorded in year-end adjusting entries. | |
| D. Warranty Liabilities—seller’s obligation to replace or fix a product or service that fails to perform as expected within a specified period. Reported to comply with the *full disclosure* and *matching principles.* Seller reports the expected warranty expense *(Dr)* and liability (*Cr*) in the period when revenue from the sales of the product is reported. When warranty liabilities are settled the liability is removed and the asset used (Ex. Parts Inventory) is reduced.  E. Multi-Period Estimated Liabilities—can be current or long-term and must be classified based upon when they will be satisfied. | |
| **IV. Contingent Liabilities**—a contingent liability is a potential liability that depends on a future event arising from a past transaction. | |
| A. Accounting for Contingent Liabilities—depends on likelihood that a future event will occur and the ability to estimate the future amount. (Accounting motivated by *full-disclosure principle.)* Three categories and appropriate accounting for each: | |
| 1*. Record liability:* future event is probably (likely), record with a journal entry if amount can be reasonably estimated; if cannot be estimated, disclose in footnotes to financial statements.  2*. Disclose in notes:* reasonably possibly (could occur)—disclose in financial statement notes  3. *No disclosure:* future event is remote (unlikely)—omit(do not record or footnote). | |
| B. Applying Rules of Contingent Liabilities  Examples: | |
| 1. Potential Legal Claims**—**recorded in the accounts only if payment for damages is probable *and* the amount can be reasonably estimated. If can’t be reasonably estimated or less than probable but *reasonably possible*, disclose in notes.  2. Debt Guarantees (of a debt owed by another company)**—**require disclosure in financial statement notes if potential liabilities are *reasonably possible*. | |
| 3. Other Contingencies (e.g., environmental damages, possible  tax assessments, insurance losses, and government  investigations)—usually disclosed in as a contingent liability.  C. Uncertainties That Are Not Contingencies—include natural disasters and new technologies. These are not contingent liabilities because they are future events *not* arising from past transactions. | |
| **V. Decision Analysis—Times Interest Earned Ratio**   1. Interest expense is often viewed as a *fixed expense*, which can be advantageous when a company is growing, but can create risk because the company might be unable to pay fixed expenses if sales decline. 2. One “measure of ability to pay” is the **times interest earned** ratio which is used to describe the risk of covering interest commitments when income varies.   C. Ratio is calculated as income before interest expense and income taxes divided by interest expense.  **VI. Payroll Reports, Records, and Procedures (Appendix 9A)** | |
| A.Payroll Reports**—**employers are required to prepare and submit the following reports: |
| 1. Employer’s Quarterly Federal Tax Return (IRS Form 941) Filed within one month after the end of each calendar quarter to report FICA and income withholding taxes owed and remitted.  2. Annual Federal Unemployment Tax Return (IRS Form 940) Reports employer’s FUTA taxes on an annual basis. Must be mailed on or before January 31 following the end of each tax year to report an employer’s FUTA taxes. |
| 3. Wage and Tax Statement (Form W‑2) Must be mailed on or before January 31 following the year covered by the report; employers must give each employee an annual report of the employee’s wages subject to FICA and federal income taxes and the amounts of these taxes withheld. |
| B. Payroll Records—employers are required to keep payroll records in addition to reporting and paying taxes. |
| 1. Payroll Register A record for a pay period that shows the pay period dates and the hours worked, gross pay, deductions, and net pay of each employee; contains all the data needed to record payroll (for each pay period) in the General Journal.  2. Payroll Check Generally accompanied with a detachable *statement of earnings* showing gross pay, deductions, and net pay.  3. Employee Earnings Report A cumulative record of an employee’s hours worked, gross pay, deductions, net pay, and certain personal information about the employee; contains the data the employer needs to prepare a Form W‑2. |
| C. Payroll Procedures |
| 1. Computing Federal Income Taxes Computed using a wage bracket withholding *table* based on gross pay, number of personal exemptions, the employee’s tax status, and pay period. |
| a. Withholding allowance—a number that is used to reduce the amount of federal income tax withheld from an employee's pay, and which corresponds to the personal exemptions the employee is allowed to subtract from annual earnings in calculating taxable income.  b. Form W-4—withholding allowance certificate form. Filed by employee with employer to identify personal exemptions claimed. |
| 2. Payroll Bank Account A separate payroll bank account used in a company with many employees. |
| a. One check for total payroll is drawn on the regular bank account or an *electronic funds transfer* for this amount is executed to provide deposit for the payroll bank account.  b. Individual payroll checks are drawn on payroll account.  c. Helps with internal control and reconciling the regular bank account.  3. Who Pays What Payroll Taxes and Benefits |
| **VII. Corporate Income Taxes (Appendix 9B)**  A. Income Tax Liabilities | |
| 1. Income Tax Liabilities:corporations (not sole proprietorships or partnerships) are subject to income taxes and must estimate their income tax liability when preparing financial statements. 2. Adjusting entry: *Dr* Income Taxes Expense, *Cr* Income Taxes Payable. Quarterly payments remove (*Dr*) the liability, and credit Cash.   3. Deferred Income Tax Liabilities Arise from temporary differences between GAAP and income tax rules. This results in temporary differences between the tax return and the income statement. This difference results in a deferred income tax liability. Adjusting entry: *Dr* Income Taxes Expense, *Cr* Deferred Income Tax Liability.  4. Payment of Income Taxes  When the tax liability is recorded, *Dr* Income Taxes Payable (to reduce it) and *Cr* Cash. |