Current Liabilities and Payroll Accounting

Chapter 11

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Fundamental Accounting Principles

3rd Edition

Chapter 11 Learning Objectives

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

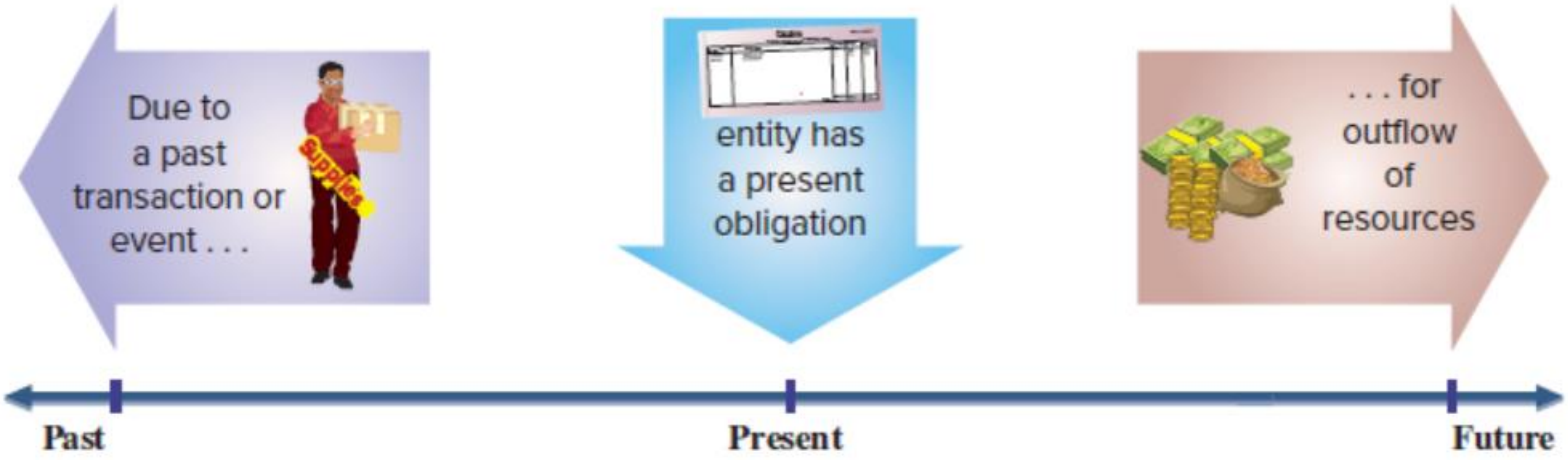
PROCEDURAL
P1 Prepare entries to account for short-term notes payable.
P2 Compute and record *employee* payroll deductions and liabilities.
P3 Compute and record *employer* payroll expenses and liabilities.
P4 Account for estimated liabilities, including warranties and bonuses.

Learning Objective C1

Describe current and long-term liabilities and their characteristics.

Defining Liabilities

Exhibit 11.1



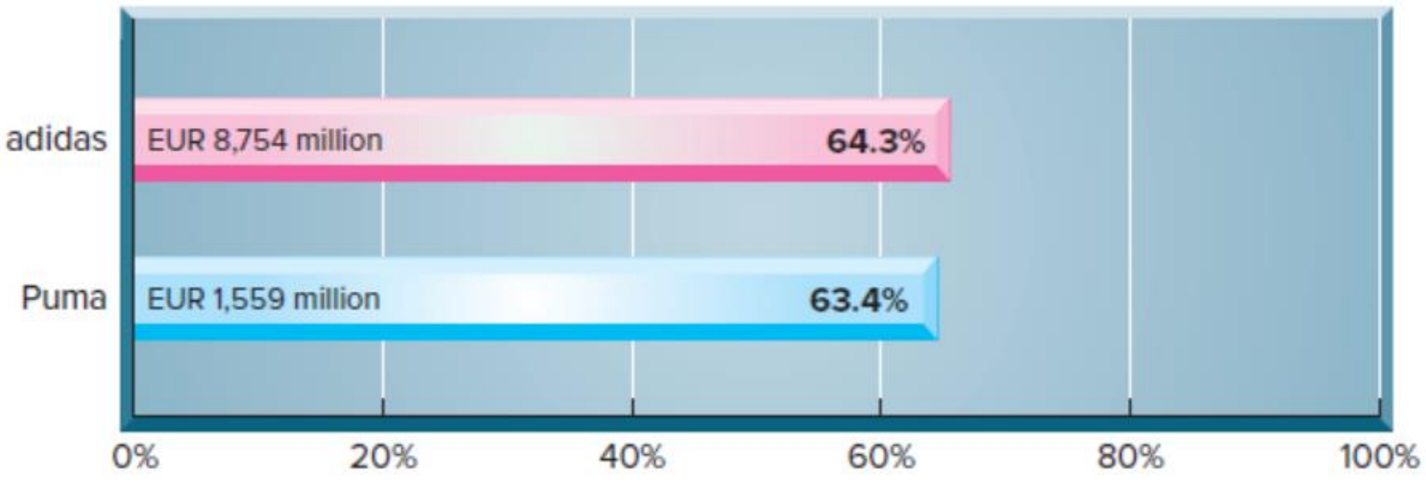
Classifying Liabilities

Current Liabilities	Long-Term Liabilities
Due within one year or the company's operating cycle if longer.	Due after one year or the company's operating cycle if longer.

Current and Long-Term Liabilities

Exhibit 11.2

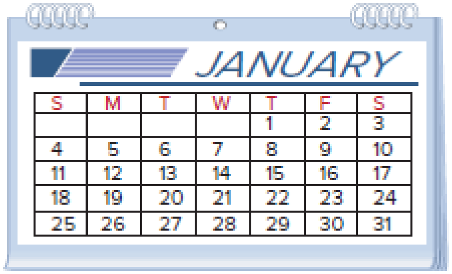
- Current liabilities are due within one year or the company's operating cycle if longer.
- Long-term liabilities are due after one year or the company's operating cycle if longer.



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

Uncertainty In Liabilities

Uncertainty in Whom to Pay



Uncertainty in When to Pay

Uncertainty in How Much to Pay

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

Learning Objective C2

Identify and describe known current liabilities.

Known Liabilities

Accounts Payable

Sales Taxes Payable

Unearned Revenues

Short-Term Notes Payable

Payroll Liabilities

Multi-Period Known Liabilities

Learning Objective C2: Identify and describe known current liabilities.

Sales Taxes Payable

On August 31, Harvey Norman sold goods for $6,000 that are subject to a 10% GST (Goods and Service Tax).

Aug. 31	Cash	6,600	
	Sales		6,000
	GST Payable ($6,000 × 0.10)		600
	*Record cash sales and 10% GST.**		
	*We also Dr. Cost of Sales and Cr. Inventory for cost of sales under perpetual inventory system.		

Unearned Revenues

On June 30, Selena Gomez sells $5,000,000 in tickets for eight concerts.

June 30	Cash	5,000,000	
	Unearned Ticket Revenue		5,000,000
	Record sale of tickets for eight concerts.		

On Oct. 31, Selena performs a concert.

Oct. 31	Unearned Ticket Revenue	625,000	
	Ticket Revenue		625,000
	Record concert revenues earned ($5,000,000 × 1/8).		

$5,000,000 × 1/8 = $625,000

Learning Objective C2: Identify and describe known current liabilities.

Discussion Question

Q: What is the difference between a current and a long-term liability?

Discussion Question

Q: What is the difference between a current and a long-term liability?

A current liability is expected to be paid within one year or the company's operating cycle, whichever is longer. Any liability that is not current is considered to be long-term.

Learning Objective P1

Prepare entries to account for short-term notes payable.

Short-Term Notes Payable

- A written promise to pay a specified amount on a stated future date within one year.
- Most notes bear interest.

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

Note Given to Extend Credit Period: Date of Replacement

On August 23, Brady Company asks McGraw to accept $100 cash and a 60-day, 12% $500 note to replace its existing $600 Account Payable.

Aug. 23	Accounts Payable—McGraw	600	
	Cash		100
	Notes Payable—McGraw		500
	Send cash and a note for payment on account.		

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

Note Given to Extend Credit Period: Date of Payment

On October 22, Brady pays the note plus interest to McGraw.

Oct. 22	Notes Payable—McGraw	500	
	Interest Expense	10	
	Cash		510
	Pay note with interest ($500 × 12% × 60/360).		

Interest expense = $500 × 12% × (60 ÷ 360) = $10

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

Note Given To Borrow From Bank

Company borrows $2,000 from a bank at 12% annual interest.
The loan is made on September 30, 2021, and is due in 60 days.

Sep. 30	Cash	2,000	
	Notes Payable		2,000
	Borrow $2,000 cash with a 60-day, 12%, $2,000 note.		

Nov. 29	Notes Payable	2,000	
	Interest Expense	40	
	Cash		2,040
	Pay note with interest ($2,000 × 12% × 60/360).		

Interest expense = $2,000 × 12% × (60 ÷ 360) = $40

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

When Note Extends over Two Periods

Note Date

End of Period

Maturity Date

An adjusting entry is required to record Interest Expense incurred to date.

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

End-of-Period Adjustment to Notes

Assume a company borrows $2,000 cash on December 16, 2021, at 12% annual interest. This 60-day note matures on February 14, 2022, and the company's fiscal year ends on December 31. This means 15 of the 60 days are in 2021 and 45 of the 60 days are in 2022.

Dec. 31, 2021	Interest Expense	10	
	Interest Payable		10
	Record accrued interest ($2,000 × 12% × 15/360).		

Feb. 14, 2022	Interest Expense*	30	
	Interest Payable	10	
	Notes Payable	2,000	
	Cash		2,040
	*Pay note with interest. *$2,000 × 12% × 45/360*		

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

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

Required:

1. On what date does this note mature?

2. How much interest expense results from this note in the current year? (Assume a 360-day year.)

3. How much interest expense results from this note in the next year? (Assume a 360-day year.)

4. Prepare journal entries to record (a) issuance of the note (b) accrual of interest at the end of the current year, and (c) payment of the note at maturity.

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

1. On what date does this note mature?

Maturity date = November 1 + 90 days = January 30 (next year)

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

2. How much interest expense results from this note in the current year? (Assume a 360-day year.)

Principal	$150,000
x Interest rate..	9%
x Fraction of year (Nov. 1 – Dec. 31)	60/360
Total interest current year....................	$ 2,250

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

3. How much interest expense results from this note in the next year? (Assume a 360-day year.)

Principal	$150,000
x Interest rate..	9%
x Fraction of year (Jan. 1 – Jan. 30)	30/360
Total interest next year.........................	$ 1,125

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

4a. Prepare journal entries to records issuance of the note.

Nov. 1	Cash	150,000	
	Notes Payable		150,000

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

4b. Prepare journal entries to records accrual of interest at the end of the current year.

Dec. 31	Interest Expense	2,250	
	Interest Payable		2,250

E 11-5

Kwon Co. borrows $150,000 cash on November 1 of the current year, by signing a 90-day, 9% note with a face value of $150,000.

4c. Prepare journal entries to record payment of the note at maturity.

Jan. 30	Interest Expense	1,125	
	Interest Payable	2,250	
	Notes Payable	150,000	
	Cash		153,375

Learning Objective P3

Compute and record *employer* payroll expenses and liabilities.

Multi-Period Known Liabilities

Includes 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 would be classified as a current liability for one year and a long-term liability for two years.

Learning Objective C2: Identify and describe known current liabilities.

Internal Control of Payroll

Exhibit 11.2

Employee Hiring

Duty: Authorize, hire, and fire.
Aim: Keep fake workers off payroll.

Payroll Preparation

Duty: Verify tax rates and payroll amounts.
Aim: Rates updated and amounts accurate.

Timekeeping

Duty: Track and verify time worked.
Aim: Paid for time worked only.

Payroll Payment

Duty: Sign and issue prenumbered checks.
Aim: Checks valid, secured, and correct.

Learning Objective P3: Compute and record *employer* payroll expenses and liabilities.

Learning Objective P4

Account for estimated liabilities, including warranties and bonuses.

Estimated Liabilities

- An estimated liability is a known obligation of an uncertain amount that can be reasonably estimated.
- Examples: vacation pay, warranties

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

Vacation Benefits

Assume an employee earns two weeks of paid vacation each year.

Dec. 31	Vacation Benefits Expense	3,200	
	Vacation Benefits Payable		3,200
	Record vacation benefits accrued.		

When employee takes vacation, following journal entry is recorded:

	Vacation Benefits Payable	400	
	Cash		400
	Record vacation benefits taken.		

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

Bonus Plans

Assume that a bonus of $10,000 will be paid to employees to be shared by all:

Dec. 31	Employee Bonus Expense	10,000	
	Bonus Payable		10,000
	Record expected bonus costs.		

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

Warranty Liabilities: Definition

- Seller's obligation to replace or fix a product (or service) that fails to perform as expected within a specified period.
- Seller reports expected warranty expense in the period when revenue from the sale is reported.
- Seller reports warranty as a liability.

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

Warranty Liabilities: Journal Entries

On Dec. 1, 2021, a dealer sells a car for $16,000 with a maximum one-year or 12,000 mile warranty covering parts. Past experience indicates warranty expenses average 4% of a car's selling price.

Dec. 1	Warranty Expense	640	
	Warranty Provision		640
	Record estimated warranty expense.		

On Jan. 9, 2022, the customer returns the car for repairs. The dealer replaces parts costing $200.

Jan. 9	Warranty Provision	200	
	Auto Parts Inventory		200
	Record costs of warranty repairs.		

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

Discussion Question

Q: Why are warranty provisions usually recognized on the balance sheet as liabilities even when they are uncertain?

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Q: Why are warranty provisions usually recognized on the balance sheet as liabilities even when they are uncertain?

The obligation to correct or replace defective products (or services) is created when the products are sold with the warranties. Even though the seller does not know with certainty when the obligation will be paid, to whom it will be paid, or the amount to be paid, past experience shows that some amount will probably be paid. If the seller can reliably estimate that amount, the warranty liability must be reported on balance sheet.

Learning Objective C3

Explain how to account for contingent liabilities.

Accounting for Contingent Liabilities

A **contingent liability** is a potential obligation that depends on a future event arising from a past transaction or event. An example is a pending lawsuit.

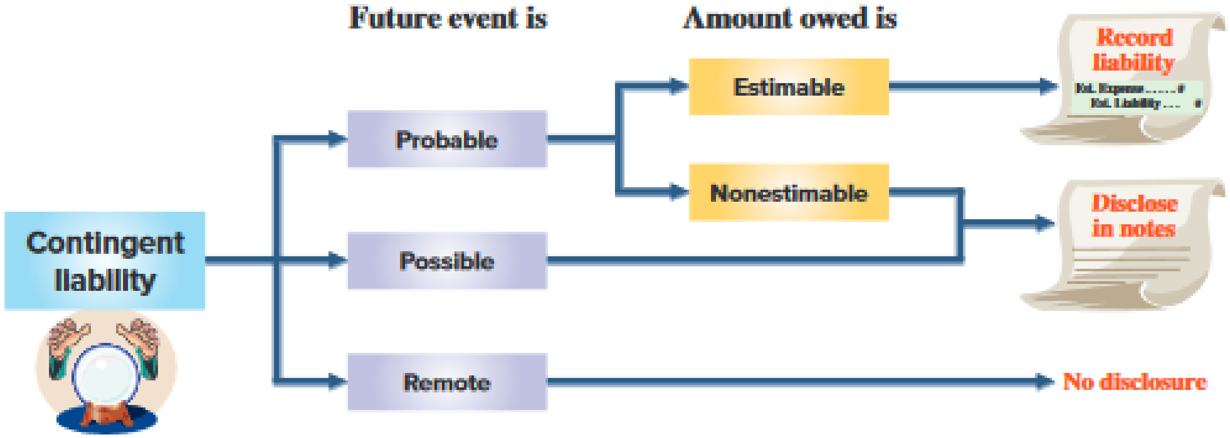

Exhibit 11.4

Learning Objective C3: Explain how to account for contingent liabilities.

Probable and Possible Contingent Liabilities

Potential Legal Claims – A potential claim is recorded if the amount can be reasonably estimated and payment for damages is probable. If a legal claim or lawsuit cannot be reliably estimated or is less than probable but possible, then it is disclosed in notes.

Loss from Lawsuit	10,000,000	
Lawsuit Provision		10,000,000
Record probable loss from lawsuit		

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

Learning Objective C3: Explain how to account for contingent liabilities.

Remote Contingencies Liabilities and Uncertainties

Remote Contingent Liabilities – Disclosure not required but company may voluntarily disclose to provide transparency.

Uncertainties – Uncertainties from future events are not contingent liabilities because they are future events and do not arise from past transactions. These are not disclosed.

Learning Objective C3: Explain how to account for contingent liabilities.

Discussion Question

Q: What are the three important questions concerning the uncertainty of liabilities?

Discussion Question

Q: What are the three important questions concerning the uncertainty of liabilities?

The three questions are: (1) Who must be paid? (2) When is payment due? (3) How much is to be paid?

E 11-7

Chang Co. sold a copier costing $3,800 with a two-year parts warranty to a customer on August 16, Year 1, for $5,500 cash. Chang uses the perpetual inventory system. On November 22, Year 2, the copier requires on-site repairs that are completed the same day. The repairs cost $199 for materials taken from the Repair Parts Inventory. These are the only repairs required in Year 2 for this copier. Based on experience, Chang expects to incur warranty costs equal to 4% of the dollar sales. It records warranty expense with an adjusting entry at the end of each year.

Required:

1. How much warranty expense does the company report in Year 1 for this copier?
2. How much is the warranty provision for the copier as at December 31, Year 1?
3. How much warranty expense does the company report in Year 2 for this copier?
4. How much is the warranty provision for the copier as at December 31, Year2?
5. Prepare journal entries to record (a) the copier's sale; (b) the adjustment on December 31, Year1, to recognize the warranty expense; and (c) the repairs that occur in November Year 2.

E 11-7

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5a. Prepare journal entries to record the copier's sale.

Year 1

Aug. 16	Cash	5,500	
	Sales		5,500

	Cost of Goods Sold	3,800	
	Merchandise Inventory		3,800

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1. How much warranty expense does the company report in Year 1 for this copier?

Warranty Expense = 4% of dollar sales = 4% x $5,500 = $220

E 11-7

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5b. Prepare journal entries to record the adjustment on December 31, Year1, to recognize the warranty expense.

Year 1

Dec. 31	Warranty Expense	220	
	Warranty Provision		220

E 11-7

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2. How much is the warranty provision for the copier as at December 31, Year 1?

Year 1's balance of the liability equals the expense because no repairs are provided. Therefore, the ending balance of the Warranty Provision account is $220.

E 11-7

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3. How much warranty expense does the company report in Year 2 for this copier?

The company should report no additional warranty expense in Year 2 for this copier.

E 11-7

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5c. Prepare journal entries to record the repairs that occur in November Year 2.

Year 2

Nov. 22	Warranty Provision	199	
	Repair Parts Inventory		199

E 11-7

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4. How much is the warranty provision for the copier as at December 31, Year2?

The December 31, Year 2, balance of the Warranty Provision account equals the Year 2's beginning balance minus the costs incurred in Year 2 to repair the copier:

Beginning balance	$220
Less parts cost	(199)
Ending balance	$ 21

End of Chapter 11