Chapter 7

Current Liabilities

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Learning Objectives

- Describe the classification framework and typical examples of current liabilities.
- Describe the accounting for accounts and notes payable and other typical current liabilities.
- Understand the nature of accruals, deposits, estimates, contingencies, and similar obligations.
- Prepare the current liability section of a balance sheet.
- Understand and apply important concepts in corporate financing.
- Discuss the basic principles and duties related to proper accounting for a business payroll.
- Interpret amounts reported in financial statements that pertain to employee benefits.

Chapter Outline

Introduction

Current liabilities are obligations that must be settled within 1 year or the operating cycle, whichever is longer. Current liabilities are usually satisfied by transferring a current asset. Accounts payable, salaries payable, utilities payable, taxes payable, and short-term loans are all examples of such current liabilities. Also included are amounts related to collections for others, accrued liabilities, warranty obligations, unearned revenue, and the current portion of long-term debt. The formal definition of a current liability is sufficiently broad to capture each of these amounts. In addition, current liabilities include amounts that will be satisfied by the creation of another liability or provision of a service. For example, unearned revenue is reported as a current liability. It is transferred to revenue at the time when goods or services are delivered to the customer.

It may be helpful to review the concept of an operating cycle. The operating cycle is the length of time it takes to turn credit back into cash. For instance, a business may buy inventory, sell the inventory in exchange for a receivable, and eventually collect the receivable. The typical time period during which cash is tied up in the inventory and receivables is the operating cycle. A typical operating cycle might span 45 to 180 days but can be much longer or shorter depending on the business. A fast-food restaurant may have an operating cycle of a mere few days, whereas a winery's cycle might span years. In a hospital environment, certain types of medical supplies may be used daily, while others could stay in inventory for months. The diverse nature of operating cycles explains why the definition of "current" is related to the longer of the operating cycles or 1 year.

7.1 Accounts and Notes Payable

Let's turn our attention to a closer look as some specific types of current liabilities. **Accounts payable** are amounts due to suppliers for the purchase of medical supplies and services. Such payables may be based on very informal credit terms, but those terms usually stipulate the expected date of payment. For credit terms, 30 to 60 days is a common time length. Accounts payable incurred in the normal course of business ordinarily do not incur interest charges, although you might find exceptions, especially for delinquent accounts. Accounts payable are almost always shown as current liabilities on the balance sheet.

When a formal written instrument (agreement) shows purchases on credit, the resulting payable may be reported as a **note payable**. Specifically, a note payable is a written promise to pay and will ordinarily incur interest over the duration of its outstanding period. Such notes arise not only with purchases of medical supplies and services on account but also from bank loans, equipment purchases, and simple cash loans. The party who owes is referred to as the maker of the note. This person's signature on the instrument represents a formal promise to pay the amount of the note, along with any agreed interest levies. If constructed properly, the note can actually become a negotiable instrument, allowing its holder (owner) to sell the collection rights to another person. The written note instrument can be as simple as Exhibit 7.1. A full legal form would typically include specific information about remedies upon default, place of payment, requirements of demand and notice, and so forth.

Exhibit 7.1: An example of a promissory note

FOR VALUE RECEIVED, the undersigned promises to pay to the order of

Harris Medical Equipment

the sum of:

*Five Thousand and no/100 Dollars******* ($5,000)*

with annual interest of 6% on any unpaid balance. This note shall mature and be payable, along with accrued interest, on:

December 31, 20X7

July 1, 20X7
Issue date

Kaplan Medical
Maker Signature

A closer inspection of the note in Exhibit 7.1 reveals that Kaplan Medical has agreed to pay Harris Medical Equipment $5,150 on December 31, 20X7. The principal amount of the note is $5,000 and the interest is $150. Interest is calculated by multiplying the $5,000 by the interest rate of 6% and time outstanding of one half of a year: $5,000 × 6% × (1 ÷ 2) = $150. The interest calculation formula is often simply expressed as

Principal × Rate ÷ Time.

Assuming the note originated with a cash loan, Kaplan Medical would initially record the borrowing transaction by increasing Cash (debit) and Notes Payable (credit). Had the

transaction originated by Kaplan Medical buying inventory from Harris Medical Equipment, the debit would reflect Inventory (instead of Cash). At repayment, Cash is credited, Notes Payable is debited, and the difference is booked as Interest Expense. The following journal entries reveal this approach:

7-1-X7	Cash	5,000.00	
	Note payable		5,000.00
	To record cash borrowed via a formal note payable bearing interest at 6% per annum		
12-31-X7	Interest expense	150.00	
	Note payable	5,000.00	
	Cash		5,150.00
	To record payment of note and interest		

Notes occasionally have terms that extend beyond 1 year; these notes may be shown as long-term, rather than current, liabilities. The notes may also have amounts due that span several time periods. This feature can require the accountant to split the note's presentation into two balance sheet amounts reflecting both the current and noncurrent portions.

On a Balance Sheet, the interest and principle due in the next 12 months would be shown in the Current Liabilities section in a line item called "Current Liability on Long-Term Notes Payable." The Note Payable due beyond 12 months would be shown in the Long-Term Liabilities section.

Accruals

The interest on a note is said to accrue. This means that it accumulates gradually with the passage of time. On any given balance sheet date, a company would need to calculate the total amount of its accrued obligations and report them in the current liability section. These amounts are called accrued liabilities (also, accrued expenses). For instance, if the 6-month note previously illustrated had originally been issued on October 1, rather than July 1, then $75 of interest would have accrued by December 31. The company would need to prepare the following adjusting journal entry on December 31, and the accumulated interest would appear within the current liability section of the balance sheet:

12-31-X7	Interest expense	75.00	
	Interest payable		75.00
	To record accrued interest for 3 months: $5,000 × 6% × (3/12 months)		

This calculation is based on the assumption that the note's interest is calculated on an annual basis, so we use 3 months/12 months to calculate the interest. Sometimes you will find that note is stated in days rather than years. If that were the case, you would then use the number of days for which interest is due divided by the total number of days in the year.

Interest is not the only type of obligation that is said to accrue. Salaries, wages, taxes, and utilities are typical expenses that must be accrued at the end of an accounting period. For instance, consider the following example of an entry that is used to accrue salaries:

12-31-X6	Salaries expense	15,000.00	
	Salaries payable		15,000.00
	To record accrued salaries at end of period		

The accounting department within an organization must be very cautious to correctly identify all such accruals; otherwise, liabilities will be understated and income overstated.

Prepayments, Deposits, and Collections for Others

A patient sometimes makes an advance payment or deposit on a future procedure, such as a prepayment to speed up admission prior to the birth of a baby. Or a medical equipment supply company may require a deposit for customized equipment.

You have probably purchased an airline ticket, a ticket to a concert or sporting event, or a magazine subscription. Ordinarily, the seller collects the sales price well in advance of delivery of the promised goods and services. When this occurs, the seller cannot recognize revenue at the time of collection. Remember that revenue is only recognized when earned; the mere collection of the sales price is not sufficient. Therefore, the initial entry is for the seller to debit Cash and credit Unearned Revenue.

The Unearned Revenue is reported as a current liability until such time as the goods or services are delivered, whereupon the seller will debit Unearned Revenue and credit Revenue. If you are examining financial statements, you will often identify a significant amount related to unearned revenue (often called deferred revenue). So long as you reasonably expect this revenue to be earned by delivery of future goods and services, you can take some comfort that the business's liability actually corresponds to a future revenue amount.

Medical equipment suppliers, home builders, car dealers, and retailers sometimes collect deposits toward future transactions. These down payments are intended to secure a firm customer commitment prior to beginning actual construction of a major or customized project. Hopefully, the customer deposits are sufficient to ensure that the customer will follow through on their promise to accept and pay for the product. Whether these deposits are refundable or not, they are nonetheless reported as current liabilities. Oftentimes, such amounts are called deferred revenues, deferred liabilities, or just simply deferrals.

Another potentially large current liability relates to collections for third parties. For instance, businesses are tasked with collecting sales taxes. The seller of taxable goods must collect sales tax from a customer and then turn the money over to a taxing authority. Such amounts are appropriately reflected as a current liability until the funds are remitted to the rightful owner.

Estimated Liabilities

Companies routinely offer prizes, coupons, promotions, warranties, rebates, and other incentives to induce customers to purchase. Each type of transaction introduces unique accounting questions. (For example, a dentist's office may offer a promotion of free x-rays and initial exam to attract new patients.) Some are so unique that specific accounting rules have been developed and the accountant must perform detailed research to identify and apply appropriate principles. The accounting profession, through its primary accounting standard setting body, has developed a research database of pronouncements. If you are curious about this database, you might check with your library or a practicing accountant and ask if they have access to the Financial Accounting Standards Board Codification. This tool will let you enter keyword searches, and you will be amazed at the number of pronouncements and references you will find related to these types of estimated liabilities.

Despite the deep and specific detail on accounting for estimated liabilities, it is possible to make a broad generalization. A company should report the estimated amount of future cost associated with those agreements and promises that are probable to occur. This amount, at least, should be presented as a liability on the corporate balance sheet. To illustrate using warranties as the example, when goods are sold, an estimate of the future amount of warranty costs associated with the sales should be recorded as an expense. The offsetting credit is to a Warranty Liability account. As warranty work is performed, the Warranty Liability is reduced, and Cash (or other resources used) is credited. This approach not only results in a fair presentation of the remaining liability on the balance sheet but also produces a proper matching of revenues and expenses.

The following entries show how a $40,000 sale of a piece of medical equipment—costing the medical supplier $32,000 and having future estimated warranty work of $3,000—is to be recorded. Also shown is the provision of one element of warranty service. Take special note that seller will make a $5,000 profit consisting of the $40,000 sale and $35,000 of total expenses.

Date of Sale	Cash	40,000.00	
	Sales		40,000.00
	To record sale of new equipment		
Date of Sale	Cost of goods sold	32,000.00	
	Inventory		32,000.00
	To record cost of new equipment sold		
Date of Sale	Warranty expense	3,000.00	
	Warranty liability		3,000.00
	To record estimated cost of future warranty work to be provided on equipment		
Date of Warranty Service	Warranty liability	1,000.00	
	Cash		1,000.00
	To provide a portion of anticipated warranty service		

Contingencies

Some business obligations seem to take on a heightened degree of uncertainty. In some respects, the aforementioned estimated liabilities can be regarded in this fashion because one does not truly know the eventual outcome. However, there is yet another class of potential liability in which the amount and timing of a possible obligation is far more subjective. These uncertain potential obligations are known as **contingent liabilities**. Numerous examples include lawsuits, environmental damage, risk of expropriation of assets by a foreign government, and other firm-specific issues.

Accountants have developed a well-defined framework for the reporting of contingencies. Before diving in, be advised that this framework is not applied to general business risks, like business fluctuations due to the broader economy, risk of war, risk of weather damage, and so forth. No one can see the future, and investors are presumed to be mature enough to know that these risks are intrinsic to the hazards of investing. Thus, accountants do not include financial statement measurements related to general business risks.

The starting point for justifying contingent liabilities is to make a subjective assessment of the probability of an unfavorable outcome. If an unfavorable outcome is viewed as probable, a liability will generally be reported on the balance sheet. The credit to set up the liability is offset with a debit to a loss or an expense account. The amount to record is the estimated amount of loss (if the loss cannot be estimated, a robust footnote to the financial statements will likely explain the obligation and reasons why an estimate is not possible).

For contingencies that are deemed to be reasonably possible (but not quite probable), no accrual (i.e., recording on the balance sheet) is necessary. However, the accountant is certainly expected to disclose the risk with a footnote, possibly indicating the dollar amount of potential exposure faced by the company. Finally, if a contingent exposure is viewed as presenting an immaterial or remote risk, the accountant is permitted to conclude that no balance sheet accrual or footnote is needed. See Table 7.1 for further details about reporting contingent liabilities. Maybe you thought accountants only did bookkeeping; think again. The accountant is engaged in a number of complex activities related to items like risk assessment!

Table 7.1: Where to report contingent liabilities

Example Contingency	Where to Report the Contingency
Probable unfavorable outcome	Report contingency on Balance Sheet with estimated amount of loss. Details to be found in the Notes to the Financial Statements.
Reasonably probable unfavorable outcome	Nothing on the Balance Sheet, but a Note to the Financial Statements should detail the possibility with an estimate of the expense (if possible).
Unfavorable outcome not material	Nothing needed on Balance Sheet or in the Notes to the Financial Statements.

Balance Sheet Presentation

You may now appreciate how complex the current liabilities section of the balance sheet can become. Table 7.2 shows a typical presentation for a variety of obligations. Your review of this may leave you wondering about the specific order in which current obligations are to be listed. No one scheme dominates, although it is relatively common to first show the current portion of Long-Term Debt, followed by Short-Term Notes Payable, Loans Payable, and then Accounts Payable. Accrued and other liabilities are usually listed last.

Table 7.2: Current liabilities section of a balance sheet

Current Liabilities		
Note payable	$100,000	
Accounts payable	125,000	
Salaries payable	80,000	
Utilities payable	20,000	
Customer prepayments	5,000	
Warranty obligation	23,000	
Accrual for pending litigation	25,000	$400,000

Being a Better Borrower Yourself

Accountants learn a lot about business financing and gain some competitive advantages as a result. The skills you have already learned and a few added tips may actually put you in a position to gain a competitive edge yourself.

Begin by recognizing that some short-term borrowing agreements may stipulate that a year is only 360 days long. Of course, this is not correct. In years gone by, maybe one could argue that this assumption made it possible to calculate interest more readily. If you happen to see some very old bank statements, you might get a glimpse into the past when tellers manually calculated and posted interest. Using a 360-day year (30 days each month) made these manual calculations simpler. With calculators and computers, it is just as easy to compute interest for a 360- or 365-day year.

However, some borrowing agreements continue to hold over the 360 day–year provision. Why? Because it favors the lender! For example, interest on a $10,000, 90-day, 6% loan is $150, assuming a 360-day year [$10,000 $\times$ 0.06 $\times$ (90 $\div$ 360)], but only $147.95 based on the more correct 365-day year [$100,000 $\times$ 0.06 $\times$ (90 $\div$ 365)]. That may not look like much of a difference to you, but it is to the lender if they make enough loans. *Caveat emptor* means, "let the buyer beware"; perhaps "let the borrower beware" is also an appropriate admonition.

Compounding is another concept that you should grasp. The formula for simple interest, such as used in the preceding paragraph, is

$$\text{Interest} = \text{Loan} \times \text{Interest Rate} \times \text{Time}.$$

There are more involved formulas for compound interest, which are discussed at length in a managerial accounting course. Compound interest means that interest is earned on the interest. A loan agreement will stipulate how often the interest calculation is applied (e.g., once per day, once per week, once per month, once per quarter, annually). The calculated amount of interest is added to the balance of the loan, and it too begins to accrue interest. The greater the frequency of interest compounding, the greater will be the total amount of interest incurred. Lenders are usually required to present you with an extensive truth-in-lending document that describes the basis on which they will assess interest, but that is no guarantee that the terms are good! Read the fine print and try to negotiate your best deal. Buying the use of money (i.e., borrowing) is no different than buying any other asset; you should negotiate the best possible terms.

Sometimes lenders may try to collect their "interest" up front in the form of points (a single point is equal to 1% of the loan amount), fees, or discounts. This can take many forms but is best illustrated with a note payable issued at a discount. Assume Advantage borrowed $1,000 on January 1, to be repaid on December 31. The stated terms included "10% interest, or $100, to be withheld up front from the $1,000 loan." Following is the accounting sequence:

1-1-XX	Cash	900.00	
	Discount on note payable	100.00	
	Note payable		1,000.00
	To record note payable, issued at a discount		
12-31-XX	Note payable	1,000.00	
	Interest expense	100.00	
	Discount on note payable		100.00
	Cash		1,000.00
	To record repayment of note and related interest via discount "amortization"		

Observe that the $100 discount is initially recorded to a special account. This account is shown on a balance sheet as a contra account to the note payable. Simply, this means that a balance sheet will show the $1,000 note, less the $100 discount, netting to the $900 amount borrowed. Over time, the discount is amortized via a transfer to Interest Expense. The above entry did this at maturity, but it could have apportioned ratably over the life of the loan. At maturity, the "$1,000 loan" is repaid, as shown. It is important to understand that the loan was only $900, on which $100 of interest was paid. This brings the true rate of interest to over 11% ($100 ÷ $900).

7.2 Concepts in Payroll Accounting

Payroll is one of the most significant expenditures that businesses may face. It involves not only a significant amount of money but also is subject to strict legal and tax implications. Failure to meet payroll funding and accounting expectations is usually fatal for a business.

The starting point of payroll accounting is distinguishing between an **employee**, such as a full time nurse, and **independent contractor**, such as a nurse contracted by the day with no benefits. Payroll accounting principles pertain to employees. An employee is someone who provides services to a business in exchange for payment, with the business controlling what, when, and how work will be done. In contrast, an independent contractor performs agreed tasks but generally decides the processes that will achieve the end result. The distinction is important because tax and record-keeping requirements differ for employees and independent contractors.

It is common for disputes to arise about the classification of a worker as an employee versus contractor; in particular, tax rules have become increasingly specific about the ways in which the differentiation occurs. If you are working for someone else or engaging another to perform a service, you are well advised to research the specific situation carefully to make the proper distinction between employee and contractor. As you are about to discover, the distinction is very important.

Under U.S. tax law, monies paid to independent contractors do not require that the payer incur payroll taxes or withhold taxes. The primary requirement is that the payer obtain the contractor's tax identification number (usually the Social Security number) and provide the contractor and Internal Revenue Service (IRS) with an annual report of the amount paid. This annual report is known as **Form 1099**. It is a simple matter to prepare and file this report. The contractor is responsible for paying all income and self-employment taxes on the amounts received from the payer.

Paying employees becomes far more involved. You may have some work experience, and if you do, you know that your paycheck is usually reduced by a variety of charges. The list of potential withholdings is long, including federal income tax, state income tax, FICA (Social Security taxes and Medicare/Medicaid), insurance, retirement contributions, charitable contributions, special healthcare and childcare deferrals, and other similar items. The total amount you earned is termed the **gross pay**. The amount you receive after deducting all these charges is the **net pay**.

When you look at your pay stub and see all the withholdings, you may feel like you are taking two steps forward and one step back. However, don't blame your employer. The bulk of these withholdings is mandated by law, and certain of them must be matched by your employer. This has the effect of increasing the total payroll cost to the employer to an amount well in excess of your gross pay.

Employers are required to match your FICA payments. Employers additionally pay unemployment taxes that are completely invisible and not borne directly by employees. Some employers also contribute to health insurance costs and retirement programs. A business

must not only correctly account for the gross pay but also must measure, report, and fund these additional costs as well.

Calculating Gross and Net Pay

For hourly employees, gross pay is the number of hours worked multiplied by the hourly rate. For salaried employees, it is usually a flat amount. Gross pay might be increased or decreased for both hourly and salaried employees based on overtime rules or periods of compensated/uncompensated leaves. Statutes vary by country and state, and global employers must be very careful to understand fully the rules that apply in each jurisdiction. Laws tend to punish employers that don't get it right and typically trigger payments and penalties due to both employees and governmental agencies.

Once gross pay is determined, all applicable withholdings must be considered. **Income tax** is usually the single most significant amount. Employees ultimately bear the tax on income, but the employer must withhold the money (i.e., it is taken out of the gross pay before disbursing payroll to employees). In other words, employees never touch the funds; if too much (or not enough) is withheld over the span of a tax year, final adjustment will occur when employees file their income tax returns for the preceding year.

The employer must periodically remit to the government(s) (based on schedules tied to the amounts involved) all such income tax withholdings. The amount to withhold is based on rates set by federal, state (when applicable), and city (when applicable) governments, as well as employee withholding allowances. Withholding allowances identify the tax statuses of employees as they relate to the number of exemptions to which they may be entitled based on marital status and personal dependents. Employers learn about these employee characteristics by having employees fill out a **W-4 form**.

The **Federal Insurance Contributions Act (FICA)** establishes a tax that transfers money from those currently working to aged retirees, disabled workers, and certain children. FICA is a blanket act encompassing programs normally called Social Security and Medicare/Medicaid. You are likely aware that that these programs are becoming increasingly costly and controversial as extended life expectancies, rising healthcare costs, and shifting imbalances between retired and working persons is calling into question the financial solvency and viability of these programs. It is difficult to predict the future state of this tax. For now, the Social Security tax is levied as a designated percentage of income, up to a certain maximum level of annual income per employee.

Despite regular revisions to the Social Security tax rates and income levels, the method of applying the tax has been relatively stable. For illustrative purposes, let's assume a 7% rate on a maximum of $120,000 of income. This simply means that an employee making $200,000 per year would pay $8,400 in Social Security taxes (remember, this tax is also matched by the employer, as will be shown shortly). The $8,400 amount is the 7% rate applied to the $120,000 maximum; anything earned over $120,000 per calendar year is not assessed by the tax.

Medicare/Medicaid tax is assessed at fixed percentage on total gross pay, no matter the level. Assuming a 2% rate, the employee grossing $200,000 would pay $4,000 per year. Like Social Security, the employer also matches this medical benefits tax. Do not

confuse Medicare/Medicaid with health insurance; the former benefits retirees using the government-provided coverage plan, and the latter is for people below the poverty line, retired or not. Active employees and retirees on a company provided plan may not draw Medicare/Medicaid.

Once the mandatory withholdings are covered, it is time to consider more discretionary types of costs. A large cost can arise through company-provided healthcare for its own work force and retirees. Usually, employees are asked to participate in the costs of these plans, especially if spouses and children are included in the coverage group. Such insurance premiums are withheld from gross pay. Similar withholdings arise for employee contributions to various retirement and other cash savings plans. Some companies will manage withholdings for employee charitable contributions, tax-advantaged healthcare and childcare savings programs, and other optional programs in which an employee may choose to participate. Basically, the employer is collecting money from the employee and assuming a duty to remit those funds to another party. This is like accounting for customer deposits and other collections for third parties.

Payroll Journal Entry

A company will debit Wage/Salary Expense for the gross pay and credit Cash for the net pay disbursed to an employee. The differences reflect amounts due to others (e.g., the government, insurance companies, and charities). Following is a representative monthly entry for a company's total payroll:

5-31-XX	Wage/salary expense	300,000.00	
	Federal income tax payable		30,500.00
	State income tax payable		12,000.00
	Social Security payable		18,000.00
	Medicare/medicaid payable		6,000.00
	Insurance payable		18,500.00
	Retirement contribution payable		15,000.00
	Charitable contribution payable		2,000.00
	Cash		198,000.00
	To record payroll for the month of May		

All amounts were assumed in the preceding entry. However, using the earlier tax-rate assumptions, you can see that Medicare/Medicaid reflected the 2% tax ($300,000 × 2% = $6,000). Apparently, some employee(s) had already exceeded $120,000 of annual compensation because the Social Security tax was not $21,000 (which would be the case if all employees were still paying the full 7% on all income). As the company remits the amounts withheld from employees, Cash will be credited, and the various obligations will be debited.

Additional Entries for Employer Amounts

The preceding discussion pointed out that employers must match certain taxes like Social Security and Medicare/Medicaid. Additionally, the employer must pay other taxes such as unemployment tax (both federal and state levies). **Unemployment taxes** are levied and pooled to provide a source of funds to support persons who are temporarily out of work. Here the tax rate varies significantly based on the history of an employer. Employers who rarely lay off or fire employees receive a much lower rate than those who don't maintain a stable work force. Like Social Security, the unemployment tax is levied only on a base amount of pay; earnings in excess of the base are exempt from the tax. In this text, assume that the federal unemployment tax (FUT) is 1% on a $15,000 base, and the state unemployment tax (SUT) is 5% on a $15,000 base.

Employers that offer health insurance coverage to employees usually foot a significant share of the bill. This is an additional cost that increases the overall cost of having an employee on the payroll. Along with optional healthcare, some states require employers to maintain **workers' compensation insurance**. This insurance provides payments to workers for work-related injuries. Other employee benefits can be found in the form of retirement plan contributions, tuition reimbursement programs, training costs, gym memberships, automobile allowances, and so forth. For some companies, the added cost of employee support can be as much as 50% of gross pay. Following is a companion entry to that shown earlier, this time reflecting the employer's added burden associated with the May payroll. The amounts are assumed and would normally be based on formulas that are situational dependent.

5-31-XX	Payroll tax expense	31,200.00	
	Employee benefits expense	40,000.00	
	Social Security payable		18,000.00
	Medicare/medicaid payable		6,000.00
	FUT payable		1,200.00
	SUT payable		6,000.00
	Insurance payable		25,000.00
	Retirement contribution payable		15,000.00
	To record employer portion of payroll taxes and benefits		

Accurate Payroll

As you can tell, accuracy is vital in payroll accounting. Payroll requires accurate and timely reporting and funding of all related obligations. Because of the complexity of payroll law and the severe penalties for errors, a specialized industry can provide payroll support services. For a fee, these businesses will manage payroll functions efficiently. The employer provides information about hours worked for each employee and transfers funds to cover the full cost of payroll and payroll taxes. The payroll service firm then pays employees, keeps payroll records, reports compliance, processes tax deposits, and generates payroll tax reports.

Businesses that do not rely on payroll services must establish an accurate payroll system for tracking information about every employee. It is imperative to pay employees the correct amounts at the agreed time, to make timely payments of withholdings to the appropriate parties, and to file all necessary tax reports associated with the payroll. For example, an employer is required to provide each employee with an annual wage and tax statement known as the **W-2 form**. This document includes information on gross pay, tax withholdings, and other related information. Copies of this information must also be furnished to tax authorities, and they reconcile income reported by employees on their own tax returns to amounts reported as paid by employers.

Remitting tax withholdings to the government is simple and can be done at most commercial banks. There is also an online system that is easy to use. It is very important for you to know that the employer's obligation to protect withheld taxes and make timely remittances to the government is taken seriously. Employers who fail to do so are subject to harsh penalties, and employees who are aware of misapplication of such funds can expect serious legal problems. You should never be party to such an activity.

Pension and Other Postretirement Benefits

Another potentially costly payroll component relates to a company's retirement savings programs for the benefit of employees. Broadly speaking, these **pension** plans involve current "set asides" of money into trust, with a goal of current investment and future distributions to retirees. To the extent the company's trust fund is deemed inadequate to cover anticipated obligations under a pension, a company will disclose underfunded pension obligations as balance sheet liabilities. On a related note, some companies provide postretirement healthcare, life insurance, and related benefits. These costs can be substantial, and accountants have developed elaborate models for estimating these costs. A company is to report the value of the accumulated obligation as a liability on the balance sheet. This can be one of the most significant liabilities faced by many companies.

Today, most companies choose to offer defined contribution plans, such as 401(k) plans in a for-profit environment or 403(b) plans in a nonprofit environment. These types of retirement options require a cash contribution on a periodic basis. Companies that fund their retirement plans using defined contribution plans do not have to worry about underfunded pension obligations.

Case Study: IMS Medical Clinics

The owner of IMS Medical Clinics, which operates clinics in five states, asks his accountant to figure out a way to reduce his payroll costs at his Syracuse operations. The accountant asks the bookkeeper to prepare a list of the payroll details for the Syracuse operation. The bookkeeper at the Syracuse location gives him the following tax rates and payroll information pertaining to the Syracuse operations of IMS Medical Clinics for November:

Social Security taxes: 6% on the first $55,000 earned
Medicare taxes: 1.5% on the first $130,000 earned

(continued)

Case Study: IMS Medical Clinics *(continued)*

Federal income taxes withheld from wages: $4,400
State income taxes: 6% of gross earnings
Insurance withholdings: 1% of gross earnings
Pension contributions: 2.5% of gross earnings
State unemployment taxes: 5.4% on the first $7,000 earned
Federal unemployment taxes: 0.8% on the first $7,000 earned

Sales staff salaries amounted to $26,000, $3,000 of which is over the unemployment earnings base but subject to all other appropriate taxes. The company's clinic manager, Tracy Smith, earned her regular salary of $9,000 during the month.

Case Study Exercises

1. Prepare the journal entry to record the November payroll. Smith's salary is classified as an administrative expense by the company.
2. IMS matches employees' insurance and pension contributions. Prepare a journal entry to record the firm's payroll taxes and other related payroll costs. Assume that these amounts will be remitted to the proper authorities in December.
3. The owner of IMS asked the firm's accountant to reclassify all personnel as independent contractors. The accountant explained that such a reclassification would not be appropriate because, by law, the personnel were considered employees. Briefly comment on the probable reasoning behind the owner's request.

Key Terms

accounts payable The amounts due to suppliers for the purchase of goods and services.

contingent liabilities A class of a potential liability in which the amount and timing of a possible obligation is very subjective.

employee As opposed to an independent contractor, a person who provides services to a business in exchange for payment, with the business controlling what, when, and how work will be done.

Federal Insurance Contributions Act (FICA) A tax that transfers money from those currently working to aged retirees, disabled workers, and certain children.

Form 1099 An annual report provided to an independent contractor and the IRS, showing money paid.

gross pay The total amount of wages that an employee earns.

income tax A federal and sometimes state and local tax on earned wages.

independent contractor Someone who performs agreed-on tasks but generally decides about the processes that will achieve the end result.

net pay The amount that an employee receives after deducting charges such as federal and state taxes, FICA, insurance, retirement contributions, charitable contributions, special healthcare and childcare deferrals, and other similar items.

note payable A written promise to pay for purchases bought on credit, which usually incurs interest during the payment period.

pension A plan that involves current "set asides" of money into trust, with a goal of current investment and future distributions to retirees.

unemployment tax A tax levied and pooled to provide a source of funds to support persons who are temporarily out of work.

workers' compensation insurance Insurance that provides payments to workers for work-related injuries.

W-2 form An annual wage and tax statement—which includes information on gross pay, tax withholding, and other related information—that an employer provides to an employee and the IRS.

W-4 form A form stating the tax-withholding status—marital and number of dependents—of an employee.

Review Questions

The following questions relate to several issues raised in the chapter. Test your knowledge of these issues by selecting the best answer. (The odd-numbered answers appear in the answer appendix.)

1. Which of the following comments is false?

   a. Current liabilities include prepayments (advances) by customers.
   b. Current liabilities will be settled within 1 year or the operating cycle, whichever is longer.
   c. Current liabilities must be settled by using cash.
   d. Current liabilities arise from past transactions and events.

2. The Discount on Notes Payable account

   a. usually has a credit balance.
   b. is associated with a note payable when interest is included in the obligation's face value.
   c. represents future interest revenue on the note payable.
   d. is used for notes payable when interest is not included in the obligation's face value.

3. A balance in the Estimated Liability for Warranties account at year-end indicates

   a. that the accounting records have not been closed.
   b. that the accounting records have not been adjusted.
   c. the amount incurred during the year to service outstanding warranty agreements.
   d. future amounts expected to be incurred when outstanding warranty agreements are honored.

4. Assume that Robert Conrad, a nurse, worked 45 hours last week. He is paid $28 per hour, with hours in excess of 40 being compensated at one and one half times the regular rate. Income tax withholdings amounted to $270; his medical insurance deduction was $30. The Social Security tax rate is 6% on the first $55,000 earned per employee, and Medicare is 1.5% on the first $130,000. Cumulative gross pay before considering the preceding data totaled $54,202. What is Conrad's take-home pay?

   a. $930.25
   b. $962.17
   c. $982.12
   d. some amount other than those listed

5. Social Security and Medicare taxes are levied on

   a. employees only.
   b. employers only.
   c. both employees and employers.
   d. either the employee or the employer, depending on the number of withholding allowances claimed by the employee.

6. Is a commitment for future goods and services entered in the accounting records as a liability? Explain.

7. Define the term "current liability" and present six examples.

8. Present three different situations where a business collects monies from customers and employees and reports such amounts as current liabilities.

9. Briefly discuss the correct treatment of vacation pay in the accounting records.

10. What does the Discount on Notes Payable account represent?

11. Does discount amortization increase or decrease a company's reported interest expense for the year?

12. What guidelines must be met for a contingent liability to be recorded in the accounts?

13. Why is a warranty considered a contingent liability?

14. Are internal control procedures important in the area of payroll? Why?

15. What is the purpose of requiring businesses to withhold income taxes (federal, state, and local) from employee wages? How are these withholdings treated in the accounting records of the employer?

16. Which payroll taxes are incurred by an employer? How are these taxes treated in the accounting records?

Exercises

1. **Prepayments by customers**. Green's wellness center began a new magazine in the fourth quarter of 20X2. Annual subscriptions, which cost $18 each, were sold as follows:

	Number of Subscriptions Sold
October	400
November	700
December	1,000

If subscriptions begin (and magazines are sent) in the month of sale:

a. Name the necessary journal entry to record the magazine subscriptions sold during the fourth quarter.
b. Determine how much subscription revenue Greenland earned by the end of 20X2.
c. Compute Greenland's liability to subscribers at the end of 20X2.

2. **Accrued liability: current portion of long-term debt**. On July 1, 20X1, Hall Medical Clinic borrowed $225,000 via a long-term loan. Terms of the loan require that Hall pay interest and $75,000 of principal on July 1, 20X2, 20X3, and 20X4. The unpaid balance of the loan accrues interest at the rate of 10% per year. Hall has a December 31 year-end.

a. Compute Hall's accrued interest as of December 31, 20X1.
b. Present the appropriate balance sheet disclosure for the accrued interest and the current and long-term portion of the outstanding debt as of December 31, 20X1.
c. Repeat parts (a) and (b) using a date of December 31, 20X2, rather than December 31, 20X1. Assume that Hall is in compliance with the terms of the loan agreement.

3. **Notes payable**. Stewart Medical purchased $72,000 of office equipment on April 1, 20X3, by signing a 3-year, 12% note payable to Sharp, Inc. One third of the principal, along with interest on the outstanding balance, is payable each April 1 until maturity. (The first payment is due in 20X4.)

a. Fill in the following table to reflect Stewart's liabilities, assuming a March 31 year-end.

	20X4	20X5	20X6
Current liabilities			
Current portion of long-term debt			
Interest payable			
Long-term liabilities			
Long-term debt			

b. Assuming that interest is properly recorded at the end of each year, present the proper journal entry to record the last payment on April 1, 20X6.

4. **Payroll accounting**. Assume that the following tax rates and payroll information pertain to Brookhaven Health Clinic:

   Social Security taxes: 6% on the first $55,000 earned

   Medicare taxes: 1.5% on the first $130,000 earned

   Federal income taxes withheld from wages: $7,500

   State income taxes: 5% of gross earnings

   Insurance withholdings: 1% of gross earnings

   State unemployment taxes: 5.4% on the first $7,000 earned

   Federal unemployment taxes: 0.8% on the first $7,000 earned.

   The company incurred a salary expense of $50,000 during February. All employees had earned less than $5,000 by month-end.

   a. Prepare the necessary entry to record Brookhaven's February payroll that will be paid on March 1.
   b. Prepare the journal entry to record Brookhaven's payroll tax expense.

5. **Payroll accounting**. The following payroll information relates to Viking Medical Center for the month of July:

Total (gross) employee earnings	$150,000
Earnings in excess of Social Security base earnings	18,000
Earnings in excess of Medicare base earnings	2,000
Earnings in excess of unemployment base earnings	94,000
Federal income taxes withheld	14,500
State income taxes withheld	3,000
Employee deductions for medical insurance	2,200

   The Social Security tax rate is 6% on the first $55,000 earned per employee; Medicare is 1.5% on the first $130,000 earned. The state and federal unemployment tax rates are 5.4% and 0.8%, respectively, on the first $7,000 earned per employee.

   a. Compute the employees' total take-home pay.
   b. Compute Viking's total payroll-related expenses.
   c. Assuming a stable work force, is total take-home pay likely to increase, decrease, or remain the same in August? Briefly explain.

Problems

1. **Current liabilities: recognition and valuation**. The seven transactions and events that follow relate to the 20X2 operations of Blue Medical Clinics.

   - On February 1, the company signed a 1-year contract with the nurses' union, agreeing to a 6% wage increase for all nurses. The cost of the wage increase is estimated to be $100,000 per month.
   - A customer slipped on a soft drink that he had spilled while walking through a Blue Medical Clinic facility. The customer injured his back and has filed a

$50,000 damage suit against the company. Blue Medical attorneys feel the suit is uncalled for and without merit.

- Blue Medical purchased merchandise on October 15 for $4,000; terms 5 ÷ 15, *n* ÷ 60. The company overlooked the discount and intends to pay the supplier in January 20X3.
- Equipment that cost $12,000 was acquired on November 1 by issuing a 3-month, 10%, $12,000 note payable.
- Office furniture that cost $4,000 was purchased on December 1, with Blue Medical signing a $4,240, 12-month note payable. Interest is included in the note's face value.
- On the last day of 20X2, Blue Medical borrowed $1 million from Monticello Bank. The loan's principal is due in 10 equal annual installments of $100,000 each, with each installment payable on December 31. The loan has a 9% interest rate.

Instructions

a. Indicate which of the six transactions and events would appear in the Current Liability section of the firm's December 31, 20X2, balance sheet.
b. Show how the items in part (a) would be disclosed. Use proper dollar amounts.
c. Indicate how the transactions and events that are not current liabilities would be handled for accounting purposes.

2. **Notes payable**. Smith Medical Supply was involved in the following transactions during the fiscal year ending October 31:

8/2: Borrowed $75,000 from the Bank of Kingsville by signing a 120-day note for $79,000.

8/20: Issued a $40,000 note to Harris Motors for the purchase of a $40,000 delivery truck. The note is due in 180 days and carries a 12% interest rate.

9/10: Purchased merchandise from Paris Enterprises in the amount of $15,000. Issued a 30-day, 12% note in settlement of the balance owed.

9/11: Issued a $60,000 note to Datatex Equipment in settlement of an overdue account payable of the same amount. The note is due in 30 days and carries a 14% interest rate.

10/10: The note to Paris Enterprises was paid in full.

10/11: The note to Datatex Equipment was due today, but insufficient funds were available for payment. Management authorized the issuance of a new 20-day, 18% note for $60,700, the maturity value of the original obligation.

10/31: The new note to Datatex Equipment was paid in full.

Instructions

a. Prepare journal entries to record the transactions.
b. Prepare adjusting entries on October 31 to record accrued interest.
c. Prepare the Current Liability section of Smith Medical Supplies's balance sheet as of October 31. Assume that the Accounts Payable account totals $203,600 on this date.