

Current Liabilities and Payroll

SMART TOUCH LEARNING Balance Sheet May 31, 2013

This amount must be paid in one year or the business's operating cycle, whichever is longer.

Assets		Liabilities	
Current assets:		Current liabilities:	
Cash	\$ 4,800	Accounts payable	\$ 48,700
Accounts receivable	2,600	Salary payable	900
Inventories	32,500	Interest payable	100
Supplies	600	Unearned service revenue	400
Prepaid rent	2,000	Total current liabilities	50,100
Total current assets	\$ 40,500	Long-term liabilities:	
Plant assets:		Notes payable	20,000
Furniture	\$18,000	Total liabilities	70,100
Less: Accumulated depreciation—furniture	300		
	17,700		
Building	48,000		
Less: Accumulated depreciation—building	200		
	47,800		
Total plant assets	65,500	Owner's Equity	
Total assets	\$106,000	Bright, capital	\$5,900
		Total liabilities and owner's equity	\$106,000

Learning Objectives

- 1 Account for current liabilities of known amount
- 2 Account for current liabilities that must be estimated
- 3 Calculate payroll and payroll tax amounts
- 4 Journalize basic payroll transactions

Up to this point, we've been focusing on all the assets a business owns. But what about the bills a business owes? As a business owner or manager, you have to know what you owe (your liabilities) and what date you have to pay them. Why? To be sure you have cash on hand to pay these bills. In this chapter, we'll focus on some common current liabilities a business may owe. As with other chapters, we'll continue to focus on Smart Touch Learning and see how it manages its current liabilities.

Current Liabilities of Known Amount

The amounts of most liabilities are known. Recall that current liabilities are those debts due to be paid within one year, or within the entity's operating cycle if that cycle is longer than a year. Let's begin with current liabilities of a known amount.

- 1 Account for current liabilities of known amount

Accounts Payable

Amounts owed for products or services purchased on account are *accounts payable*. Since these are due on average in 30 days, they are current liabilities. We have seen many accounts payable illustrations in preceding chapters. Consider the balance sheet for May 31, 2013, prepared in Chapter 4 for Smart Touch Learning and reproduced as follows:

EXHIBIT 10-1 Classified Balance Sheet in Account Form
(Reproduced from Exhibit 4-12)

SMART TOUCH LEARNING Balance Sheet May 31, 2013					
Assets			Liabilities		
Current assets:			Current liabilities:		
Cash		\$ 4,800	Accounts payable		\$18,200
Accounts receivable		2,600	Salary payable		900
Supplies		600	Interest payable		100
Prepaid rent		2,000	Unearned service revenue		400
Total current assets		\$10,000	Total current liabilities		19,600
Plant assets:			Long-term liabilities:		
Furniture	\$18,000		Notes payable		20,000
Less: Accumulated depreciation—furniture	300	17,700	Total liabilities		39,600
Building	48,000		Owner's Equity		
Less: Accumulated depreciation—building	200	47,800	Bright, capital		35,900
Total plant assets		65,500	Total liabilities and owner's equity		\$75,500
Total assets		\$75,500			

Notice that the balance on May 31, 2013, for Accounts payable is \$18,200. As we learned in Chapter 5, one of Smart Touch's common transactions is the credit purchase of inventory. With accounts payable and inventory systems integrated, Smart Touch records the purchase of inventory on account, using the perpetual system. A reproduction of the Chapter 5 entry that Smart Touch made on June 3 to purchase \$700 of inventory on account follows:

Jun 3	Inventory (A+)	700	
	Accounts payable (L+)		700
	Purchase on account.		

Then, when Smart Touch paid the liability and took advantage of the purchase discount on June 15, the entry was as follows:

Jun 15	Accounts payable (L-)	700	
	Cash (A-)		679
	Inventory (A-)		21
	Paid on account within discount period.		

Keep in mind that Smart Touch purchased more inventory in other transactions in June.

Short-Term Notes Payable

Short-term notes payable are a common form of financing. Short-term notes payable are promissory notes that must be paid within one year. Consider how the entry on June 3 would change if Smart Touch had purchased the inventory with a 10%, one-year note payable. The modified June 3 purchase entry follows:

2013				
Jun 3	Inventory (A+)		700	
	Short-term notes payable (L+)			700
	<i>Purchased inventory on a one-year, 10% note.</i>			

A

At year-end it is necessary to accrue interest expense for the seven months from June to December (do not adjust interest for the three days in June) as follows:

2013				
Dec 31	Interest expense ($\$700 \times 0.10 \times 7/12$) (E+)		41	
	Interest payable (L+)			41
	<i>Accrued interest expense at year-end.</i>			

B

The interest accrual at December 31, 2013, allocated \$41 of the interest on this note to 2013. During 2014, the interest on this note for the five remaining months is \$29, as shown in the following entry for the payment of the note in 2014:

2014				
Jun 3	Short-term notes payable (L-)		700	
	Interest payable (L-)		41	
	Interest expense ($\$700 \times 0.10 \times 5/12$) (E+)		29	
	Cash (A-)			770
	<i>Paid note and interest at maturity.</i>			

Sales Tax Payable

Most states assess sales tax on retail sales. Retailers collect the sales tax in addition to the price of the item sold. Sales tax payable is a current liability because the retailer must pay the state in less than a year. **Sales tax collected is owed to the state.** Let's apply this to Smart Touch.

Suppose December's taxable sales for Smart Touch totaled \$10,000. Smart Touch collected an additional 6% sales tax, which would equal \$600 ($\$10,000 \times 0.06$). Smart Touch would record that month's sales as follows:

2013				
Dec 31	Cash ($\$10,000 \times 1.06$) (A+)		10,600	
	Sales revenue (R+)			10,000
	Sales tax payable ($\$10,000 \times 0.06$) (L+)			600
	<i>To record cash sales and the related sales tax.</i>			

C

As noted above, Sales tax payable is a current liability. Notice how it shows as an obligation (credit balance) in the Sales tax payable T-account, just after the sale.

*The red colored boxes throughout the chapter reference Exhibit 11-5 in Chapter 11 on page 547.

Sales tax payable

600

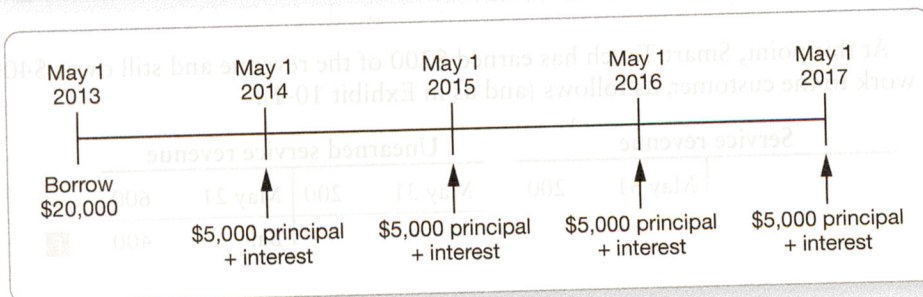
Companies forward the sales tax to the state at regular intervals. They normally submit it monthly, but they could file it at other intervals, depending on the state and the amount of the tax. To pay the tax, the company debits Sales tax payable and credits Cash.

2014				
Jan 20	Sales tax payable	(L-)	600	
	Cash	(A-)		600

Current Portion of Long-Term Notes Payable

Most long-term notes payable are paid in installments. The **current portion of notes payable** (also called **current maturity**) is the principal amount that will be paid within one year—a current liability. **The current portion of notes payable is equal to this year's principal payments.** The remaining portion is long-term. Let's consider the \$20,000 notes payable that Smart Touch signed on May 1, 2013 (refer to Exhibit 10-1). The note bears interest at 6%. If the note will be paid over four years with payments of \$5,000 plus interest due each May 1, what portion of the note is current? The portion that must be paid within one year, \$5,000, is current. At the inception of the note, the company recorded the entire note as long term. A second entry to the account for the \$5,000 principal that is current will need to be made on May 1, 2013.

2013				
May 1	Cash	(A+)	20,000	
	Long-term notes payable	(L+)		20,000
May 1	Long-term notes payable	(L-)	5,000	
	Current portion of long-term notes payable	(L+)		5,000



Notice that the reclassification entry on May 1 does not change the total amount of debt. It only reclassifies \$5,000 of the total debt from long-term to current. Interest would still accrue (see the next section). We focus on the current portion classification in this chapter. In Chapter 11, we'll focus on the long-term portion and the yearly payments on the note.

Accrued Liabilities

In Chapter 3, we learned that an accrued expense is any expense that has been incurred but has not yet been paid. When an expense is accrued (debited), it often has a related unpaid bill, or an accrued liability (credited). Accrued liabilities typically occur with the passage of time, such as interest on a note payable.

Refer to Exhibit 10-1, Smart Touch's May 31, 2013, balance sheet. Like most other companies, Smart Touch has accrued liabilities for salaries payable and interest

payable. Smart Touch has already accrued one month of interest on the \$20,000 note ($20,000 \times 6\% \times 1/12$); \$100 interest for the month of May 2013, as shown in Exhibit 10-1. Now, at December 31, Smart Touch still needs to accrue interest from May 31 to December 31, or seven more month's interest on the \$20,000 note:

Dec 31	Interest expense ($20,000 \times 6\% \times 7/12$) (E+)	700	
	Interest payable (L+)		700

B

Unearned Revenues

Unearned revenue is also called *deferred revenue*. Unearned revenue arises when a business has received cash in advance of performing work and, therefore, has an obligation to provide goods or services to the customer in the future. **If you receive cash before you do the work, you owe the work (unearned service revenue).** Let's consider an example using Smart Touch's May 31, 2013, balance sheet.

Smart Touch received \$600 in advance on May 21 for a month's work beginning on that date. On May 31, because it received cash before earning the revenue, Smart Touch has a liability to perform 20 more days of work for the client. The liability is called Unearned service revenue. The entry made by Smart Touch on May 21, 2013, follows:

2013				
May 21	Cash (A+)		600	
	Unearned service revenue (L+)			600

During May, Smart Touch delivered one-third of the work and earned \$200 ($\$600 \times 1/3$) of the revenue. The May 31, 2013, adjusting entry made by Smart Touch decreased the liability and increased the revenue as follows:

2013				
May 31	Unearned service revenue (L-)		200	
	Service revenue (R+)			200

At this point, Smart Touch has earned \$200 of the revenue and still owes \$400 of work to the customer, as follows (and as in Exhibit 10-1):

Service revenue			Unearned service revenue		
	May 31	200	May 31	200	May 21 600
					Bal 400

F

Key Takeaway

A current liability must be paid in a year or less. For some current liabilities, the exact amount is known or can easily be calculated, such as the amount of sales tax payable, interest owed (payable) on a note, or the amount of work still owed to a customer who paid in advance (unearned revenue). For some, the current liability is known based on a contract, such as with the current portion of long-term notes payable. Still others must be accrued and are known based on a bill received or hours worked, such as accounts payable or salaries payable. The key to all of these is the current liability amount is known, not estimated.

Current Liabilities that Must Be Estimated

- Account for current liabilities that must be estimated

A business may know that a liability exists, but not know the exact amount. The business cannot simply ignore the liability. It must report it on the balance sheet. A prime example is Estimated warranty payable, which is common for manufacturing companies like Dell and Sony.

Estimated Warranty Payable

Many companies guarantee their products against defects under **warranty** agreements. Both 90-day and one-year warranties are common.

The matching principle says to record the *Warranty expense* in the same period that the company records the revenue related to that warranty. The expense, therefore, is incurred when the company makes a sale, not when the company pays the

warranty claims. At the time of the sale, the company does not know the exact amount of warranty expense, but can estimate it.

Assume that Smart Touch made sales on account of \$50,000 subject to product warranties on June 10, 2013. Smart Touch estimates that 3% of its products may require warranty repairs. The company would record the sales and the estimated warranty expense in the same period, as follows:

2013				
Jun 10	Accounts receivable (A+)	50,000		
	Sales revenue (R+)		50,000	
	<i>Sales on account.</i>			
Jun 10	COGS (E+)	21,000		
	Inventory (A-)		21,000	
	<i>To record cost of inventory sold.</i>			
Jun 10	Warranty expense ($\$50,000 \times 0.03$) (E+)	1,500		
	Estimated warranty payable (L+)		1,500	
	<i>To accrue warranty payable.</i>			

Assume that some of Smart Touch's customers make claims that must be honored through the warranty offered by the company. The warranty payments total \$800 and are made on June 27, 2013. Smart Touch repairs the defective goods and makes the following journal entry:

2013				
Jun 27	Estimated warranty payable (L-)	800		
	Cash (A-)		800	
	<i>To pay warranty claims.</i>			

Smart Touch's expense on the income statement is \$1,500, the estimated amount, not the \$800 actually paid. After paying for these warranties, Smart Touch's liability account has a credit balance of \$700. This \$700 balance represents warranty claims Smart Touch expects to pay in the future based on its estimates; therefore, the \$700 is a liability to Smart Touch.

Estimated warranty payable	
800	1,500
Bal	700

Contingent Liabilities

A **contingent liability** is a potential, rather than an actual, liability because it depends on a *future* event. **Some event must happen (the contingency) for a contingent liability to have to be paid.** For example, suppose Smart Touch is sued because of alleged patent infringement on one of its learning DVDs. Smart Touch, therefore, faces a contingent liability, which may or may not become an actual liability. If the outcome of this lawsuit is unfavorable, it could hurt Smart Touch by increasing its liabilities. Therefore, it would be unethical to withhold knowledge of the lawsuit from investors and creditors.

Another contingent liability arises when you *co-sign a note payable* for another entity. An example of this would occur if Greg's Tunes were to co-sign Smart Touch's note payable. The company co-signing (Greg's Tunes) has a contingent liability until the note comes due and is paid by the other entity (Smart Touch). If the other company (Smart Touch) pays off the note, the contingent liability vanishes (for Greg's Tunes). If not, the co-signing company (Greg's Tunes) must pay the debt for the other entity (Smart Touch).

Connect To: Ethics

Accounting for liabilities poses an ethical challenge. Businesses like to show high levels of net income because that makes them look successful. As a result, owners and managers may be tempted to overlook some expenses and liabilities at the end of the accounting period. For example, a company can fail to accrue warranty expense. This will cause total expenses to be understated, net income to be overstated, and total liabilities to be understated. Contingent liabilities also pose an ethical challenge. Because contingencies are potential, rather than actual, liabilities, they are easier to overlook. But a contingency can turn into an actual liability and can significantly change the company's financial position. Successful people do not play games with their accounting. Falsifying financial statements can land a person in prison.

As shown in Exhibit 10-2, the accounting profession divides contingent liabilities into three categories—remote, reasonably possible, and probable—based on the likelihood of an actual loss.

EXHIBIT 10-2 Contingent Liabilities: Three Categories

Likelihood of an Actual Loss	How to Report the Contingency
Remote	Do not disclose. <i>Example:</i> A frivolous lawsuit.
Reasonably possible	Describe the situation in a note to the financial statements. <i>Example:</i> The company is the defendant in a significant lawsuit and the outcome is unknown.
Probable, and the amount of the loss can be reasonably estimated	Record an expense and an actual liability, based on estimated amounts. <i>Example:</i> Warranty expense, as illustrated in the preceding section.

Codification Section: 450-20-55

Key Takeaway

Estimated current liabilities are owed, but the amount owed is based on an educated guess, not an exact known amount. So, for example, estimated warranty claims are recorded as a liability at the time a sale is made. The estimated expense and liability are journalized at the time of sale because of the matching principle. So the sales revenue and its related expense (estimated warranty claims) are reported (matched) in the same time period on the income statement.

Stop and review what you have learned by studying the Decision Guidelines on the next page.

Stop & Think...

Do you ever guess how much money you will need to pay your tuition each semester? If you do, you are making an informal sort of accounting estimate. Estimations can be formal or informal, but we all make accounting estimates. The key to why we estimate is so that we can accurately measure income. In the case of estimating your tuition, it might be just so you are sure you have enough cash on hand to pay it. Journalizing an estimate, such as for your tuition, is an example of an accrued liability.

Decision Guidelines 10-1

ACCOUNTING FOR CURRENT LIABILITIES

Suppose you are in charge of accounting for a large construction company. The company needs to borrow \$10,000 for materials for an upcoming construction job. The bank wants to see the company's balance sheet. These Decision Guidelines will help you report current liabilities accurately.

Decision

- What are the two main issues in accounting for current liabilities?
- What are the two basic categories of current liabilities?

Guidelines

- *Recording* the liability in the journal
- *Reporting* the liability on the balance sheet
- Current liabilities of *known amount*:
 - Accounts payable Accrued liabilities (interest payable, rent payable)
 - Short-term notes payable Salary, wages, commission, and bonus payable
 - Sales tax payable Unearned revenues
 - Current portion of long-term notes payable
- Current liabilities that *must be estimated*:
 - Estimated warranty payable
 - Estimated lawsuit losses where the likelihood of an actual loss is probable and the amount of the loss can be reasonably estimated

Summary Problem 10-1

Answer each question independently.

Requirements

1. A Wendy's restaurant made cash sales of \$4,000 subject to a 5% sales tax. Record the sales and the related sales tax. Also record Wendy's payment of the tax to the state of South Carolina.
2. At December 31, 2011, Chastains' Hair Salons reported the following liabilities:

Current Liabilities

Portion of long-term note payable due within one year	\$ 10,000
Interest payable ($\$210,000 \times 0.06 \times 6/12$).....	6,300
Total current liabilities	<u>\$ 16,300</u>

Long-Term Liabilities

Long-term note payable	<u>\$200,000</u>
Total liabilities	<u><u>\$216,300</u></u>

Chastains' Hair Salons signed a \$210,000, 21-year, 6% note on July 1, 2011. The note payments of \$10,000 plus interest are due June 30 each year.

Show how Chastains' Hair Salons would report its liabilities on the year-end balance sheet one year later—December 31, 2012.

3. How does a contingent liability differ from an actual liability? When would a contingent liability be journalized?

Solution

Requirement 1

Cash ($\$4,000 \times 1.05$) (A+)	4,200	
Sales revenue (R+)		4,000
Sales tax payable ($\$4,000 \times 0.05$) (L+)		200
<i>To record cash sales and sales tax.</i>		
Sales tax payable (L-)	200	
Cash (A-)		200
<i>To pay sales tax.</i>		

Requirement 2

Chastains' Hair Salons' balance sheet at December 31, 2012, is as follows:

Current Liabilities

Portion of long-term note payable due within one year	\$ 10,000
Interest payable ($\$200,000 \times 0.06 \times 6/12$).....	6,000
Total current liabilities	<u>\$ 16,000</u>

Long-Term Liabilities

Long-term note payable	<u>\$190,000</u>
Total liabilities	<u><u>\$206,000</u></u>

Requirement 3

A contingent liability is a *potential*, rather than an actual, liability because it depends on a future event. Some event must happen (the contingency) for a contingent liability to have to be paid. Contingent liabilities are journalized when the likelihood of an actual loss is *probable*, and the amount of the loss can be reasonably estimated.

Accounting for Payroll

Payroll, also called **employee compensation**, also creates accrued expenses. For service organizations—such as CPA firms and travel agencies—payroll is *the* major expense. Labor cost is so important that most businesses develop a special payroll system. There are numerous ways to label an employee's pay:

3 Calculate payroll and payroll tax amounts

- **Salary** is pay stated at an annual, monthly, or weekly rate, such as \$62,400 per year, \$5,200 per month, or \$1,200 per week.
- **Wages** are pay amounts stated at an hourly rate, such as \$10 per hour.
- **Commission** is pay stated as a percentage of a sale amount, such as a 5% commission on a sale. A realtor who earns 5% commission, for example, earns \$5,000 on a \$100,000 sale of real estate.
- **Bonus** is pay over and above base salary (or wage or commission). A bonus is usually paid for exceptional performance—in a single amount after year-end.
- **Benefits** are extra compensation—items that are not paid directly to the employee. Benefits cover health, life, and disability insurance. The employer pays the insurance company, which then provides coverage for the employee. Another type of benefit, retirement, sets aside money for the employee for his or her future retirement.

Businesses pay employees at a base rate for a set period—called *straight time*. For additional hours—*overtime*—the employee may get a higher pay rate, depending on the job classification and wage and hour laws.

Assume Ryan Oliver was hired as an accountant for Smart Touch. His pay is as follows:

- Ryan earns wages of \$600 per week for straight time (40 hours), so his hourly pay rate is \$15 (\$600/40).
- The company pays *time-and-a-half* for overtime. That rate is 150% (1.5 times) the straight-time pay rate. Thus, Ryan earns \$22.50 per hour of overtime ($15.00 \times 1.5 = \$22.50$).
- For working 42 hours during a week, he earns gross pay of \$645, computed as follows:

Straight-time pay for 40 hours	\$600
Overtime pay for 2 overtime hours: $2 \times \$22.50$	45
Gross pay	<u>\$645</u>

Gross Pay and Net (Take-Home) Pay

Two pay amounts are important for accounting purposes:

- **Gross pay** is the total amount of salary, wages, commissions, and bonuses earned by the employee during a pay period, before taxes or any other deductions. Gross pay is an expense to the employer. In the preceding example, Ryan Oliver's gross pay was \$645.

- Net pay is the amount the employee gets to keep. **Net pay is also called take-home pay.** Take-home pay equals gross pay minus all deductions. The employer either writes a paycheck to each employee for his or her take-home pay or direct deposits the employee's take home pay into the employee's bank account.

Payroll Withholding Deductions

The federal government and most states require employers to deduct taxes from employee paychecks. Insurance companies and investment companies may also get some of the employee's gross pay. Amounts withheld from paychecks are called *withholding deductions*. Payroll withholding deductions are the difference between gross pay and take-home pay. These deductions are withheld from paychecks and sent directly to the government, to insurance companies, or to other entities. Payroll withholding deductions fall into two categories:

- *Required deductions*, such as employee federal and state income tax and Social Security tax. Employees pay their income tax and Social Security tax through payroll deductions.
- *Optional deductions*, including insurance premiums, retirement plan contributions, charitable contributions, and other amounts that are withheld at the employee's request.

After being withheld, payroll deductions become the liability of the employer, who then pays the outside party—taxes to the government and contributions to charitable organizations, for example.

Required Withholding for Employee Income Tax

United States law requires companies to withhold income tax from employee paychecks. The income tax deducted from gross pay is called **withheld income tax**. The amount withheld depends on the employee's gross pay and on the number of *withholding allowances* he or she claims.

An employee files Form W-4 with his or her employer to indicate the number of allowances claimed for income-tax withholding. Each allowance lowers the amount of tax withheld:

- An unmarried taxpayer usually claims one allowance.
- A childless married couple usually claims two allowances.
- A married couple with one child usually claims three allowances, and so on.

Exhibit 10-3 shows a W-4 for Ryan Oliver, who claims married with three allowances (line 5).

Required Withholding for Employee Social Security (FICA) Tax

The Federal Insurance Contributions Act (FICA), also known as the Social Security Act, created the Social Security Tax. The Social Security program provides retirement, disability, and medical benefits. The law requires employers to withhold **Social Security (FICA) tax** from employees' paychecks. The FICA tax has two components:

1. Old age, survivors, and disability insurance (OASDI)
2. Health insurance (Medicare)

The amount of tax withheld varies from year to year because the wage base is subject to OASDI tax changes each year. For 2010, the OASDI tax applies to the first \$106,800 of employee earnings in a year. The taxable amount of earnings is adjusted annually. The OASDI tax rate is 6.2%. Therefore, the maximum OASDI tax that an employee paid in 2010 was \$6,622 ($\$106,800 \times 0.062$).

EXHIBIT 10-3

W-4 for Ryan Oliver (2010 form was the latest form released by the IRS at the time of printing)

Form W-4 Department of the Treasury Internal Revenue Service		Employee's Withholding Allowance Certificate ▶ Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.		OMB No. 1545-0074 2010
1 Type or print your first name and middle initial. Ryan G.		Last name Oliver		2 Your social security number 123 45 6789
Home address (number and street or rural route) 305 Lost Key Drive		3 <input type="checkbox"/> Single <input checked="" type="checkbox"/> Married <input type="checkbox"/> Married, but withheld at higher Single rate. Note: If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.		
City or town, state, and ZIP code Pensacola, FL 32526		4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card. <input type="checkbox"/>		
5 Total number of allowances you are claiming (from line H above or from the applicable worksheet on page 2) 3		6 \$ 3		
7 I claim exemption from withholding for 2010, and I certify that I meet both of the following conditions for exemption. • Last year I had a right to a refund of all federal income tax withheld because I had no tax liability and • This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here 7		Under penalties of perjury, I declare that I have examined this certificate and to the best of my knowledge and belief, it is true, correct, and complete.		
Employee's signature (Form is not valid unless you sign it.) Ryan G. Oliver		Date 1/1/2013		
8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.) Smart Touch Learning; 281 Wave Ave; Niceville, FL 32578		9 Office code (optional) 20		10 Employer identification number (EIN) 1234567
For Privacy Act and Paperwork Reduction Act Notice, see page 2.		Cat. No. 10220Q Form W-4 (2010)		

The Medicare portion of the FICA tax applies to all employee earnings—that means that there is no maximum tax. This tax rate is 1.45%. Therefore, an employee pays a combined FICA tax rate of 7.65% (6.2% + 1.45%) of the first \$106,800 of annual earnings (\$106,800 is the 2010 rate as it was the most current wage cap at the time of printing), plus 1.45% of earnings above \$106,800.

To make your calculations easier to compute, assume that the 2012 FICA tax rate is 7.65%. The wage limit for Social Security (6.2%) is only on the first \$106,800 of employee earnings each year. For Medicare, there is no wage limit. (Use these numbers when you complete this chapter's assignments.)

Assume that James Kolen, another employee of Smart Touch, earned \$99,800 prior to December. Kolen's salary for December is \$10,000.

- How much of Kolen's December salary is subject to FICA tax? Only \$7,000 is subject to Social Security tax—from \$99,800 up to the \$106,800 maximum. All \$10,000 is subject to Medicare tax.
- How much FICA tax will be withheld from Kolen's December paycheck? The computation follows:

	OASDI (Social Security)	HI (Medicare)
Employee earnings subject to the tax in one year	\$106,800	No max
Employee earnings prior to the current month	– 99,800	
Current pay subject to OASDI portion of FICA tax	\$ 7,000	\$ 10,000
FICA tax rate	× 0.062	× 0.0145
FICA tax to be withheld from the current paycheck	\$ 434	\$ 145
Total OASDI & HI tax (434 + 145)	\$ 579	

Optional Withholding Deductions

As a convenience to employees, some companies withhold payroll deductions and then pay designated organizations according to employee instructions. Insurance premiums, retirement savings, union dues, and gifts to charities are examples.

The following table summarizes James Kolen's final pay period on December 31. Employee income tax is assumed to be 20% of gross pay. The FICA tax of \$579 was calculated on the previous page. The insurance and contribution amounts are assumed.

Gross pay	\$10,000
Withholding deductions:	
Employee income tax (20%)	\$2,000
Employee FICA tax	579
Employee co-pay for health insurance	180
Employee contribution to United Way	20
Total withholdings	2,779
Net (take-home) pay	<u>\$ 7,221</u>

Employer Payroll Taxes

In addition to income tax and FICA tax, which are withheld from employee paychecks, *employers* must pay at least three payroll taxes. These taxes do *not* come out of employee paychecks:

1. Employer FICA tax
2. State unemployment compensation tax
3. Federal unemployment compensation tax

Employer FICA Tax

In addition to the FICA tax withheld from the employee's paycheck, the employer must pay an equal amount into the program. The Social Security system is funded by equal contributions from employer and employee.

State and Federal Unemployment Compensation Taxes

State and federal unemployment compensation taxes finance workers' compensation for people laid off from work. In recent years, employers have paid a combined tax of 6.2% on the first \$7,000 of each employee's annual earnings for unemployment tax. The proportion paid to the state depends on the individual state, but for many it is 5.4% to the state plus 0.8% to the federal government. For this payroll tax, the employer uses two liability accounts:

- Federal unemployment tax payable (FUTA payable)
- State unemployment tax payable (SUTA payable)

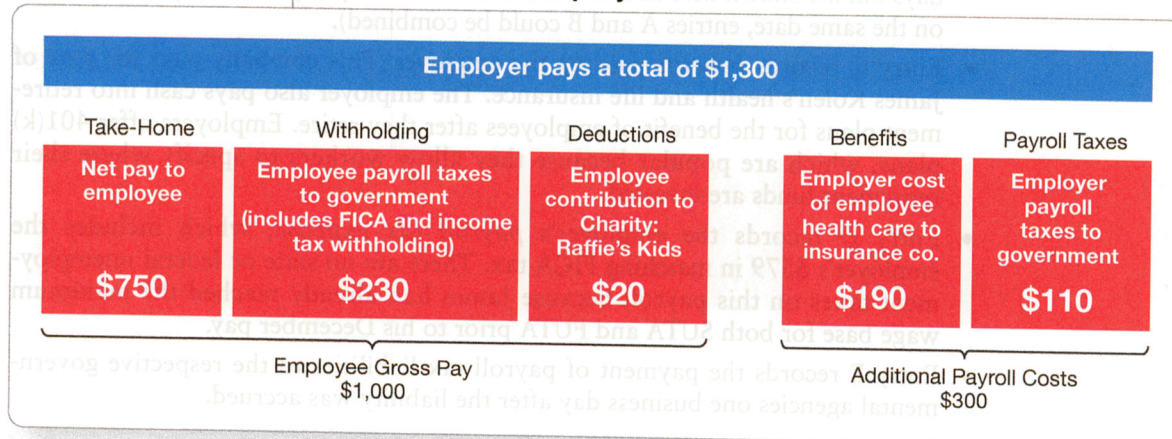
Exhibit 10-4 shows a typical distribution of payroll costs for an employee who earns a weekly salary of \$1,000. All amounts are assumed.

Key Takeaway

Almost all businesses have employees and, thus, have payroll to pay. It is important to remember that taxes the employee pays are deducted from the employee's gross pay before the employee gets his or her paycheck. The employer must also pay taxes based on the gross pay of each employee. Each tax has its own unique purpose as well as its own annual maximum.

EXHIBIT 10-4

Typical Breakdown of Payroll Costs for One Employee



Journalizing Payroll Transactions

Exhibit 10-5A summarizes an employer's entries for a monthly payroll of \$10,000. All amounts are assumed, based on James Kolen's December salary.

4 Journalize basic payroll transactions

EXHIBIT 10-5A

Payroll Accounting by the Employer—James Kolen's Paydate December 31, 2013

	2013			
a.	Dec 31	Salary expense (E+)	10,000	
		Salary payable (L+)		10,000
		To record salary expense.		
b.	Dec 31	Salary payable (L-)	10,000	
		Employee income tax payable (L+)	2,000	
		FICA tax payable (L+)	579	
		Payable to health insurance (L+)	180	
		Payable to United Way (L+)	20	
		Cash (take-home pay) (A-)	7,221	
		To record payment of salaries.		
c.	Dec 31	Health insurance expense (E+)	800	
		Life insurance expense (E+)	200	
		Retirement plan expense (E+)	500	
		Employee benefits payable (L+)		1,500
		To record employee benefits payable by the employer.		
d.	Dec 31	Payroll tax expense (E+)**	579	
		FICA tax payable (L+)		579
		To record employer's payroll taxes.		
	2014			
e.	Jan 2	Employee income tax payable (L-)	2,000	
		FICA tax payable (L-) (\$579 + \$579)	1,158	
		Cash (A-) (\$2,000 + \$1,158)		3,158
		To record payment of payroll taxes to the government.		

*The red colored boxes throughout the chapter reference Exhibit 11-5 in Chapter 11 on page 547.

**No FUTA or SUTA tax is due in December because James is over the maximum wage base.

- Entry A records the salary expense accrual and the liability based on gross pay.
- Entry B records the payment of salaries. Gross salary is \$10,000, and net (take-home) pay is \$7,221. There is a payable to United Way of \$20 because James Kolen

specified this charitable deduction. (Note entries A and B often occur on different days but are shown here as December 31. If the salary expense and payment occur on the same date, entries A and B could be combined).

- Entry C records *benefits* paid by the employer. This company pays for part of James Kolen's health and life insurance. The employer also pays cash into retirement plans for the benefit of employees after they retire. Employers offer 401(k) plans, which are popular because they allow workers to specify where their retirement funds are invested.
- Entry D records the employer's *payroll tax expense*, which includes the employer's \$579 in matching FICA tax. There are no state or federal unemployment taxes on this payroll because James had already reached the maximum wage base for both SUTA and FUTA prior to his December pay.
- Entry E records the payment of payroll tax liabilities to the respective governmental agencies one business day after the liability was accrued.

What if the payday for James Kolen were January 6, 2014, instead of December 31, 2013—would James's pay change? What about the employer's taxes—would they change? Exhibit 10-5B shows the changes, highlighted in blue:

EXHIBIT 10-5B Payroll Accounting by the Employer—James Kolen's Paydate January 6, 2014

	2013			
a.	Dec 31	Salary expense (E+)	10,000	
		Salary payable (L+)		10,000
		<i>To record salary expense.</i>		
	2014			
b.	Jan 6	Salary payable (L-)	10,000	
		Employee income tax payable (L+)		2,000
		FICA tax payable (L+) (10,000 [^] × 7.65%)		765
		Payable to health insurance (L+)		180
		Payable to United Way (L+)		20
		Cash (take home pay) (A-)		7,035
		<i>To record payment of salaries.</i>		
	2013			
c.	Dec 31	Health insurance expense (E+)	800	
		Life insurance expense (E+)	200	
		Retirement plan expense (E+)	500	
		Employee benefits payable (L+)		1,500
		<i>To record employee benefits payable by the employer.</i>		
	2014			
d.	Jan 6	Payroll tax expense (E+) (\$765 + \$378 + \$56)	1,199	
		FICA tax payable (L+) (10,000 [^] × 7.65%)		765
		State unemployment tax payable (L+) (7,000* × 5.4%)		378
		Federal unemployment tax payable (L+) (7,000* × 0.8%)		56
		<i>To record employer's payroll taxes.</i>		
	2014			
e.	Jan 7	Employee income tax payable (L-)	2,000	
		FICA tax payable (L-) (\$765 + \$765)	1,530	
		State unemployment tax payable (L-)	378	
		Federal unemployment tax payable (L-)	56	
		Cash (A-) (\$2,000 + \$1,530 + \$378 + \$56)		3,964
		<i>To record payment of payroll taxes to the government.</i>		

[^]All \$10,000 of James's wages would be subject to FICA tax because James's 2014 year-to-date wages would be less than the Social Security max wage limit of \$106,800.

*James's 2014 year-to-date wages of \$10,000 on January 6 would be greater than the annual unemployment maximum taxable wage base of \$7,000. So, only \$7,000 of James's \$10,000 gross pay would be subject to federal and state unemployment taxes.

Internal Control over Payroll

There are two main controls for payroll:

- Controls for efficiency
- Controls to safeguard payroll disbursements

Controls for Efficiency

Reconciling the bank account can be time-consuming because there may be many outstanding paychecks. To limit the outstanding checks, a company may use two payroll bank accounts. It pays the payroll from one account one month and from the other account the next month. This way the company can reconcile each account every other month, and that decreases accounting expense. Alternatively, the company may require direct deposits for employees' pay.

Payroll transactions are ideal for computer processing. The payroll data are stored in a file, and the computer makes the calculations, prints paychecks, and updates all records electronically.

Controls to Safeguard Payroll Disbursements

The owner of a small business can monitor his or her payroll by personal contact with employees. Large companies cannot. A particular risk is that a paycheck may be written to a fictitious person and cashed by a dishonest employee. To guard against this, large businesses adopt strict internal controls for payrolls.

Hiring and firing employees should be separated from accounting and from passing out paychecks. Photo IDs ensure that only actual employees are paid. Employees clock in at the start and clock out at the end of the workday to prove their attendance and hours worked.

As we saw in Chapter 7, the foundation of internal control is the separation of duties. This is why companies have separate departments for the following payroll functions:

- The Human Resources Department hires and fires workers.
- The Payroll Department maintains employee earnings records.
- The Accounting Department records all transactions.
- The Treasurer (or bursar) distributes paychecks to employees.

Now let's summarize the accounting for payroll by examining the Decision Guidelines on the next page.

Key Takeaway

Recording payroll amounts requires five basic journal entries. The first entry records the gross payroll expense and liability. The second entry records the payment of net pay and the accrual of all employee-paid payroll liabilities. The third entry records employee benefits. The fourth journal entry records the employer payroll liabilities. The last journal entry records the payment of taxes to the taxing authorities. These payroll liabilities are all current liabilities of the company. Internal controls over payroll focus on operational efficiency and insuring the payroll disbursements are valid and accurate.

Decision Guidelines 10-2

ACCOUNTING FOR PAYROLL

What decisions must Smart Touch on the next page (or any another company) make to account for payroll?

Decision	Guidelines
<ul style="list-style-type: none"> What records will Smart Touch keep in its payroll system to determine how much income tax to withhold from an employee's pay? 	Employee's Withholding Allowance Certificate, Form W-4
<ul style="list-style-type: none"> How does Smart Touch determine an employee's take-home pay? 	$Gross\ pay$ (Total amount earned by the employee) – <i>Payroll withholding deductions</i> : <ol style="list-style-type: none"> Withheld income tax Withheld FICA tax—equal amount also paid by employer Optional withholding deductions (insurance, retirement, charitable contributions, union dues) $= Net\ (take-home)\ pay$
<ul style="list-style-type: none"> What is Smart Touch's total payroll expense? 	$Total\ payroll\ expense = Gross\ pay$ + <i>Employer paid benefits</i> <ol style="list-style-type: none"> Insurance (health, life, and disability) Retirement benefits + <i>Employer payroll taxes</i> <ol style="list-style-type: none"> Employer FICA tax—equal amount also paid by employee Employer state and federal unemployment taxes
<ul style="list-style-type: none"> Where will Smart Touch report payroll costs? 	<ul style="list-style-type: none"> Payroll expenses on the income statement Payroll liabilities on the balance sheet

Summary Problem 10-2

Rags-to-Riches, a clothing resale store, employs one salesperson, Dee Hunter. Hunter's straight-time wage is \$400 per week, with time-and-a-half pay for hours above 40. Rags-to-Riches withholds income tax (10%) and FICA tax (7.65%) from Hunter's pay. Rags-to-Riches also pays payroll taxes for FICA (7.65%) and state and federal unemployment (5.4% and 0.8%, respectively). In addition, Rags-to-Riches contributes 6% of Hunter's gross pay into her retirement plan.

During the week ended December 26, Hunter worked 50 hours. Prior to this week, she had earned \$2,000.

Requirements

(Round all amounts to the nearest dollar.)

1. Compute Hunter's gross pay and net (take-home) pay for the week.
2. Record the payroll entries that Rags-to-Riches would make for each of the following:
 - a. Hunter's gross pay, including overtime
 - b. Expense for employee benefits
 - c. Employer payroll taxes
 - d. Payment of net pay to Hunter
 - e. Payment for employee benefits
 - f. Payment of all payroll taxes
3. How much was Rags-to-Riches' total payroll expense for the week?

Solution

Requirement 1

Gross pay:	Straight-time pay for 40 hours	\$400	
	Overtime pay:		
	Rate per hour ($\$400/40 \times 1.5$)	\$15	
	Hours (50 – 40)	10	150
	Gross pay		<u>\$550</u>
Net pay:	Gross pay		\$550
	Less: Withheld income tax ($\$550 \times 0.10$)	\$55	
	Withheld FICA tax ($\$550 \times 0.0765$)	42	97
	Net pay		<u><u>\$453</u></u>

Requirement 2

a.	Wages expense (E+)	550	
	Wages payable (L+)		550
b.	Retirement-plan expense ($\$550 \times 0.06$) (E+)	33	
	Employee benefits payable (L+)		33
c.	Payroll tax expense (E+)	76	
	FICA tax payable ($\$550 \times 0.0765$) (L+)		42
	State unemployment tax payable ($\$550 \times 0.054$) (L+)		30
	Federal unemployment tax payable ($\$550 \times 0.008$) (L+)		4
d.	Wages payable (L-)	550	
	Employee income tax payable (L+)		55
	FICA tax payable (L+)		42
	Cash (A-)		453
e.	Employee benefits payable (L-)	33	
	Cash (A-)		33
f.	Employee income tax payable (L-)	55	
	FICA tax payable ($\$42 \times 2$) (L-)	84	
	State unemployment tax payable (L-)	30	
	Federal unemployment tax payable (L-)	4	
	Cash (A-)		173

Requirement 3

Rags-to-Riches incurred *total payroll expense* of \$659 (gross pay of \$550 + payroll taxes of \$76 + benefits of \$33). See entries (a) through (c).

Review Current Liabilities and Payroll

Accounting Vocabulary

Contingent Liability (p. 501)

A potential liability that depends on some future event.

Current Maturity (p. 499)

Amount of the principal that is payable within one year. Also called **current portion of notes payable**.

Current Portion of Notes Payable (p. 499)

Amount of the principal that is payable within one year. Also called **current maturity**.

Employee Compensation (p. 505)

A major expense. Also called **payroll**.

Federal Insurance Contributions Act (FICA) Tax (p. 506)

Federal Insurance Contributions Act (FICA) tax, which is withheld from employees' pay and matched by the employer. Also called **Social Security tax**.

Gross Pay (p. 505)

Total amount of salary, wages, commissions, or any other employee compensation before taxes and other deductions.

Net (Take-Home) Pay (p. 506)

Gross pay minus all deductions. The amount of compensation that the employee actually takes home.

Payroll (p. 505)

A major expense. Also called **employee compensation**.

Short-Term Note Payable (p. 498)

Promissory note payable due within one year—a common form of financing.

Social Security (FICA) Tax (p. 506)

Federal Insurance Contributions Act (FICA) tax, which is withheld from employees' pay and matched by the employer. Also called **FICA tax**.

Unemployment Compensation Tax (p. 508)

Payroll tax paid by employers to the government, which uses the money to pay unemployment benefits to people who are out of work.

Warranties (p. 500)

Product guarantees.

Withheld Income Tax (p. 506)

Income tax deducted from employees' gross pay.

Destination: Student Success

Student Success Tips

The following are hints on some common trouble areas for students in this chapter:

- Keep in mind that current is defined as one year or the operating cycle, whichever is less. So current liabilities will be paid in one year or less.
- Recall the formula for interest is $\text{Principal} \times \text{Rate} \times \text{Time}$. Interest expense accrues on the liability as the amount of time passes on the note.
- Remember the cash received from a taxable sale is split between the sales revenue earned and the liability to the state for the sales tax collected.
- Recall the current portion of long-term notes is only the portion of principal that is due currently (in a year or less).
- Remember that unearned revenue results when the company is paid by a customer BEFORE the company does the work (earnings); therefore, it is a liability—the company owes the work or it must pay the money back.
- Consider that contingent means dependent on some future event. So, contingent liabilities are potential liabilities that depend on the future event's outcome.
- Recall in calculating payroll, some taxes the employee pays (federal income tax withholding), some taxes the employer pays (unemployment taxes), and some taxes both employee and employer must pay (Social Security and Medicare).

Getting Help

If there's a learning objective from the chapter you aren't confident about, try using one or more of the following resources:

- Review Exhibit 10-4 for a depiction of total payroll costs.
- Review the Summary Problems in the chapter to reinforce your understanding of current liabilities and payroll.
- Practice additional exercises or problems at the end of Chapter 10 that cover the specific learning objective that is challenging you.
- Watch the white board videos for Chapter 10, located at myaccountinglab.com under the Chapter Resources button.
- Go to myaccountinglab.com and select the Study Plan button. Choose Chapter 10 and work the questions covering that specific learning objective until you've mastered it.
- Work the Chapter 10 pre/post tests in myaccountinglab.com.
- Visit the learning resource center on your campus for tutoring.

Quick Check

Experience the Power of Practice!

As denoted by the logo, all of these questions, as well as additional practice materials, can be found in

MyAccountingLab

Please visit
myaccountinglab.com

- Known liabilities of estimated amounts are
 - ignored. (Record them when paid.)
 - reported on the balance sheet.
 - contingent liabilities.
 - reported only in the notes to the financial statements.
- On January 1, 2012, you borrowed \$18,000 on a five-year, 5% note payable. At December 31, 2013, you should record
 - interest payable of \$900.
 - note receivable of \$18,000.
 - cash payment of \$18,000.
 - nothing. (The note is already on the books.)
- Your company sells \$180,000 of goods and you collect sales tax of 8%. What current liability does the sale create?
 - Sales tax payable of \$14,400
 - Sales revenue of \$194,400
 - Unearned revenue of \$14,400
 - None; you collected cash up front.
- Wells Electric (WE) owed Estimated warranty payable of \$1,200 at the end of 2011. During 2012, WE made sales of \$120,000 and expects product warranties to cost the company 3% of the sales. During 2012, WE paid \$2,300 for warranties. What is WE's Estimated warranty payable at the end of 2012?
 - \$2,300
 - \$2,500
 - \$3,600
 - \$4,800
- At December 31, your company owes employees for three days of the five-day workweek. The total payroll for the week is \$7,800. What journal entry should you make at December 31?
 - Nothing because you will pay the employees on Friday.
 - | | | |
|----------------|-------|-------|
| Salary expense | 7,800 | |
| Salary payable | | 7,800 |
 - | | | |
|----------------|-------|-------|
| Salary payable | 4,680 | |
| Salary expense | | 4,680 |
 - | | | |
|----------------|-------|-------|
| Salary expense | 4,680 | |
| Salary payable | | 4,680 |
- Swell Company has a lawsuit pending from a customer claiming damages of \$100,000. Swell's attorney advises that the likelihood the customer will win is remote. GAAP requires at a minimum that this contingent liability be
 - disclosed in the footnotes.
 - disclosed in the footnotes, with ranges of potential loss.
 - booked, as well as disclosed in the footnotes.
 - No disclosure is required.

7. An employee has year-to-date earnings of \$105,000. The employee's gross pay for the next pay period is \$5,000. If the FICA wage base is \$106,800, how much FICA tax will be withheld from the employee's pay?
 - a. \$184.10
 - b. \$382.50
 - c. \$310.00
 - d. \$137.70
8. The employer is responsible for which of the following payroll taxes?
 - a. 6.2% Social Security
 - b. 1.45% Medicare tax
 - c. Federal and state unemployment taxes
 - d. All of the above
9. Jade Larson Antiques owes \$20,000 on a truck purchased for use in the business. The company makes principal payments of \$5,000 each year plus interest at 8%. Which of the following is true?
 - a. After the first payment is made, the company owes \$15,000 plus three year's interest.
 - b. After the first payment, \$15,000 would be shown as a long-term liability.
 - c. After the first payment is made, \$5,000 would be shown as the current portion due on the long-term note.
 - d. Just before the last payment is made, \$5,000 will appear as a long-term liability on the balance sheet.
10. Sydney Park Fitness Gym has Unearned revenue of \$10,000, Salaries payable of \$15,000, and Allowance for uncollectible accounts of \$5,000. What amount would Sydney report as Total current liabilities?
 - a. \$30,000
 - b. \$25,000
 - c. \$20,000
 - d. \$15,000

Answers are given after Apply Your Knowledge (p. 528).

Assess Your Progress

• Short Exercises

S10-1 1 Accounting for a note payable [10 min]

On December 31, 2012, Edmont purchased \$10,000 of inventory on a one-year, 10% note payable. Edmont uses a perpetual inventory system.

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Requirements

1. Journalize the company's accrual of interest expense on June 30, 2013, its fiscal year-end.
2. Journalize the company's payment of the note plus interest on December 31, 2013.

S10-2 2 Accounting for warranty expense and warranty payable [10 min]

Trekster Corrector guarantees its snowmobiles for three years. Company experience indicates that warranty costs will add up to 4% of sales.

Assume that the Trekster dealer in Colorado Springs made sales totaling \$533,000 during 2012. The company received cash for 30% of the sales and notes receivable for the remainder. Warranty payments totaled \$17,000 during 2012.

Requirements

1. Record the sales, warranty expense, and warranty payments for the company.
2. Post to the Estimated warranty payable T-account. At the end of 2012, how much in Estimated warranty payable does the company owe?

S10-3 2 Interpreting an actual company's contingent liabilities [5–10 min]

Farley Motors, a motorcycle manufacturer, included the following note (adapted) in its annual report:

Notes to Consolidated Financial Statements

7 Commitments and Contingencies (Adapted)

The Company self-insures its product liability losses in the United States up to \$3,000,000. Catastrophic coverage is maintained for individual claims in excess of \$3,000,000 up to \$25,000,000.

Requirements

1. Why are these *contingent* (versus actual) liabilities?
2. How can a contingent liability become an actual liability for Farley Motors? What are the limits to the company's product liabilities in the United States?

S10-4 3 Computing an employee's total pay [10 min]

Gloria Traxell is paid \$800 for a 40-hour workweek and time-and-a-half for hours above 40.

Requirements

1. Compute Traxell's gross pay for working 48 hours during the first week of February. Carry amounts to the nearest cent.
2. Traxell is single, and her income tax withholding is 10% of total pay. Traxell's only payroll deductions are payroll taxes. Compute Traxell's net (take-home) pay for the week. Use a 7.65% FICA tax rate, and carry amounts to the nearest cent.

Note: Short Exercise 10-5 should be used only after completing Short Exercise 10-4.

S10-5 3 Computing the payroll expense of an employer [10 min]

Return to the Gloria Traxell payroll situation in Short Exercise 10-4. Traxell's employer, College of San Bernardino, pays all the standard payroll taxes plus benefits for the employee retirement plan (5% of total pay), health insurance (\$113 per employee per month), and disability insurance (\$8 per employee per month).

Requirement

1. Compute College of San Bernardino's total expense of employing Gloria Traxell for the 48 hours that she worked during the first week of February. Carry amounts to the nearest cent.

S10-6 3 Computing payroll amounts considering Social Security tax ceilings [10 min]

Suppose you work for MRK, the accounting firm, all year and earn a monthly salary of \$5,700. There is no overtime pay. Your withheld income taxes consume 15% of gross pay. In addition to payroll taxes, you elect to contribute 5% monthly to your retirement plan. MRK also deducts \$150 monthly for your co-pay of the health insurance premium.

Requirement

1. Compute your net pay for November. Use 7.65% FICA tax rate and assume the 2010 FICA wage ceiling of \$106,800 applies.

Note: Short Exercise 10-7 should be used only after completing Short Exercises 10-4 and 10-5.

S10-7 4 Journalizing payroll [10 min]

Consult your solutions for Short Exercises 10-4 and 10-5.

Requirements

1. Journalize salary expense and payment for College of San Bernardino related to the employment of Gloria Traxell.
2. Journalize benefits expense for College of San Bernardino related to the employment of Gloria Traxell.
3. Journalize employer payroll taxes for College of San Bernardino related to the employment of Gloria Traxell.

Exercises

E10-8 1 Recording sales tax [5–15 min]

Consider the following transactions of Pearl Software:

Mar 31	Recorded cash sales of \$180,000, plus sales tax of 8% collected for the state of Texas.
Apr 6	Sent March sales tax to the state.

Requirement

1. Journalize the transactions for the company.

E10-9 1 Recording note payable transactions [5–10 min]

Consider the following note payable transactions of Creative Video Productions.

2012	
May 1	Purchased equipment costing \$17,000 by issuing a one-year, 6% note payable.
Dec 31	Accrued interest on the note payable.
2013	
May 1	Paid the note payable at maturity.

Requirement

1. Journalize the transactions for the company.

E10-10 1 Recording and reporting current liabilities [10–15 min]

TransWorld Publishing completed the following transactions during 2012:

Oct 1	Sold a six-month subscription, collecting cash of \$330, plus sales tax of 9%.
Nov 15	Remitted (paid) the sales tax to the state of Tennessee.
Dec 31	Made the necessary adjustment at year-end to record the amount of subscription revenue earned during the year.

Requirement

1. Journalize the transactions (explanations are not required).

E10-11 1 Journalizing current liabilities [15 min]

Edmund O'Mally Associates reported short-term notes payable and salary payable as follows:

	2012	2011
Current liabilities—Partial:		
Short-term notes payable	\$ 16,400	\$ 15,600
Salary payable	3,400	3,100

During 2012, O'Mally paid off both current liabilities that were left over from 2011, borrowed money on short-term notes payable, and accrued salary expense.

Requirement

1. Journalize all four of these transactions for O'Mally during 2012.

E10-12 2 Accounting for warranty expense and warranty payable [5–15 min]

The accounting records of Clay Ceramics included the following at January 1, 2012:

Estimated warranty payable

Beginning balance	4,000
-------------------	-------

In the past, Clay's warranty expense has been 8% of sales. During 2012, Clay made sales of \$136,000 and paid \$7,000 to satisfy warranty claims.

Requirements

1. Journalize Clay's warranty expense and warranty payments during 2012. Explanations are not required.
2. What balance of Estimated warranty payable will Clay report on its balance sheet at December 31, 2012?

E10-13 3 4 Computing and recording gross and net pay [10–15 min]

Henry Striker manages a Frosty Boy drive-in. His straight-time pay is \$10 per hour, with time-and-a-half for hours in excess of 40 per week. Striker's payroll deductions include withheld income tax of 8%, FICA tax of 7.65%, and a weekly deduction of \$5 for a charitable contribution to the United Fund. Striker worked 52 hours during the week.

Requirements

1. Compute Striker's gross pay and net pay for the week. Carry amounts to the nearest cent.
2. Journalize Frosty Boy's wage expense accrual for Striker's work. An explanation is not required.
3. Journalize the subsequent payment of wages to Striker.

E10-14 4 Recording a payroll [10–15 min]

Ricardo's Mexican Restaurants incurred salary expense of \$65,000 for 2012. The payroll expense includes employer FICA tax of 7.65%, in addition to state unemployment tax of 5.4% and federal unemployment tax of 0.8%. Of the total salaries, \$17,000 is subject to unemployment tax. Also, the company provides the following benefits for employees: health insurance (cost to the company, \$2,060), life insurance (cost to the company, \$350), and retirement benefits (cost to the company, 7% of salary expense).

Requirement

1. Journalize Ricardo's expenses for employee benefits and for payroll taxes. Explanations are not required.

● Problems (Group A)

P10-15A 1 2 Journalizing liability transactions [30–40 min]

The following transactions of Denver Pharmacies occurred during 2011 and 2012:

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2011

- Jan 9 Purchased computer equipment at a cost of \$9,000, signing a six-month, 6% note payable for that amount.
- 29 Recorded the week's sales of \$64,000, three-fourths on credit, and one-fourth for cash. Sales amounts are subject to a 6% state sales tax.
- Feb 5 Sent the last week's sales tax to the state.
- 28 Borrowed \$204,000 on a four-year, 10% note payable that calls for \$51,000 annual installment payments plus interest. Record the current and long-term portions of the note payable in two separate accounts.
- Jul 9 Paid the six-month, 6% note, plus interest, at maturity.
- Aug 31 Purchased inventory for \$12,000, signing a six-month, 9% note payable.
- Dec 31 Accrued warranty expense, which is estimated at 2% of sales of \$603,000.
- 31 Accrued interest on all outstanding notes payable. Make a separate interest accrual for each note payable.

2012

- Feb 28 Paid the first installment and interest for one year on the four-year note payable.
- 29 Paid off the 9% note plus interest at maturity.

Requirement

1. Journalize the transactions in Denver's general journal. Explanations are not required.

P10-16A 2 Journalizing liability transactions [20–25 min]

The following transactions of Brooks Garrett occurred during 2012:

- Apr 30 Garrett is party to a patent infringement lawsuit of \$200,000. Garrett's attorney is certain it is remote that Garrett will lose this lawsuit.
- Jun 30 Estimated warranty expense at 2% of sales of \$400,000.
- Jul 28 Warranty claims paid in the amount of \$6,000.
- Sep 30 Garrett is party to a lawsuit for copyright violation of \$100,000. Garrett's attorney advises that it is probable Garrett will lose this lawsuit.
- Dec 31 Garrett estimates warranty expense on sales for the second half of the year of \$500,000 at 2%.

Requirements

1. Journalize required transactions, if any, in Garrett's general journal. Explanations are not required.
2. What is the balance in Estimated warranty payable?

P10-17A 1 3 Journalizing and posting liabilities [35–45 min]

The general ledger of Speedy Ship at June 30, 2012, the end of the company's fiscal year, includes the following account balances before adjusting entries.

Accounts payable	\$ 114,000
Current portion of notes payable	
Interest payable	
Salary payable	
Employee payroll taxes payable	970
Employer payroll taxes payable	
Unearned rent revenue	6,900
Long-term note payable	210,000

The additional data needed to develop the adjusting entries at June 30 are as follows:

- The long-term debt is payable in annual installments of \$42,000, with the next installment due on July 31. On that date, Speedy Ship will also pay one year's interest at 8%. Interest was last paid on July 31 of the preceding year. Make the adjusting entry to shift the current installment of the long-term note payable to a current liability. Also accrue interest expense at year end.
- Gross salaries for the last payroll of the fiscal year were \$4,300.
- Employer payroll taxes owed are \$850.
- On February 1, the company collected one year's rent of \$6,900 in advance.

Requirements

- Using the four-column ledger format, open the listed accounts and insert the unadjusted June 30 balances.
- Journalize and post the June 30 adjusting entries to the accounts that you opened. Key adjusting entries by letter.
- Prepare the current liabilities section of the balance sheet at June 30, 2012.

P10-18A 3 4 Computing and journalizing payroll amounts [25–35 min]

Louis Welch is general manager of United Tanning Salons. During 2012, Welch worked for the company all year at a \$6,200 monthly salary. He also earned a year-end bonus equal to 10% of his salary.

Welch's federal income tax withheld during 2012 was \$850 per month, plus \$924 on his bonus check. State income tax withheld came to \$70 per month, plus \$40 on the bonus. The FICA tax withheld was 7.65% of the first \$106,800 in annual earnings. Welch authorized the following payroll deductions: Charity Fund contribution of 1% of total earnings and life insurance of \$5 per month.

United incurred payroll tax expense on Welch for FICA tax of 7.65% of the first \$106,800 in annual earnings. The company also paid state unemployment tax of 5.4% and federal unemployment tax of 0.8% on the first \$7,000 in annual earnings. In addition, United provides Welch with health insurance at a cost of \$150 per month. During 2012, United paid \$4,000 into Welch's retirement plan.

Requirements

- Compute Welch's gross pay, payroll deductions, and net pay for the full year 2012. Round all amounts to the nearest dollar.
- Compute United's total 2012 payroll expense for Welch.
- Make the journal entry to record United's expense for Welch's total earnings for the year, his payroll deductions, and net pay. Debit Salary expense and Bonus expense as appropriate. Credit liability accounts for the payroll deductions and Cash for net pay. An explanation is not required.

● Problems (Group B)

P10-19B 1 2 Journalizing liability transactions [30–40 min]



The following transactions of Plymouth Pharmacies occurred during 2011 and 2012:

2011

- Jan 9 Purchased computer equipment at a cost of \$7,000, signing a six-month, 9% note payable for that amount.
- 29 Recorded the week's sales of \$67,000, three-fourths on credit, and one-fourth for cash. Sales amounts are subject to a 6% state sales tax.
- Feb 5 Sent the last week's sales tax to the state.
- 28 Borrowed \$210,000 on a four-year, 8% note payable that calls for \$52,500 annual installment payments plus interest. Record the current and long-term portions of the note payable in two separate accounts.
- Jul 9 Paid the six-month, 9% note, plus interest, at maturity.
- Aug 31 Purchased inventory for \$6,000, signing a six-month, 11% note payable.
- Dec 31 Accrued warranty expense, which is estimated at 4% of sales of \$608,000.
- 31 Accrued interest on all outstanding notes payable. Make a separate interest accrual for each note payable.

2012

- Feb 28 Paid the first installment and interest for one year on the four-year note payable.
- 29 Paid off the 11% note plus interest at maturity.

Requirement

1. Journalize the transactions in Plymouth's general journal. Explanations are not required.

P10-20B 2 Journalizing liability transactions [20–25 min]

The following transactions of Dunn Miles occurred during 2012:

- Apr 30 Miles is party to a patent infringement lawsuit of \$230,000. Miles's attorney is certain it is remote that Miles will lose this lawsuit.
- Jun 30 Estimated warranty expense at 3% of sales of \$430,000.
- Jul 28 Warranty claims paid in the amount of \$6,400.
- Sep 30 Miles is party to a lawsuit for copyright violation of \$130,000. Miles's attorney advises that it is probable Miles will lose this lawsuit.
- Dec 31 Miles estimates warranty expense on sales for the second half of the year of \$510,000 at 3%.

Requirements

1. Journalize required transactions, if any, in Miles's general journal. Explanations are not required.
2. What is the balance in Estimated warranty payable?

P10-21B 1 3 Journalizing and posting liabilities [35–45 min]

The general ledger of Pack-N-Ship at June 30, 2012, the end of the company's fiscal year, includes the following account balances before adjusting entries.

Accounts payable	\$ 111,000
Current portion of notes payable	
Interest payable	
Salary payable	
Employee payroll taxes payable	960
Employer payroll taxes payable	
Unearned rent revenue	6,300
Long-term note payable	220,000

The additional data needed to develop the adjusting entries at June 30 are as follows:

- The long-term debt is payable in annual installments of \$44,000, with the next installment due on July 31. On that date, Pack-N-Ship will also pay one year's interest at 10%. Interest was last paid on July 31 of the preceding year. Make the adjusting entry to shift the current installment of the long-term note payable to a current liability. Also accrue interest expense at year end.
- Gross salaries for the last payroll of the fiscal year were \$4,900.
- Employer payroll taxes owed are \$810.
- On February 1, the company collected one year's rent of \$6,300 in advance.

Requirements

- Using the four-column ledger format, open the listed accounts and insert the unadjusted June 30 balances.
- Journalize and post the June 30 adjusting entries to the accounts that you opened. Key adjusting entries by letter.
- Prepare the current liabilities section of the balance sheet at June 30, 2012.

P10-22B 3 4 Computing and journalizing payroll amounts [25–35 min]

Lenny Worthington is general manager of Crossroad Tanning Salons. During 2012, Worthington worked for the company all year at a \$6,100 monthly salary. He also earned a year-end bonus equal to 5% of his salary.

Worthington's federal income tax withheld during 2012 was \$810 per month, plus \$928 on his bonus check. State income tax withheld came to \$80 per month, plus \$60 on the bonus. The FICA tax withheld was 7.65% of the first \$106,800 in annual earnings. Worthington authorized the following payroll deductions: United Fund contribution of 1% of total earnings and life insurance of \$15 per month.

Crossroad incurred payroll tax expense on Worthington for FICA tax of 7.65% of the first \$106,800 in annual earnings. The company also paid state unemployment tax of 5.4% and federal unemployment tax of 0.8% on the first \$7,000 in annual earnings. In addition, Crossroad provides Worthington with health insurance at a cost of \$110 per month. During 2012, Crossroad paid \$7,000 into Worthington's retirement plan.

Requirements

- Compute Worthington's gross pay, payroll deductions, and net pay for the full year 2012. Round all amounts to the nearest dollar.
- Compute Crossroad's total 2012 payroll expense for Worthington.
- Make the journal entry to record Crossroad's expense for Worthington's total earnings for the year, his payroll deductions, and net pay. Debit Salary expense and Bonus expense as appropriate. Credit liability accounts for the payroll deductions and Cash for net pay. An explanation is not required.

Continuing Exercise



E10-23 3 4 Computing and journalizing payroll amounts [25–35 min]

This exercise continues the Lawlor Lawn Service situation from Exercise 9-39 of Chapter 9. Refer to the Chapter 2 data for Exercise 2-61. Lawlor Lawn Service is considering hiring its first "real" employee. The employee will earn \$900 weekly and will have \$81 in federal income tax and \$33 for health insurance withheld, in addition to 7.65% FICA, each week. Assume the employee will pay no state

or other taxes. The employer must pay 7.65% FICA tax, federal unemployment tax of 0.8% of the first \$7,000 in pay, and state unemployment tax of 5.4% of the first \$7,000 in pay.

Requirements

1. Calculate the amount of the employee's weekly net pay.
2. Journalize the entries to accrue the weekly payroll on July 31, 2012, to record the employer's payroll taxes associated with the payroll, and to pay the payroll on August 4, 2012.

• Continuing Problem

P10-24 1 Accounting for liabilities of a known amount [15–20 min]

MyAccountingLab

This problem continues the Draper Consulting situation from Problem 9-40 of Chapter 9. Refer to Problem 2-62 of Chapter 2. Draper Consulting believes the company will need to borrow \$300,000 in order to expand operations. Draper consults the bank and secures a 10%, five-year note on March 1, 2013. Draper must pay the bank principal in 5 equal installments plus interest annually on March 1.

Requirements

1. Record the \$300,000 note payable on March 1, 2013.
2. Record the entry to accrue interest due on the note at December 31, 2013.
3. Record the entry Draper would make to record the payment to the bank on March 1, 2014.

Apply Your Knowledge

• Decision Cases

Decision Case 10-1 Golden Bear Construction operates throughout California. The owner, Gaylan Beavers, employs 15 work crews. Construction supervisors report directly to Beavers, and the supervisors are trusted employees. The home office staff consists of an accountant and an office manager.

Because employee turnover is high in the construction industry, supervisors hire and fire their own crews. Supervisors notify the office of all personnel changes. Also, supervisors forward to the office the employee W-4 forms. Each Thursday, the supervisors submit weekly time sheets for their crews, and the accountant prepares the payroll. At noon on Friday, the supervisors come to the office to get paychecks for distribution to the workers at 5 PM.

The company accountant prepares the payroll, including the paychecks. Beavers signs all paychecks. To verify that each construction worker is a bona fide employee, the accountant matches the employee's endorsement signature on the back of the canceled paycheck with the signature on that employee's W-4 form.

Requirements

1. Identify one way that a supervisor can defraud Golden Bear Construction under the present system.
2. Discuss a control feature that the company can use to *safeguard* against the fraud you identified in Requirement 1.

Decision Case 10-2 Sell-Soft is the defendant in numerous lawsuits claiming unfair trade practices. Sell-Soft has strong incentives not to disclose these contingent liabilities. However, GAAP requires that companies report their contingent liabilities.

Requirements

1. Why would a company prefer *not* to disclose its contingent liabilities?
2. Describe how a bank could be harmed if a company seeking a loan did not disclose its contingent liabilities.
3. What ethical tightrope must companies walk when they report contingent liabilities?

• Ethical Issue 10-1

Many small businesses have to squeeze down costs any way they can just to survive. One way many businesses do this is by hiring workers as “independent contractors” rather than as regular employees. Unlike rules for regular employees, a business does not have to pay Social Security (FICA) taxes and unemployment insurance payments for independent contractors. Similarly, they do not have to withhold federal income taxes or the employee’s share of FICA taxes. The IRS has a “20 factor test” that determines whether a worker should be considered an employee or a contractor, but many businesses ignore those rules or interpret them loosely in their favor. When workers are treated as independent contractors, they do not get a W-2 form at tax time (they get a 1099 instead), they do not have any income taxes withheld, and they find themselves subject to “self-employment” taxes, by which they bear the brunt of both the employee and the employer’s share of FICA taxes.

Requirements

1. When a business abuses this issue, how is the independent contractor hurt?
2. If a business takes an aggressive position—that is, interprets the law in a very slanted way—is there an ethical issue involved? Who is hurt?

• Fraud Case 10-1

Sara Chung knew the construction contractors in her area well. She was the purchasing manager at the power plant, a business that was the major employer in the region. Whenever a repair or maintenance job came up, Sara’s friends would inflate the invoice by 10%. The invoice would then be passed through the accounts payable department, where the clerk was supposed to review and verify the charges before processing the payment. The accounts payable clerk, Valerie Judson, was happy to have a job and didn’t want anything to jeopardize it. She knew the deal, but kept her mouth shut. Sara’s contractor friends would always “kick back” the 10% extra to Sara under the table. One day Valerie had a heart attack and went into the hospital. The company hired a new accounts payable clerk, Spencer Finn. He had worked construction in his college days and suspected something was fishy, but he couldn’t prove it. He did, however, wish to protect himself in case the fraud came to light.

Requirements

1. How could an auditor detect fraud of this sort?
2. What can a business do to prevent this kind of fraudulent activity?
3. What should the new accountant do to protect himself?

● Financial Statement Case 10-1

Details about a company's liabilities appear in a number of places in the annual report. Use **Amazon.com's** financial statements, including Note 1, to answer the following questions. **Amazon's** financial statements are in Appendix A at the end of this book.

Requirements

1. Give the breakdown of **Amazon's** current liabilities at December 31, 2009. Give the January 2010 entry to record the payment of accrued expenses and other current liabilities that **Amazon** owed at December 31, 2009. (Please assume the entire balance of this item represents accrued expenses.)
2. At December 31, 2009, how much did **Amazon** report for unearned revenue that **Amazon** had collected in advance? Which account on the balance sheet reports this liability?

● Team Project 10-1

In recent years, the airline industry has dominated headlines. Consumers are shopping **Priceline.com** and other Internet sites for the lowest rates. The airlines have also lured customers with frequent-flyer programs, which award free flights to passengers who accumulate specified miles of travel. Unredeemed frequent-flyer mileage represents a liability that airlines must report on their balance sheets, usually as Air traffic liability.

Southwest Airlines, a profitable, no-frills carrier based in Dallas, has been rated near the top of the industry. **Southwest** controls costs by flying to smaller, less-expensive airports; using only one model of aircraft; serving no meals; increasing staff efficiency; and having a shorter turnaround time on the ground between flights. The fact that most of the cities served by **Southwest** have predictable weather maximizes its on-time arrival record.

Requirements

With a partner or group, lead your class in a discussion of the following questions, or write a report as directed by your instructor.

1. Frequent-flyer programs have grown into significant obligations for airlines. Why should a liability be recorded for those programs? Discuss how you might calculate the amount of this liability. Can you think of other industries that offer incentives that create a similar liability?
2. One of **Southwest Airlines'** strategies for success is shortening stops at airport gates between flights. The company's chairman has stated, "What [you] produce is lower fares for the customers because you generate more revenue from the same fixed cost in that airplane." Look up **fixed cost** in the **Gindex** of this book. What are some of the "fixed costs" of an airline? How can better utilization of assets improve a company's profits?

• Communication Activity 10-1

In 30 words or fewer, explain how to report the total owed on a long-term note.

Quick Check Answers

1. b 2. a 3. a 4. b 5. d 6. d 7. a 8. d 9. c 10. b

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