

# ACCOUNTING FOR CURRENT LIABILITIES

## Key Terms and Concepts to Know

### Classification of liabilities

- Current liabilities are due within one year or operating cycle
- Long-term liabilities are due after or beyond one year or operating cycle

### Characteristics of liabilities

- All liabilities have Past/Present/Future elements
  - Liabilities result from a past event which
  - Creates an obligation to pay a third party in the present time which
  - Will be paid to the third party on some future date
- Liabilities may be uncertain as to
  - Amount
  - Payee
  - Payment date
- Liabilities may be known, estimated or contingent
  - Known liabilities have a definite payment amount, payment date and payee
  - Estimated liabilities have a known payment date and payee and a payment amount that can be estimated with reasonable certainty
  - Contingent liabilities are potential liabilities whose existence and payment amount are dependent on the uncertain occurrence of a future event.

### Types of Current Liabilities

- Wide variety of different sources or causes:
  - Notes Payable
  - Current maturities of long-term debt, such as bond or mortgage payments due within one year
  - Accounts payable
  - Unearned revenues
  - Payroll-related payables and accruals
  - Non-payroll accruals, such as real estate taxes payable and sales taxes payable
  - Estimated liabilities
  - Contingent liabilities

**Analysis**

- Liquidity ratios measure short-term ability to pay current liabilities
  - Current ratio and working capital
- Solvency ratios measure the ability to pay short-term and long-term liabilities
  - Debt to Assets ratio and Times Interest earned ratio

## Key Topics to Know

### Short-Term Notes Payable

\*\* See separate module on Notes Payable \*\*

### Current Maturities of Long-Term Debt

- The portion of long-term debt payments due within one year.
- The balance of the payments beyond one year is classified as long-term debt.

#### **Example #1**

H Company entered into a 4-year 6% installment note with the following payment schedule.

<u>Year</u>	<u>Beginning Balance</u>	<u>Payment Amount</u>	<u>Interest Expense</u>	<u>Principal Payment</u>	<u>Ending Balance</u>
1	30,000	8,658	1,800	6,858	23,142
2	23,142	8,658	1,389	7,269	15,873
3	15,873	8,658	952	7,706	8,168
4	8,168	8,658	490	8,168	0

Required:                      How was the balance of \$15,873 due on December 31 of year 2 reported on the balance sheet?

#### **Solution #1**

At the end of year 2, \$7,706 would be dues within one year and reported as a current liability. \$8,168 would be reported as a long-term liability.

### Accounts Payable

Accounts payable includes liabilities due within one year arising from purchases on account of merchandise or goods and services from vendors or suppliers. Typically the company has received an invoice for these liabilities.

## Payroll-Related Payables and Accruals

Payroll-related Payables and Accruals are complex.

The essence of payroll is:

- An employer is obligated to pay an employee a certain amount based on the work performed, sometimes as a salary for a period of time, sometimes as hours worked x an hourly wage or sometimes as an amount earned for an accomplishment such as a sales commission based on a percentage of the amount sold.
- From the amount earned, the employer is required by law to deduct various federal and state taxes, called withholdings. Typical withholdings include FICA taxes and federal and state income taxes. Just as with sales taxes, these withholdings are not expenses for the employers, as the employer is merely acting as a collection agent for the government.
- From the amount earned, with the employee's consent, the employer may deduct or withhold amounts for charitable contributions, health or life insurance premiums, payroll or retirement savings plans and many other deductions.
- This is why the net amount of a payroll check (the cash the employee receives) is so much smaller than the gross the employee earns.
- In addition to the liabilities from withholdings, the employer incurs payroll tax liabilities that it must pay and record as an expense. These payroll liabilities include FICA equal to the amount withheld from employees and state and federal unemployment taxes.

### **Example #2**

P Company has a \$200,000 gross payroll each week. The FICA tax rate is 7.65%. Federal income taxes withheld total \$45,833 and state income taxes withheld total \$8,692. Federal unemployment tax rate is 0.8% and the state unemployment tax rate is 2.8%. Payroll is recorded and paid every Friday.

Required:                      Prepare the journal entries required to record and pay the weekly payroll.

**Solution #2**

Wages and salaries expense	200,000	
FICA taxes payable		15,300
Federal income taxes payable		45,833
State income taxes payable		8,692
Wages and salaries payable		130,175
To record payroll liabilities		
Payroll tax expense	22,500	
FICA taxes payable		15,300
Federal unemployment taxes payable		1,600
State unemployment taxes payable		5,600
To record employer portion of payroll taxes		
Wages and salaries payable	130,175	
Cash		130,175
To record payroll paid		

**Non-Payroll Accrued Liabilities**

Accrued liabilities occur when goods or services have been received or used but an invoice has not been received. Accrued liabilities are typically recorded at the end of the accounting period through adjusting entries.

Another type of accrued liability is sales tax payable. Companies are required by law to collect sales tax from customers at the time of sale and periodically remit the sales taxes collected to the appropriate government taxing authority.

Sales taxed collected are not expenses for the employer. The employer is merely acting as a collection agent or conduit for the government. Sales taxes are collected, held for a short period of time and then remitted to the appropriate government agency.

**Example #3**

K Company has only cash sales to customers. For June, the cash register reported total cash collections of \$108,000. K Company does business in a state with an 8% sales tax.

- Required:
- a) What journal entry was made to record June sales?
  - b) What journal entry will be made when the taxes are paid to the state?

**Solution #3**

a)		6/30	Cash		108,000		
			Sales Tax Payable			8,000	
			Sales			100,000	
b)		x/x	Sales Tax Payable		8,000		
			Cash			8,000	

**Unearned Revenues**

Unearned revenues arise when payment for goods or services has been received prior to the goods or services being provided. Unearned revenues are liabilities because the payor is owed either the goods or services or a refund of the payment made.

Common examples are season tickets for a professional sports team, magazine subscriptions, airline tickets purchased days or weeks or more in advance of the actual flight date and a retainer paid to an attorney in advance of any legal services being performed.

At the time the payment is received, the following entry is made:

x/x	Cash			xxx	
	Unearned Revenue				xxx

At the end of the period in which the goods or services were provided, the following adjusting entry is made:

x/x	Unearned Revenue	xxx	
	Revenue		xxx

### Estimated Liabilities

Estimated liabilities have a known payee and a known payment date but an uncertain payment amount which can be reasonably estimated. The uncertainty for the amount may arise because the amount to be paid is based on a future event or another amount that has yet to be determined.

Examples of estimated liabilities include bonuses, vacation, health and pension benefits and warranty liabilities.

An estimated expense is recorded in the same period as the revenue and an estimated liability is recorded for the expected future goods/services to be provided. When payments are made or services provided in the future, the liability is debited and the appropriate balance sheet account is credited.

### Contingent Liabilities

The difference between a contingent liability and a known liability is that a contingent liability is a potential liability; uncertain as to whether the future event will occur.

The more certainty that is involved, the more information that is recorded or disclosed:

- Contingent liabilities are recorded when the future event is probable and the amount is known or can be reasonably estimated.
- Contingent liabilities are disclosed in the footnotes to the financial statements when the future event is probable and the amount is not known or cannot be reasonably estimated or when the future event is possible and the amount is not known or cannot be reasonably estimated.
- Contingent liabilities are not recorded or disclosed when the future event is unlikely to occur.

## Practice Problems

### **Practice Problem #1**

During a two-week pay period, Y Company's employees earned gross wages and salaries of \$67,500. The employees have income tax withholdings of \$7,800 and the company owes a total of \$10,400 in FICA taxes (includes both the company and employee portions).

Required: Prepare the journal entries that your company would use to record the payroll. Consider both employee and employer payroll taxes.

### **Practice Problem #2**

T Company publishes a magazine for the travel industry. Subscriptions cost \$60 per year or \$100 for two years. During the first year the magazine was published, 720 one-year and 300 two-year subscriptions were sold. All subscriptions were paid for in cash. 25% of the subscriptions were sold on April 1, 50% were sold on July 1 and 25% were sold on October 1.

Required:

- How much cash was collected by T Company during the year?
- How much revenue was earned by T Company during the year?
- How much unearned revenue did T Company have on December 31?



**Practice Problem #3**

G Company reported the following information as of September 30:

Cash	\$22,200
Accounts receivable, net	169,100
Inventory	68,300
Property, Plant and Equipment	<u>132,800</u>
Total assets	\$392,400
Accounts payable	\$49,200
Current portion of long-term debt	68,800
Long-term notes payable	<u>100,000</u>
Total liabilities	<u>218,000</u>
Common stock	100,000
Retained earnings	<u>74,400</u>
Total equity	<u>174,400</u>
Total liabilities and equity	\$392,400
Revenue	\$2,765,000
Operating expenses	<u>2,472,600</u>
Operating income	292,400
Interest expense	<u>17,000</u>
Income before income taxes	275,400
Income tax expense	<u>103,800</u>
Net Income	\$171,600

- Required:
- Calculate the current ratio.
  - Calculate working capital
  - Calculate the times interest earned ratio.
  - Calculate the debt to assets ratio

## True / False Questions

1. Commonly, current liabilities are payable within one year, and long-term liabilities are payable more than one year from now.  
True   False
2. Interest expense is recorded in the period in which it is paid, rather than in the period incurred.  
True   False
3. Accounts payable are amounts the company owes to suppliers of merchandise or services that it has bought on credit.  
True   False
4. When a company receives cash in advance, it debits Cash and credits a revenue account called Unearned Revenue.  
True   False
5. Airlines do not record revenue when a ticket is sold, but wait to record revenue until the actual flight occurs.  
True   False
6. Sales taxes collected from customers by the seller are not an expense, instead they represent current liabilities payable to the government.  
True   False
7. If the likelihood of loss is remote, disclosure usually is not required.  
True   False
8. A contingent liability is recorded when the likelihood of the loss occurring is reasonably possible and the amount can be reasonably estimated.  
True   False
9. Amounts withheld from employees in connection with payroll often represent liabilities to be remitted to third parties.  
True   False
10. State and Federal Unemployment Taxes (SUTA and FUTA) must be withheld from employees' wages.  
True   False

## Multiple Choice Questions

1. Which of the following is not a typical current liability?
  - a) Sales Taxes Payable
  - b) Mortgage Payable
  - c) Unearned Revenue
  - d) Interest Payable
  
2. Sales taxes collected by a company on behalf of the state and local governments are recorded by:
  - a) A debit to an expense account.
  - b) A credit to a revenue account.
  - c) A debit to a revenue account.
  - d) A credit to a liability account.
  
3. The current portion of long-term debt should be
  - a) Reported as a current liability on the balance sheet.
  - b) Reported as a long-term liability on the balance sheet.
  - c) Combined with the rest of the long-term debt on the balance sheet.
  - d) Paid immediately.
  
4. If management can estimate the amount of loss that will occur due to litigation against the company, and the likelihood of the loss is probable, a contingent liability should be
  - a) Disclosed, but not reported as a liability.
  - b) Disclosed and reported as a liability.
  - c) Neither disclosed nor reported as a liability.
  - d) Reported as a liability, but not disclosed.
  
5. Which of the following may create employer liabilities in connection with their payrolls?
  - a) Employee withholding taxes.
  - b) Employee voluntary deductions.
  - c) Employee fringe benefits.
  - d) All of these answer choices are correct.

6. When a product or service is delivered for which a customer payment in advance has been previously received, the appropriate journal entry includes:
  - a) A debit to a revenue and a credit to a liability account.
  - b) A debit to a revenue and a credit to an asset account.
  - c) A debit to an asset and a credit to a revenue account.
  - d) A debit to a liability and a credit to a revenue account.
  
7. Which of the following is **not** true about deferred revenue?
  - a) Deferred revenue will be recognized when payment is received from the customer
  - b) Deferred revenue is a liability.
  - c) Deferred revenue may be recognized on both cash and credit sales
  - d) Customer prepayments typically require recognition of deferred revenue.
  
8. The key accounting considerations relating to accounts payable are:
  - a) Determining their existence and ensuring that they are recorded in the appropriate accounting period.
  - b) Determining their present value and ensuring that they are recorded in the appropriate accounting period.
  - c) Determining their existence and determining the correct amount.
  - d) Determining the present value of the principal and the amount of the interest.
  
9. Solvency ratios measure a company's ability to:
  - a) Pay for current liabilities
  - b) Pay for long-term liabilities
  - c) Pay for all liabilities
  - d) Pay for interest on long-term debt
  
10. Operating leases allow:
  - a) Lease payments to be capitalized as long-term assets
  - b) The lessor to use property for a specific time period
  - c) Transfer ownership from the lessor to the lessee
  - d) The lessee to use property for a specific time period

## Solutions to Practice Problems

### Practice Problem #1

Wages and salaries payable	67,500	
Federal and state income taxes payable		7,800
FICA taxes payable		5,200
Cash		54,500
Payroll tax expense	5,200	
FICA taxes payable		5,200

### Practice Problem #2

a)

One-year:	720 x \$60 =	\$43,200
Two year:	300 x \$100 =	<u>30,000</u>
		\$73,200

b)

April 1:	720 x 25% X \$60 x 9/12 =	\$8,100
	300 x 25% X \$100 x 9/12 =	5,625

July 1:	720 x 50% X \$60 x 6/12 =	10,800
	300 x 50% x \$100 x 6/12 =	7,500

April 1:	720 x 25% X \$60 x 3/12 =	\$2,700
	300 x 25% X \$100 x 3/12 =	1,875
		\$36,000

c)

Cash collected	\$73,200
Revenue earned	\$36,600
Unearned revenue	\$36,000

**Practice Problem #3**

$$\text{Current ratio:} \quad \frac{22,200 + 169,100 + 68,300}{49,200 + 68,800} = 2.2$$

$$\text{Working capital:} \quad 22,200 + 169,100 + 68,300 - 49,200 - 68,800 = \$141,600$$

$$\text{Times interest earned:} \quad \frac{171,600 + 103,800 + 17,000}{17,000} = 17.2$$

$$\text{Debt to assets ratio:} \quad \frac{218,000}{392,400} = .56$$

## Solutions to True / False Problems

1. True
2. False - Interest expense is recorded in the period incurred, not in the period in which we pay it.
3. True
4. False - When a company receives cash in advance, it debits Cash and credits a liability account called Unearned Revenue.
5. True
6. True
7. True
8. False - We record a contingent liability when the likelihood of the loss occurring is probable and the amount can be reasonably estimated.
9. True
10. False – Unemployment taxes are a liability and expense of the company.

## Solutions to Multiple Choice Questions

- |     |   |
|-----|---|
| 1.  | B |
| 2.  | D |
| 3.  | A |
| 4.  | B |
| 5.  | D |
| 6.  | D |
| 7.  | A |
| 8.  | A |
| 9.  | C |
| 10. | D |