Chapter 11

Current Liabilities and Payroll Accounting

STUDY OBJECTIVES

After studying this chapter, you should be able to:

1. Explain a current liability, and identify the major types of current liabilities.
2. Describe the accounting for notes payable.
3. Explain the accounting for other current liabilities.
4. Explain the financial statement presentation and analysis of current liabilities.
5. Describe the accounting and disclosure requirements for contingent liabilities.
6. Compute and record the payroll for a pay period.
7. Describe and record employer payroll taxes.
8. Discuss the objectives of internal control for payroll.

The Navigator

The Navigator

Scan **Study Objectives**

Read **Feature Story**

Read **Preview**

Read text and answer **DO IT!**
p. 489 p. 494 p. 501 p. 505

Work **Comprehensive DO IT!** p. 507

Review **Summary of Study Objectives**

Answer **Self-Study Questions**

Complete **Assignments**

Feature Story

FINANCING HIS DREAMS

What would you do if you had a great idea for a new product, but couldn't come up with the cash to get the business off the ground? Small businesses often cannot attract investors. Nor can they obtain traditional debt financing through bank loans or bond issuances. Instead, they often resort to unusual, and costly, forms of nontraditional financing.

Such was the case for Wilbert Murdock. Murdock grew up in a New York housing project, and always had great ambitions. This ambitious spirit led him

into some business ventures that failed: a medical diagnostic tool, a device to eliminate carpal-tunnel syndrome, custom-designed sneakers, and a device to keep people from falling asleep while driving.

Another idea was computerized golf clubs that analyze a golfer's swing and provide immediate feedback. Murdock saw great potential in the idea: Many golfers are willing to shell out considerable sums of money for devices that might improve their game. But Murdock had no cash to develop his product, and banks and other lenders had shied away. Rather than give up, Murdock resorted to credit cards—in a big way. He quickly owed $25,000 to credit card companies.

While funding a business with credit cards might sound unusual, it isn't. A recent study found that one-third of businesses with fewer than 20 employees financed at least part of their operations with credit cards. As Murdock explained, credit cards are an appealing way to finance a start-up because "credit-card companies don't care how the money is spent." However, they do care how they are paid. And so Murdock faced high interest charges and a barrage of credit card collection letters.

Murdock's debt forced him to sacrifice nearly everything in order to keep his business afloat. His car stopped running, he barely had enough money to buy food, and he lived and worked out of a dimly lit apartment in his mother's basement. Through it all he tried to maintain a positive spirit, joking that, if he becomes successful, he might some day get to appear in an American Express commercial.

Source: Rodney Ho, "Banking on Plastic: To Finance a Dream, Many Entrepreneurs Binge on Credit Cards," *Wall Street Journal*, March 9, 1998, p. A1.

✓ *The Navigator*

Inside Chapter 11...

Preview of Chapter 11

Inventor-entrepreneur Wilbert Murdock, as you can tell from the Feature Story, had to use multiple credit cards to finance his business ventures. Murdock's credit card debts would be classified as *current liabilities* because they are due every month. Yet by making minimal payments and paying high interest each month, Murdock used this credit source long-term. Some credit card balances remain outstanding for years as they accumulate interest.

Earlier, we defined liabilities as creditors' claims on total assets and as existing debts and obligations. These claims, debts, and obligations must be settled or paid at some time **in the future** by the transfer of assets or services. The future date on which they are due or payable (maturity date) is a significant feature of liabilities. This "future date" feature gives rise to two basic classifications of liabilities: (1) current liabilities and (2) long-term liabilities. We will explain current liabilities, along with payroll accounting, in this chapter. We will explain long-term liabilities in Chapter 15.

The content and organization of Chapter 11 are as follows.

Current Liabilities and Payroll Accounting

Accounting for Current Liabilities
- Notes payable
- Sales taxes payable
- Unearned revenues
- Current maturities of long-term debt
- Statement presentation and analysis

Contingent Liabilities
- Recording
- Disclosure

Payroll Accounting
- Determining payroll
- Recording payroll
- Employer payroll taxes
- Filing and remitting payroll taxes
- Internal control for payroll

The Navigator

ACCOUNTING FOR CURRENT LIABILITIES

STUDY OBJECTIVE 1
Explain a current liability, and identify the major types of current liabilities.

As explained in Chapter 4, a **current liability** is a debt with two key features: (1) The company reasonably expects to pay the debt from existing current assets or through the creation of other current liabilities. (2) The company will pay the debt within one year or the operating cycle, whichever is longer. Debts that do not meet **both criteria** are classified as long-term liabilities. Most companies pay current liabilities within one year out of current assets, rather than by creating other liabilities.

Companies must carefully monitor the relationship of current liabilities to current assets. This relationship is critical in evaluating a company's short-term debt-paying ability. A company that has more current liabilities than current assets may not be able to meet its current obligations when they become due.

Current liabilities include notes payable, accounts payable, and unearned revenues. They also include accrued liabilities such as taxes, salaries and wages, and interest payable. In previous chapters we explained the entries for accounts payable and adjusting entries for some current liabilities. In the following sections, we discuss other types of current liabilities.

STUDY OBJECTIVE 2
Describe the accounting for notes payable.

Notes Payable

Companies record obligations in the form of written promissory notes, called **notes payable**. Notes payable are often used instead of accounts payable because they give the lender formal proof of the obligation in case legal remedies are needed to collect the debt. Notes payable usually require the borrower to pay interest. Companies frequently issue them to meet short-term financing needs.

Notes are issued for varying periods. **Those due for payment within one year of the balance sheet date are usually classified as current liabilities.**

To illustrate the accounting for notes payable, assume that First National Bank agrees to lend $100,000 on March 1, 2010, if Cole Williams Co. signs a $100,000, 12%, four-month note. With an interest-bearing promissory note, the amount of assets received upon issuance of the note generally equals the note's face value. Cole Williams Co. therefore will receive $100,000 cash and will make the following journal entry.

Mar. 1	Cash	100,000	
	Notes Payable		100,000
	(To record issuance of 12%, 4-month note to First National Bank)		

A	=	L	+	OE
+100,000				
		+100,000		

Cash Flows
+100,000

Interest accrues over the life of the note, and the company must periodically record that accrual. If Cole Williams Co. prepares financial statements on June 30, it makes an adjusting entry at June 30 to recognize interest expense and interest payable of $4,000 ($100,000 × 12% × 4/12). Illustration 11-1 shows the formula for computing interest, and its application to Cole Williams Co.'s note.

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
$100,000	×	12%	×	4/12	=	**$4,000**

Illustration 11-1
Formula for computing interest

Cole Williams makes an adjusting entry as follows:

June 30	Interest Expense	4,000	
	Interest Payable		4,000
	(To accrue interest for 4 months on First National Bank note)		

A	=	L	+	OE
				−4,000 Exp
		+4,000		

Cash Flows
no effect

In the June 30 financial statements, the current liabilities section of the balance sheet will show notes payable $100,000 and interest payable $4,000. In addition, the company will report interest expense of $4,000 under "Other expenses and losses" in the income statement. If Cole Williams Co. prepared financial statements monthly, the adjusting entry at the end of each month would have been $1,000 ($100,000 × 12% × 1/12).

At maturity (July 1, 2010), Cole Williams Co. must pay the face value of the note ($100,000) plus $4,000 interest ($100,000 × 12% × 4/12). It records payment of the note and accrued interest as shown below.

July 1	Notes Payable	100,000	
	Interest Payable	4,000	
	Cash		104,000
	(To record payment of First National Bank interest-bearing note and accrued interest at maturity)		

A	=	L	+	OE
		−100,000		
		−4,000		
−104,000				

Cash Flows
−104,000

Sales Taxes Payable

STUDY OBJECTIVE 3
Explain the accounting for other current liabilities.

As a consumer, you know that many of the products you purchase at retail stores are subject to sales taxes. Many states also are now collecting sales taxes on purchases made on the Internet. Sales taxes are expressed as a stated percentage of the sales price. The retailer collects the tax from the customer when the sale occurs. Periodically (usually monthly), the retailer remits the collections to the state's department of revenue.

Under most state sales tax laws, the selling company must ring up separately on the cash register the amount of the sale and the amount of the sales tax collected. (Gasoline sales are a major exception.) The company then uses the cash register readings to credit Sales and Sales Taxes Payable. For example, if the March 25 cash register reading for Cooley Grocery shows sales of $10,000 and sales taxes of $600 (sales tax rate of 6%), the journal entry is:

A	=	L	+	OE
+10,600				
				+10,000 Rev
		+600		

Cash Flows
+10,600

Mar. 25	Cash	10,600	
	Sales		10,000
	Sales Taxes Payable		600
	(To record daily sales and sales taxes)		

When the company remits the taxes to the taxing agency, it debits Sales Taxes Payable and credits Cash. The company does not report sales taxes as an expense. It simply forwards to the government the amount paid by the customers. Thus, Cooley Grocery serves only as a **collection agent** for the taxing authority.

Sometimes companies do not ring up sales taxes separately on the cash register. To determine the amount of sales in such cases, divide total receipts by 100% plus the sales tax percentage. To illustrate, assume that in the above example Cooley Grocery rings up total receipts of $10,600. The receipts from the sales are equal to the sales price (100%) plus the tax percentage (6% of sales), or 1.06 times the sales total. We can compute the sales amount as follows.

HELPFUL HINT

Alternatively, Cooley could find the tax by multiplying sales by the sales tax rate ($10,000 × .06).

$$\$10,600 \div 1.06 = \$10,000$$

Thus, Cooley Grocery could find the sales tax amount it must remit to the state ($600) by subtracting sales from total receipts ($10,600 − $10,000).

Unearned Revenues

A magazine publisher, such as Sports Illustrated, receives customers' checks when they order magazines. An airline company, such as American Airlines, receives cash when it sells tickets for future flights. Through these transactions, both companies have incurred **unearned revenues**—revenues that are received before the company delivers goods or provides services. How do companies account for unearned revenues?

1. When a company receives the advance payment, it debits Cash, and credits a current liability account identifying the source of the unearned revenue.
2. When the company earns the revenue, it debits the Unearned Revenue account, and credits an earned revenue account.

To illustrate, assume that Superior University sells 10,000 season football tickets at $50 each for its five-game home schedule. The university makes the following entry for the sale of season tickets:

A	=	L	+	OE
+500,000				
		+500,000		

Cash Flows
+500,000

Aug. 6	Cash	500,000	
	Unearned Football Ticket Revenue		500,000
	(To record sale of 10,000 season tickets)		

As the school completes each of the five home games, it earns one-fifth of the revenue. The following entry records the revenue earned.

A	=	L	+	OE
		−100,000		
				+100,000 Rev

Cash Flows
no effect

Sept. 7	Unearned Football Ticket Revenue	100,000	
	Football Ticket Revenue		100,000
	(To record football ticket revenue earned)		

Organizations report any balance in an unearned revenue account (in Unearned Football Ticket Revenue, for example) as a current liability in the balance sheet.

As they earn the revenue, a transfer from unearned revenue to earned revenue occurs. Unearned revenue is material for some companies. In the airline industry, for example, tickets sold for future flights represent almost 30% of total current liabilities. At United Air Lines, unearned ticket revenue is its second largest current liability, recently amounting to over $1.6 billion.

Illustration 11-2 shows specific unearned and earned revenue accounts used in selected types of businesses.

Illustration 11-2
Unearned and earned revenue accounts

	Account Title	
Type of Business	**Unearned Revenue**	**Earned Revenue**
Airline	Unearned Passenger Ticket Revenue	Passenger Revenue
Magazine publisher	Unearned Subscription Revenue	Subscription Revenue
Hotel	Unearned Rental Revenue	Rental Revenue
Insurance company	Unearned Premium Revenue	Premium Revenue

Current Maturities of Long-Term Debt

Companies often have a portion of long-term debt that comes due in the current year. That amount is considered a current liability. For example, assume that Wendy Construction issues a five-year interest-bearing $25,000 note on January 1, 2010. Each January 1, starting January 1, 2011, $5,000 of the note is due to be paid. When Wendy Construction prepares financial statements on December 31, 2010, it should report $5,000 as a current liability. It would report the remaining $20,000 on the note as a long-term liability. Current maturities of long-term debt are often termed **long-term debt due within one year**.

It is not necessary to prepare an adjusting entry to recognize the current maturity of long-term debt. The company will recognize the proper statement classification of each balance sheet account when it prepares the balance sheet.

DO IT!

CURRENT LIABILITIES

You and several classmates are studying for the next accounting examination. They ask you to answer the following questions.

1. If cash is borrowed on a $50,000, 6-month, 12% note on September 1, how much interest expense would be incurred by December 31?

2. How is the sales tax amount determined when the cash register total includes sales taxes?

3. If $15,000 is collected in advance on November 1 for 3-months' rent, what amount of rent revenue is earned by December 31?

action plan

✔ Use the interest formula: Face value of note × Annual interest rate × Time in terms of one year.

✔ Divide total receipts by 100% plus the tax rate to determine sales; then subtract sales from the total receipts.

✔ Determine what fraction of the total unearned rent was earned this year.

Solution

1. $\$50,000 \times 12\% \times 4/12 = \$2,000$

2. First, divide the total cash register receipts by 100% plus the sales tax percentage to find the sales amount. Second, subtract the sales amount from the total cash register receipts to determine the sales taxes.

3. $\$15,000 \times 2/3 = \$10,000$

Related exercise material: **BE11-2, BE11-3, BE11-4, E11-1, E11-2, E11-3, E11-4,** and **DO IT! 11-1.**

The Navigator

Statement Presentation and Analysis

STUDY OBJECTIVE 4

Explain the financial statement presentation and analysis of current liabilities.

PRESENTATION

As indicated in Chapter 4, current liabilities are the first category under liabilities on the balance sheet. Each of the principal types of current liabilities is listed separately. In addition, companies disclose the terms of notes payable and other key information about the individual items in the notes to the financial statements.

Companies seldom list current liabilities in the order of liquidity. The reason is that varying maturity dates may exist for specific obligations such as notes payable. A more common method of presenting current liabilities is to list them by **order of magnitude**, with the largest ones first. Or, as a matter of custom, many companies show notes payable first, and then accounts payable, regardless of amount. Then the remaining current liabilities are listed by magnitude. (*Use this approach in your homework*.) The following adapted excerpt from the balance sheet of Caterpillar Inc. illustrates its order of presentation.

Illustration 11-3
Balance sheet presentation of current liabilities

CATERPILLAR®

CATERPILLAR INC.
Balance Sheet
December 31, 2007
(in millions)

Assets	
Current assets	$25,477
Property, plant and equipment (net)	9,997
Other long-term assets	20,658
Total assets	$56,132
Liabilities and Stockholders' Equity	
Current liabilities	
Short-term borrowings (notes payable)	**$ 5,468**
Accounts payable	**4,723**
Accrued expenses	**3,178**
Accrued wages, salaries, and employee benefits	**1,126**
Customer advances	**1,442**
Dividends payable	**225**
Other current liabilities	**951**
Long-term debt due within one year	**5,132**
Total current liabilities	**22,245**
Noncurrent liabilities	25,004
Total liabilities	47,249
Stockholders' equity	8,883
Total liabilities and stockholders' equity	$56,132

HELPFUL HINT

For other examples of current liabilities sections, refer to the PepsiCo and Coca-Cola balance sheets in Appendixes A and B.

ANALYSIS

Use of current and noncurrent classifications makes it possible to analyze a company's liquidity. **Liquidity** refers to the ability to pay maturing obligations and meet unexpected needs for cash. The relationship of current assets to current liabilities is critical in analyzing liquidity. We can express this relationship as a dollar amount (working capital) and as a ratio (the current ratio).

The excess of current assets over current liabilities is **working capital**. Illustration 11-4 shows the formula for the computation of Caterpillar's working capital (dollar amounts in millions).

Current Assets	−	Current Liabilities	=	Working Capital
$25,477	−	$22,245	=	**$3,232**

Illustration 11-4
Working capital formula and computation

As an absolute dollar amount, working capital offers limited informational value. For example, $1 million of working capital may be far more than needed for a small company but be inadequate for a large corporation. Also, $1 million of working capital may be adequate for a company at one time but inadequate at another time.

The **current ratio** permits us to compare the liquidity of different-sized companies and of a single company at different times. The current ratio is calculated as current assets divided by current liabilities. The formula for this ratio is illustrated below, along with its computation using Caterpillar's current asset and current liability data (dollar amounts in millions).

Current Assets	÷	Current Liabilities	=	Current Ratio
$25,477	÷	$22,245	=	**1.15:1**

Illustration 11-5
Current ratio formula and computation

Historically, companies and analysts considered a current ratio of 2:1 to be the standard for a good credit rating. In recent years, however, many healthy companies have maintained ratios well below 2:1 by improving management of their current assets and liabilities. Caterpillar's ratio of 1.15:1 is adequate but certainly below the standard of 2:1.

CONTINGENT LIABILITIES

STUDY OBJECTIVE 5
Describe the accounting and disclosure requirements for contingent liabilities.

With notes payable, interest payable, accounts payable, and sales taxes payable, we know that an obligation to make a payment exists. But suppose that your company is involved in a dispute with the Internal Revenue Service (IRS) over the amount of its income tax liability. Should you report the disputed amount as a liability on the balance sheet? Or suppose your company is involved in a lawsuit which, if you lose, might result in bankruptcy. How should you report this major contingency? The answers to these questions are difficult, because these liabilities are dependent—contingent—upon some future event. In other words, a **contingent liability** is a potential liability that may become an actual liability in the future.

How should companies report contingent liabilities? They use the following guidelines:

1. If the contingency is **probable** (if it is *likely* to occur) **and** the amount can be **reasonably estimated**, the liability should be recorded in the accounts.
2. If the contingency is only **reasonably possible** (if it *could* happen), then it needs to be disclosed only in the notes that accompany the financial statements.
3. If the contingency is **remote** (if it is *unlikely* to occur), it need not be recorded or disclosed.

ACCOUNTING ACROSS THE ORGANIZATION

Contingencies: How Big Are They?

Contingent liabilities abound in the real world. Consider the following: Manville Corp. filed for bankruptcy when it was hit by billions of dollars in asbestos product-liability claims. Companies having multiple toxic waste sites are faced with cleanup costs that average $10 to $30 million and can reach as high as $500 million depending on the type of waste. For life and health insurance companies and their stockholders, the cost of diseases such as diabetes, Alzheimer's, and AIDS is like an iceberg: Everyone wonders how big such costs really are and what damage they might do in the future. And frequent-flyer programs are so popular that airlines at one time owed participants more than 3 million round-trip domestic tickets. That's enough to fly at least 5.4 billion miles—free for the passengers, but at what future cost to the airlines?

? Why do you think most companies disclose, but do not record, contingent liabilities?

Recording a Contingent Liability

Product warranties are an example of a contingent liability that companies should record in the accounts. Warranty contracts result in future costs that companies may incur in replacing defective units or repairing malfunctioning units. Generally, a manufacturer, such as Black & Decker, knows that it will incur some warranty costs. From prior experience with the product, the company usually can reasonably estimate the anticipated cost of servicing (honoring) the warranty.

The accounting for warranty costs is based on the matching principle. **The estimated cost of honoring product warranty contracts should be recognized as an expense in the period in which the sale occurs.** To illustrate, assume that in 2010 Denson Manufacturing Company sells 10,000 washers and dryers at an average price of $600 each. The selling price includes a one-year warranty on parts. Denson expects that 500 units (5%) will be defective and that warranty repair costs will average $80 per unit. In 2010, the company honors warranty contracts on 300 units, at a total cost of $24,000.

At December 31, it is necessary to accrue the estimated warranty costs on the 2010 sales. Denson computes the estimated warranty liability as follows.

Illustration 11-6
Computation of estimated product warranty liability

Number of units sold	10,000
Estimated rate of defective units	× 5%
Total estimated defective units	500
Average warranty repair cost	× $80
Estimated product warranty liability	**$40,000**

A	=	L	+	OE
				−40,000 Exp
		+40,000		

Cash Flows
no effect

The company makes the following adjusting entry.

Dec. 31	Warranty Expense	40,000	
	Estimated Warranty Liability		40,000
	(To accrue estimated warranty costs)		

Denson records those repair costs incurred in 2010 to honor warranty contracts on 2010 sales as shown below.

Jan. 1– Dec. 31	Estimated Warranty Liability	24,000	
	Repair Parts		24,000
	(To record honoring of 300 warranty contracts on 2010 sales)		

A	=	L	+	OE
		−24,000		
−24,000				

Cash Flows
no effect

The company reports warranty expense of $40,000 under selling expenses in the income statement. It classifies estimated warranty liability of $16,000 ($40,000 − $24,000) as a current liability on the balance sheet.

In the following year, Denson should debit to Estimated Warranty Liability all expenses incurred in honoring warranty contracts on 2010 sales. To illustrate, assume that the company replaces 20 defective units in January 2011, at an average cost of $80 in parts and labor. The summary entry for the month of January 2011 is:

Jan. 31	Estimated Warranty Liability	1,600	
	Repair Parts		1,600
	(To record honoring of 20 warranty contracts on 2010 sales)		

A	=	L	+	OE
		−1,600		
−1,600				

Cash Flows
no effect

Disclosure of Contingent Liabilities

When it is probable that a company will incur a contingent liability but it cannot reasonably estimate the amount, or when the contingent liability is only reasonably possible, only disclosure of the contingency is required. Examples of contingencies that may require disclosure are pending or threatened lawsuits and assessment of additional income taxes pending an IRS audit of the tax return.

The disclosure should identify the nature of the item and, if known, the amount of the contingency and the expected outcome of the future event. Disclosure is usually accomplished through a note to the financial statements, as illustrated by the following.

Illustration 11-7
Disclosure of contingent liability

YAHOO!

YAHOO! INC.
Notes to the Financial Statements

Contingencies. From time to time, third parties assert patent infringement claims against the company. Currently the company is engaged in several lawsuits regarding patent issues and has been notified of a number of other potential patent disputes. In addition, from time to time the company is subject to other legal proceedings and claims in the ordinary course of business, including claims for infringement of trademarks, copyrights and other intellectual property rights.... The Company does not believe, based on current knowledge, that any of the foregoing legal proceedings or claims are likely to have a material adverse effect on the financial position, results of operations or cash flows.

The required disclosure for contingencies is a good example of the use of the full-disclosure principle. The **full-disclosure principle** requires that companies disclose all circumstances and events that would make a difference to financial statement users. Some important financial information, such as contingencies, is not easily reported in the financial statements. Reporting information on contingencies in the notes to the financial statements will help investors be aware of events that can affect the financial health of a company.

DO IT!

CURRENT LIABILITIES

Lepid Company has the following account balances at December 31, 2010.

Notes payable ($80,000 due after 12/31/11)	$200,000
Unearned revenue	75,000
Other long-term debt ($30,000 due in 2011)	150,000
Salaries payable	22,000
Other accrued expenses	15,000
Accounts payable	100,000

In addition, Lepid is involved in a lawsuit. Legal counsel feels it is probable Lepid will pay damages of $38,000 in 2011.

(a) Prepare the current liability section of Lepid's December 31, 2010, balance sheet.
(b) Lepid's current assets are $504,000. Compute Lepid's working capital and current ratio.

action plan

✔ Determine which liabilities will be paid within one year or the operating cycle and include those as current liabilities.

✔ If the contingent liability is probable and reasonably estimable, include it as a current liability.

✔ Use the formula for working capital: Current assets − Current liabilities.

✔ Use the formula for the current ratio: Current assets ÷ Current liabilities.

Solution

(a) Current liabilities

Notes payable due in 2011	$120,000
Accounts payable	100,000
Unearned revenue	75,000
Lawsuit liability	38,000
Salaries payable	22,000
Other accrued expenses	15,000
Long-term debt due within one year	30,000
Total current liabilities	$400,000

(b) Working capital = Current assets − Current liabilities = $504,000 − $400,000 = $104,000
Current ratio: Current assets ÷ Current liabilities = $504,000 ÷ $400,000 = 1.26:1

Related exercise material: **BE11-6, E11-5, E11-6, E11-7, E11-8,** and **DO IT! 11-2.**

✔ *The Navigator*

PAYROLL ACCOUNTING

Payroll and related fringe benefits often make up a large percentage of current liabilities. Employee compensation is often the most significant expense that a company incurs. For example, Costco recently reported total employees of 103,000 and labor and fringe benefits costs which approximated 70% of the company's total cost of operations.

Payroll accounting involves more than paying employees' wages. Companies are required by law to maintain payroll records for each employee, to file and pay payroll taxes, and to comply with state and federal tax laws related to employee compensation.

The term "payroll" pertains to both salaries and wages. Managerial, administrative, and sales personnel are generally paid **salaries**. Salaries are often expressed in terms of a specified amount per month or per year rather than an hourly rate. Store clerks, factory employees, and manual laborers are normally paid **wages**. Wages are based on a rate per hour or on a piecework basis (such as per unit of product). Frequently, people use the terms "salaries" and "wages" interchangeably.

The term "payroll" does not apply to payments made for services of professionals such as certified public accountants, attorneys, and architects. Such professionals are independent contractors rather than salaried employees. Payments to them are called **fees**. This distinction is important because government regulations relating to the payment and reporting of payroll taxes apply only to employees.

Determining the Payroll

Determining the payroll involves computing three amounts: (1) gross earnings, (2) payroll deductions, and (3) net pay.

STUDY OBJECTIVE 6

Compute and record the payroll for a pay period.

GROSS EARNINGS

Gross earnings is the total compensation earned by an employee. It consists of wages or salaries, plus any bonuses and commissions.

Companies determine total **wages** for an employee by multiplying the hours worked by the hourly rate of pay. In addition to the hourly pay rate, most companies are required by law to pay hourly workers a minimum of 1½ times the regular hourly rate for overtime work in excess of eight hours per day or 40 hours per week. In addition, many employers pay overtime rates for work done at night, on weekends, and on holidays.

For example, assume that Michael Jordan, an employee of Academy Company, worked 44 hours for the weekly pay period ending January 14. His regular wage is \$12 per hour. For any hours in excess of 40, the company pays at one-and-a-half times the regular rate. Academy computes Jordan's gross earnings (total wages) as follows.

Type of Pay	Hours	×	Rate	=	Gross Earnings
Regular	40	×	\$12	=	\$480
Overtime	4	×	18	=	72
Total wages					**\$552**

Illustration 11-8
Computation of total wages

This computation assumes that Jordan receives 1½ times his regular hourly rate (\$12 × 1.5) for his overtime hours. Union contracts often require that overtime rates be as much as twice the regular rates.

An employee's **salary** is generally based on a monthly or yearly rate. The company then prorates these rates to its payroll periods (e.g., biweekly or monthly). Most executive and administrative positions are salaried. Federal law does not require overtime pay for employees in such positions.

Many companies have **bonus** agreements for employees. One survey found that over 94% of the largest U.S. manufacturing companies offer annual bonuses to key executives. Bonus arrangements may be based on such factors as increased sales or net income. Companies may pay bonuses in cash and/or by granting employees the opportunity to acquire shares of company stock at favorable prices (called stock option plans).

ETHICS NOTE

Bonuses often reward outstanding individual performance, but successful corporations also need considerable teamwork. A challenge is to motivate individuals while preventing an unethical employee from taking another's idea for his or her own advantage.

PAYROLL DEDUCTIONS

As anyone who has received a paycheck knows, gross earnings are usually very different from the amount actually received. The difference is due to **payroll deductions**.

Payroll deductions may be mandatory or voluntary. Mandatory deductions are required by law and consist of FICA taxes and income taxes. Voluntary deductions are at the option of the employee. Illustration 11-9 (page 496) summarizes common types of payroll deductions. Such deductions do not result in payroll tax expense to the employer. The employer is merely a collection agent, and subsequently transfers the deducted amounts to the government and designated recipients.

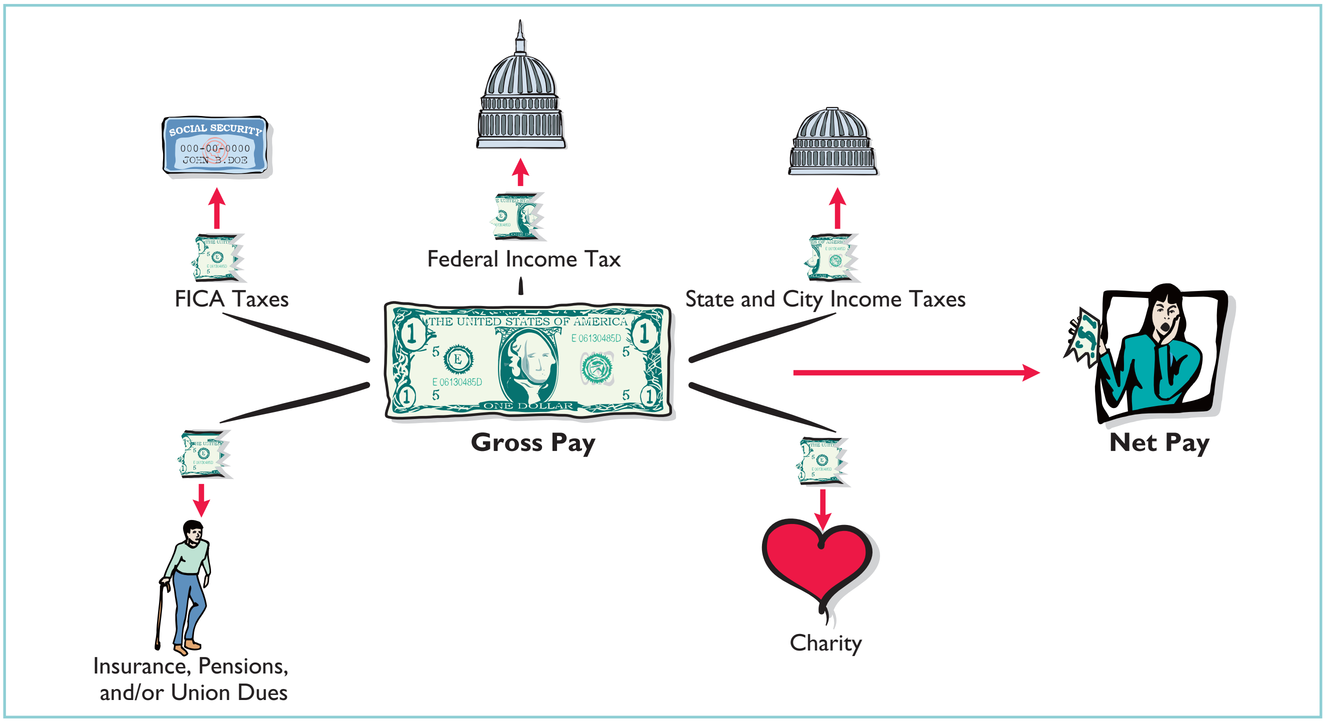


Illustration 11-9
Payroll deductions

FICA Taxes. In 1937 Congress enacted the Federal Insurance Contribution Act (FICA). **FICA taxes are designed to provide workers with supplemental retirement, employment disability, and medical benefits.** In 1965, Congress extended benefits to include Medicare for individuals over 65 years of age. The benefits are financed by a tax levied on employees' earnings. FICA taxes are commonly referred to as **Social Security taxes**.

Congress sets the tax rate and the tax base for FICA taxes. When FICA taxes were first imposed, the rate was 1% on the first $3,000 of gross earnings, or a maximum of $30 per year. The rate and base have changed dramatically since that time! In 2008, the rate was 7.65% (6.2% Social Security plus 1.45% Medicare) on the first $102,000 of gross earnings for each employee.[1] For purpose of illustration in this chapter, we will assume a rate of 8% on the first $100,000 of gross earnings, or a maximum of $8,000. Using the 8% rate, the FICA withholding for Jordan for the weekly pay period ending January 14 is $44.16 ($552 × 8%).

Income Taxes. Under the U.S. pay-as-you-go system of federal income taxes, employers are required to withhold income taxes from employees each pay period. Three variables determine the amount to be withheld: (1) the employee's gross earnings; (2) the number of allowances claimed by the employee; and (3) the length of the pay period. The number of allowances claimed typically includes the employee, his or her spouse, and other dependents.

Withholding tables furnished by the Internal Revenue Service indicate the amount of income tax to be withheld. Withholding amounts are based on gross wages and the number of allowances claimed. Separate tables are provided for weekly, biweekly, semimonthly, and monthly pay periods. Illustration 11-10 shows

---

[1] The Medicare provision also includes a tax of 1.45% on gross earnings in excess of $102,000. In the interest of simplification, we ignore this 1.45% charge in our end-of-chapter assignment material. We assume zero FICA withholdings on gross earnings above $100,000.

Illustration 11-10
Withholding tax table

MARRIED Persons — **WEEKLY** Payroll Period

(For Wages Paid in 2008)

If the wages are —		And the number of withholding allowances claimed is —										
At least	But less than	0	1	2	3	4	5	6	7	8	9	10
		The amount of income tax to be withheld is —										
490	**500**	56	48	40	32	24	17	9	1	0	0	0
500	**510**	57	49	42	34	26	18	10	3	0	0	0
510	**520**	59	51	43	35	27	20	12	4	0	0	0
520	**530**	60	52	45	37	29	21	13	6	0	0	0
530	**540**	62	54	46	38	30	23	15	7	0	0	0
540	**550**	63	55	48	40	32	24	16	9	1	0	0
550	**560**	65	57	**49**	41	33	26	18	10	2	0	0
560	**570**	66	58	51	43	35	27	19	12	4	0	0
570	**580**	68	60	52	44	36	29	21	13	5	0	0
580	**590**	69	61	54	46	38	30	22	15	7	0	0
590	**600**	71	63	55	47	39	32	24	16	8	1	0
600	**610**	72	64	57	49	41	33	25	18	10	2	0
610	**620**	74	66	58	50	42	35	27	19	11	4	0
620	**630**	75	67	60	52	44	36	28	21	13	5	0
630	**640**	77	69	61	53	45	38	30	22	14	7	0
640	**650**	78	70	63	55	47	39	31	24	16	8	0
650	**660**	80	72	64	56	48	41	33	25	17	10	2
660	**670**	81	73	66	58	50	42	34	27	19	11	3
670	**680**	83	75	67	59	51	44	36	28	20	13	5
680	**690**	84	76	69	61	53	45	37	30	22	14	6

the withholding tax table for Michael Jordan (assuming he earns $552 per week and claims two allowances). For a weekly salary of $552 with two allowances, the income tax to be withheld is $49.

In addition, most states (and some cities) require **employers** to withhold income taxes from employees' earnings. As a rule, the amounts withheld are a percentage (specified in the state revenue code) of the amount withheld for the federal income tax. Or they may be a specified percentage of the employee's earnings. For the sake of simplicity, we have assumed that Jordan's wages are subject to state income taxes of 2%, or $11.04 (2% × $552) per week.

There is no limit on the amount of gross earnings subject to income tax withholdings. In fact, under our progressive system of taxation, the higher the earnings, the higher the percentage of income withheld for taxes.

Other Deductions. Employees may voluntarily authorize withholdings for charitable, retirement, and other purposes. All voluntary deductions from gross earnings should be authorized in writing by the employee. The authorization(s) may be made individually or as part of a group plan. Deductions for charitable organizations, such as the United Way, or for financial arrangements, such as U.S. savings bonds and repayment of loans from company credit unions, are made individually. Deductions for union dues, health and life insurance, and pension plans are often made on a group basis. We will assume that Jordan has weekly voluntary deductions of $10 for the United Way and $5 for union dues.

NET PAY

Academy determines **net pay** by subtracting payroll deductions from gross earnings. Illustration 11-11 (page 498) shows the computation of Jordan's net pay for the pay period.

ALTERNATIVE TERMINOLOGY

Net pay is also called *take-home pay*.

Illustration 11-11
Computation of net pay

Gross earnings		$552.00
Payroll deductions:		
FICA taxes	$44.16	
Federal income taxes	49.00	
State income taxes	11.04	
United Way	10.00	
Union dues	5.00	119.20
Net pay		**$432.80**

Assuming that Michael Jordan's wages for each week during the year are $552, total wages for the year are $28,704 (52 × $552). Thus, all of Jordan's wages are subject to FICA tax during the year. In comparison, let's assume that Jordan's department head earns $2,000 per week, or $104,000 for the year. Since only the first $100,000 is subject to FICA taxes, the maximum FICA withholdings on the department head's earnings would be $8,000 ($100,000 × 8%).

ACCOUNTING ACROSS THE ORGANIZATION

Taxes Are the Largest Slice of the Pie

In 2008, Americans worked 74 days to afford their federal taxes and 39 more days to afford state and local taxes, according to the Tax Foundation. Each year this foundation calculates the mathematical average of tax collections in the United States, using a formula that divides the year's total tax collections (federal, state, and local taxes) by all income earned (the "national income"). The resulting national "tax burden" varies each year, and the tax burden also varies by state.

National taxation in 2008 was a bigger burden than average expenditures on housing and household operation (60 days), health and medical care (50 days), food (35 days), transportation (29 days), recreation (21 days), or clothing and accessories (13 days).

Source: *www.taxfoundation.org/taxfreedomday/* (accessed June 2008). For a map of tax burden by states, see Figure 6 at that site.

? If the information on 2008 taxation depicted your spending patterns, on what date (starting on January 1) will you have earned enough to pay all of your taxes? This date is often referred to as Tax Freedom Day.

Recording the Payroll

Recording the payroll involves maintaining payroll department records, recognizing payroll expenses and liabilities, and recording payment of the payroll.

MAINTAINING PAYROLL DEPARTMENT RECORDS

To comply with state and federal laws, an employer must keep a cumulative record of each employee's gross earnings, deductions, and net pay during the year. The record that provides this information is the **employee earnings record**. Illustration 11-12 (next page) shows Michael Jordan's employee earnings record.

Companies keep a separate earnings record for each employee, and update these records after each pay period. The employer uses the cumulative payroll data on the earnings record to: (1) determine when an employee has earned the maximum earnings subject to FICA taxes, (2) file state and federal payroll tax returns (as explained

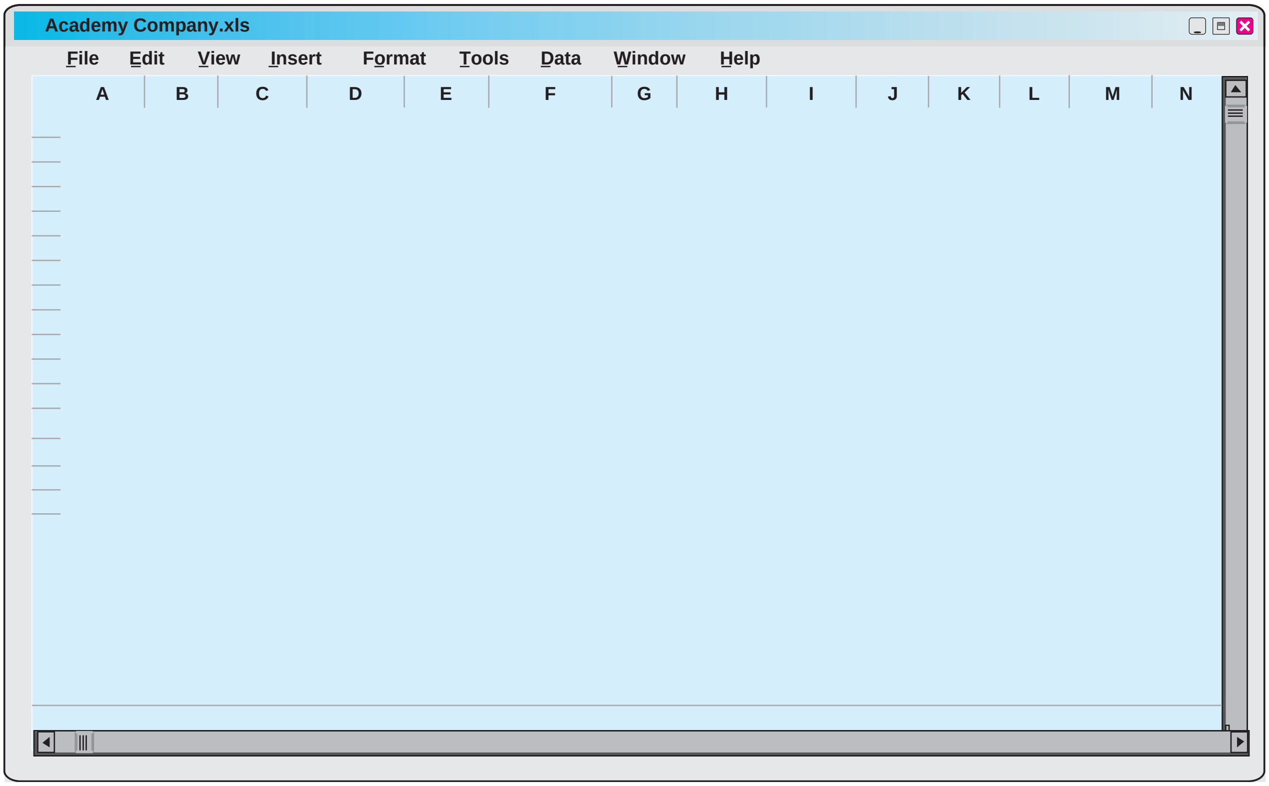


Illustration 11-12
Employee earnings record

later), and (3) provide each employee with a statement of gross earnings and tax withholdings for the year. Illustration 11-16 on page 504 shows this statement.

In addition to employee earnings records, many companies find it useful to prepare a **payroll register**. This record accumulates the gross earnings, deductions, and net pay by employee for each pay period. Illustration 11-13 presents Academy Company's payroll register. It provides the documentation for preparing a paycheck for each employee. For example, it shows the data for Michael Jordan in the wages section. In this example, Academy Company's total weekly payroll is $17,210, as shown in the gross earnings column (column E, row 24).

Note that this record is a listing of each employee's payroll data for the pay period. In some companies, a payroll register is a journal or book of original entry. Postings are made from it directly to ledger accounts. In other companies, the payroll register is a memorandum record that provides the data for a general journal entry and subsequent posting to the ledger accounts. At Academy Company, the latter procedure is followed.

RECOGNIZING PAYROLL EXPENSES AND LIABILITIES

From the payroll register in Illustration 11-13, Academy Company makes a journal entry to record the payroll. For the week ending January 14 the entry is:

A	=	L	+	OE
				−5,200.00 Exp
				−12,010.00 Exp
		+1,376.80		
		+3,490.00		
		+344.20		
		+421.50		
		+115.00		
		+11,462.50		

Cash Flows
no effect

Jan. 14	Office Salaries Expense	5,200.00	
	Wages Expense	12,010.00	
	FICA Taxes Payable		1,376.80
	Federal Income Taxes Payable		3,490.00
	State Income Taxes Payable		344.20
	United Way Payable		421.50
	Union Dues Payable		115.00
	Salaries and Wages Payable		11,462.50
	(To record payroll for the week ending January 14)		

The company credits specific liability accounts for the mandatory and voluntary deductions made during the pay period. In the example, Academy debits Office Salaries Expense for the gross earnings of salaried office workers, and it debits Wages Expense for the gross earnings of employees who are paid at an hourly rate. Other companies may debit other accounts such as Store Salaries or Sales Salaries. The amount credited to Salaries and Wages Payable is the sum of the individual checks the employees will receive.

RECORDING PAYMENT OF THE PAYROLL

A company makes payments by check (or electronic funds transfer) either from its regular bank account or a payroll bank account. Each paycheck is usually accompanied by a detachable **statement of earnings** document. This shows the employee's gross earnings, payroll deductions, and net pay, both for the period and for the year-to-date. Academy Company uses its regular bank account for payroll checks. Illustration 11-14 (next page) shows the paycheck and statement of earnings for Michael Jordan.

Following payment of the payroll, the company enters the check numbers in the payroll register. Academy Company records payment of the payroll as follows.

A	=	L	+	OE
		−11,462.50		
−11,462.50				

Cash Flows
−11,462.50

Jan. 14	Salaries and Wages Payable	11,462.50	
	Cash		11,462.50
	(To record payment of payroll)		

Many medium- and large-size companies use a payroll processing center that provides payroll record-keeping services. Companies send the center payroll information about employee pay rates and hours worked. The center maintains the payroll records and prepares the payroll checks. In most cases, it costs less to process the payroll through the center than if the company did so internally.

AC

ACADEMY COMPANY
19 Center St.
Hampton, MI 48291

No. 1028

January 14, 2010 62—1113/610

Pay to the order of Michael Jordan $ 432.80

Four Hundred Thirty-two and 80/100 Dollars

City Bank & Trust
P.O. Box 3000
Hampton, MI 48291

For Payroll

Randall E. Barnes

003244771" 1028

DETACH AND RETAIN THIS PORTION FOR YOUR RECORDS

NAME	SOC. SEC. NO.	EMPL. NUMBER	NO. EXEMP	PAY PERIOD ENDING
Michael Jordan	329-36-9547		2	1/14/10

REG. HRS.	O.T. HRS.	OTH. HRS. (1)	OTH. HRS. (2)	REG. EARNINGS	O.T. EARNINGS	OTH. EARNINGS (1)	OTH. EARNINGS (2)	GROSS
40	4			480.00	72.00			$552.00

FED. W/H TAX	FICA	STATE TAX	LOCAL TAX	OTHER DEDUCTIONS (1)	(2)	(3)	(4)	NET PAY
49.00	44.16	11.04		10.00	5.00			432.80

YEAR TO DATE

FED. W/H TAX	FICA	STATE TAX	LOCAL TAX	OTHER DEDUCTIONS (1)	(2)	(3)	(4)	NET PAY
92.00	85.44	21.36		20.00	10.00			$839.20

Illustration 11-14
Paycheck and statement of earnings

HELPFUL HINT

Do any of the income tax liabilities result in payroll tax expense for the employer?

Answer: No. The employer is acting only as a collection agent for the government.

DO IT!

In January, gross earnings in Ramirez Company were $40,000. All earnings are subject to 8% FICA taxes. Federal income tax withheld was $9,000, and state income tax withheld was $1,000. (a) Calculate net pay for January, and (b) record the payroll.

PAYROLL

action plan

- ✔ Determine net pay by subtracting payroll deductions from gross earnings.
- ✔ Record gross earnings as Salaries and Wages Expense, record payroll deductions as liabilities, and record net pay as Salaries and Wages Payable.

Solution

(a) Net pay: $40,000 − (8% × $40,000) − $9,000 − $1,000 = $26,800

(b)

Salaries and Wages Expense	40,000	
FICA Taxes Payable		3,200
Federal Income Taxes Payable		9,000
State Income Taxes Payable		1,000
Salaries and Wages Payable		26,800
(To record payroll)		

Related exercise material: **BE11-8, BE11-7, E11-10, E11-11, E11-12, E11-13,** and **DO IT! 11-3.**

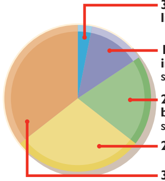
✔ The Navigator

Employer Payroll Taxes

STUDY OBJECTIVE 7

Describe and record employer payroll taxes.

Payroll tax expense for businesses results from three taxes that governmental agencies levy **on employers**. These taxes are: (1) FICA, (2) federal unemployment tax, and (3) state unemployment tax. These taxes plus



such items as paid vacations and pensions (discussed in the appendix to this chapter) are collectively referred to as **fringe benefits**. As indicated earlier, the cost of fringe benefits in many companies is substantial. The pie chart in the margin shows the pieces of the benefits "pie."

FICA TAXES

Each employee must pay FICA taxes. In addition, employers must match each employee's FICA contribution. The matching contribution results in **payroll tax expense** to the employer. The employer's tax is subject to the same rate and maximum earnings as the employee's. The company uses the same account, FICA Taxes Payable, to record both the employee's and the employer's FICA contributions. For the January 14 payroll, Academy Company's FICA tax contribution is $1,376.80 ($17,210.00 × 8%).

FEDERAL UNEMPLOYMENT TAXES

The Federal Unemployment Tax Act (FUTA) is another feature of the federal Social Security program. **Federal unemployment taxes** provide benefits for a limited period of time to employees who lose their jobs through no fault of their own. The FUTA tax rate is 6.2% of taxable wages. The taxable wage base is the first $7,000 of wages paid to each employee in a calendar year. Employers who pay the state unemployment tax on a timely basis will receive an offset credit of up to 5.4%. Therefore, the net federal tax rate is generally 0.8% (6.2%–5.4%). This rate would equate to a maximum of $56 of federal tax per employee per year (0.8% × $7,000). State tax rates are based on state law.

HELPFUL HINT

Both the employer and employee pay FICA taxes. Federal unemployment taxes and (in most states) the state unemployment taxes are borne entirely by the employer.

The **employer** bears the entire federal unemployment tax. There is no deduction or withholding from employees. Companies use the account Federal Unemployment Taxes Payable to recognize this liability. The federal unemployment tax for Academy Company for the January 14 payroll is $137.68 ($17,210.00 × 0.8%).

STATE UNEMPLOYMENT TAXES

All states have unemployment compensation programs under state unemployment tax acts (SUTA). Like federal unemployment taxes, **state unemployment taxes** provide benefits to employees who lose their jobs. These taxes are levied on employers.[2] The basic rate is usually 5.4% on the first $7,000 of wages paid to an employee during the year. The state adjusts the basic rate according to the employer's experience rating: Companies with a history of stable employment may pay less than 5.4%. Companies with a history of unstable employment may pay more than the basic rate. Regardless of the rate paid, the company's credit on the federal unemployment tax is still 5.4%.

Companies use the account State Unemployment Taxes Payable for this liability. The state unemployment tax for Academy Company for the January 14 payroll is $929.34 ($17,210.00 × 5.4%). Illustration 11-15 (next page) summarizes the types of employer payroll taxes.

RECORDING EMPLOYER PAYROLL TAXES

Companies usually record employer payroll taxes at the same time they record the payroll. The entire amount of gross pay ($17,210.00) shown in the payroll register in Illustration 11-13 is subject to each of the three taxes mentioned above. Accordingly,

[2] In a few states, the employee is also required to make a contribution. *In this textbook, including the homework, we will assume that the tax is only on the employer.*

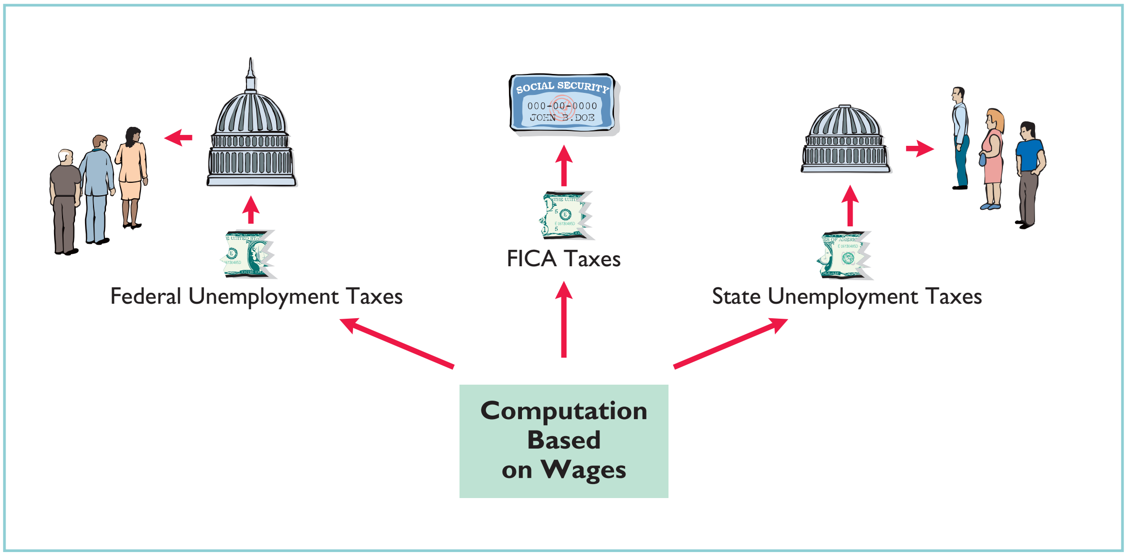


Illustration 11-15
Employer payroll taxes

Academy records the payroll tax expense associated with the January 14 payroll with the following entry.

Jan. 14	Payroll Tax Expense	2,443.82	
	FICA Taxes Payable		1,376.80
	Federal Unemployment Taxes Payable		137.68
	State Unemployment Taxes Payable		929.34
	(To record employer's payroll taxes on January 14 payroll)		

A	=	L	+	OE
				−2,443.82 Exp
		+1,376.80		
		+137.68		
		+929.34		

Cash Flows
no effect

Note that Academy uses separate liability accounts instead of a single credit to Payroll Taxes Payable. Why? Because these liabilities are payable to different taxing authorities at different dates. Companies classify the liability accounts in the balance sheet as current liabilities since they will be paid within the next year. They classify Payroll Tax Expense on the income statement as an operating expense.

Filing and Remitting Payroll Taxes

Preparation of payroll tax returns is the responsibility of the payroll department. The treasurer's department makes the tax payment. Much of the information for the returns is obtained from employee earnings records.

For purposes of reporting and remitting to the IRS, the company combines the FICA taxes and federal income taxes that it withheld. **Companies must report the taxes quarterly**, no later than one month following the close of each quarter. The remitting requirements depend on the amount of taxes withheld and the length of the pay period. Companies remit funds through deposits in either a Federal Reserve bank or an authorized commercial bank.

Companies generally file and remit federal unemployment taxes **annually** on or before January 31 of the subsequent year. Earlier payments are required when the tax exceeds a specified amount. Companies usually must file and pay state unemployment taxes by the **end of the month following each quarter**. When payroll taxes are paid, companies debit payroll liability accounts, and credit Cash.

Employers also must provide each employee with a **Wage and Tax Statement (Form W-2)** by January 31 following the end of a calendar year. This statement shows gross earnings, FICA taxes withheld, and income taxes withheld for the year. The required W-2 form for Michael Jordan, using assumed annual data, is shown in Illustration 11-16. The employer must send a copy of each employee's Wage and Tax Statement (Form W-2) to the Social Security Administration. This agency subsequently furnishes the Internal Revenue Service with the income data required.

Illustration 11-16
W-2 form

22222	Void ☐	**a** Employee's social security number 329-36-9547	**For Official Use Only ▶** **OMB No. 1545-0008**
b Employer identification number (EIN) 36-2167852		**1** Wages, tips, other compensation 26,300.00	**2** Federal income tax withheld 2,248.00
c Employer's name, address, and ZIP code Academy Company 19 Center St. Hampton, MI 48291		**3** Social security wages 26,300.00	**4** Social security tax withheld 2,104.00
		5 Medicare wages and tips 26,300.00	**6** Medicare tax withheld
		7 Social security tips	**8** Allocated tips
d Control number		**9** Advance EIC payment	**10** Dependent care benefits
e Employee's first name and initial: Michael	Last name: Jordan — Suff.	**11** Nonqualified plans	**12a** See instructions for box 12 (Code)
2345 Mifflin Ave. Hampton, MI 48292		**13** Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	**12b** (Code)
		14 Other	**12c** (Code)
f Employee's address and ZIP code			**12d** (Code)

15 State	Employer's state ID number	**16** State wages, tips, etc.	**17** State income tax	**18** Local wages, tips, etc.	**19** Local income tax	**20** Locality name
MI	423-1466-3	26,300.00	526.00			

Form **W-2** **Wage and Tax Statement** **2007**

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see back of Copy D.

Copy A For Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

Cat. No. 10134D

Internal Control for Payroll

STUDY OBJECTIVE 8
Discuss the objectives of internal control for payroll.

Chapter 8 introduced internal control. As applied to payrolls, the objectives of internal control are (1) to safeguard company assets against unauthorized payments of payrolls, and (2) to ensure the accuracy and reliability of the accounting records pertaining to payrolls.

Irregularities often result if internal control is lax. Frauds involving payroll include overstating hours, using unauthorized pay rates, adding fictitious employees to the payroll, continuing terminated employees on the payroll, and distributing duplicate payroll checks. Moreover, inaccurate records will result in incorrect paychecks, financial statements, and payroll tax returns.

Payroll activities involve four functions: hiring employees, timekeeping, preparing the payroll, and paying the payroll. For effective internal control, companies should assign these four functions to different departments or individuals. Illustration 11-17 (next page) highlights these functions and illustrates their internal control features.

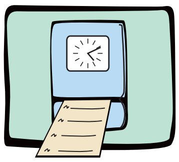
Payroll Function

Hiring Employees

Internal control feature: Human Resources department documents and authorizes employment.

Fraud prevented: Fictitious employees are not added to payroll.

Timekeeping



Internal control feature: Supervisors monitor hours worked through time cards and time reports.

Fraud prevented: Employee works appropriate hours.

Payroll Function

Preparing the Payroll

Internal control feature: Two (or more) employees verify payroll amounts; supervisor approves.

Fraud prevented: Payroll calculations are accurate and relevant.

Paying the Payroll

Internal control feature: Treasurer signs and distributes prenumbered checks.

Fraud prevented: Checks are not lost from theft; endorsed check provides proof of payment.

Illustration 11-17
Internal control for payroll

DO IT!

EMPLOYER'S PAYROLL TAXES

In January, the payroll supervisor determines that gross earnings for Halo Company are $70,000. All earnings are subject to 8% FICA taxes, 5.4% state unemployment taxes, and 0.8% federal unemployment taxes. Halo asks you to record the employer's payroll taxes.

action plan

- ✔ Compute the employer's payroll taxes on the period's gross earnings.
- ✔ Identify the expense account(s) to be debited.
- ✔ Identify the liability account(s) to be credited.

Solution

The entry to record the employer's payroll taxes is:

Payroll Tax Expense	9,940	
FICA Taxes Payable ($70,000 × 8%)		5,600
Federal Unemployment Taxes Payable ($70,000 × 0.8%)		560
State Unemployment Taxes Payable ($70,000 × 5.4%)		3,780
(To record employer's payroll taxes on January payroll)		

Related exercise material: **BE11-9, BE11-10, E11-12, E11-14,** and **DO IT! 11-4.**

The Navigator

Be sure to read **ALL ABOUT YOU: *Your Boss Wants to Know If You Jogged Today*** on page 506 for information on how topics in this chapter apply to your personal life.

Your Boss Wants to Know If You Jogged Today

As you saw in this chapter, compensation packages often include fringe benefits in addition to basic salary. Health insurance is one benefit that many employers offer. In recent years, as the cost of health insurance has sky-rocketed, many employers either have shifted some of the cost of health insurance onto employees, or have discontinued health insurance coverage altogether.

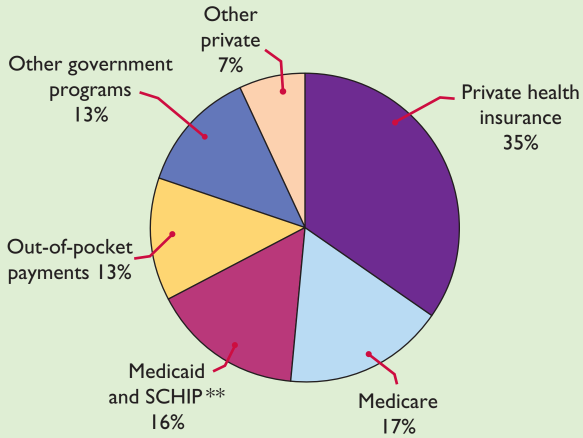
Some Facts

* Health-care spending in the U.S. was $1.9 trillion in 2004, and is projected to be $2.9 trillion by 2009. It is four times the amount spent on national defense and represents 16% of U.S. gross domestic product.
* About 45 million Americans are without any form of health insurance. Many of these people are employed, but their jobs don't provide a health-care benefit.
* For employers, the average cost of health-care benefits per employee is about $6,700 per year.
* The rate of increase of employer health-care costs has slowed somewhat as employers raised the employee share of premiums and raised deductibles (the amount of a bill that the employee pays before insurance coverage begins).
* More than 30% of small employers have a deductible of $1,000 for employee health insurance.

About the Numbers

As the graph below shows, private health insurance, such as that provided by employers, pays for less than half of health-care costs in the U.S. If employers continue to cut their health-care benefits, more of the burden will shift to the government or to individuals as out-of-pocket costs.

The Nation's Health-Care Dollar: Where it Comes From*



* Does not add to 100% due to rounding.
** State Children's Health Insurance Program.

Source: Data for 2004, from Centers for Medicare and Medicaid Services, Office of the Actuary, National Health Statistics Group.

What Do You Think?

Suppose you own a business. About a quarter of your employees smoke, and an even higher percentage are overweight. You decide to implement a mandatory health program that requires employees to quit smoking and to exercise regularly, with regular monitoring. If employees do not participate in the program, they will have to pay their own insurance premiums. Is this fair?

YES: It is the responsibility of management to try to maximize a company's profit. Employees with unhealthy habits drive up the cost of health insurance because they require more frequent and more costly medical attention.

NO: What people do on their own time is their own business. This represents an invasion of privacy, and is a form of discrimination.

Source: Dee Gill, "Get Healthy . . . Or Else," *Inc.* Magazine, April 2006; "Health Insurance Cost," The National Coalition on Health Care, *www.nchc.org/facts/cost.shtml* (accessed May 2006).

The authors' comments on this situation appear on page 525.

Comprehensive DO IT!

Indiana Jones Company had the following selected transactions.

Feb. 1 Signs a $50,000, 6-month, 9%-interest-bearing note payable to CitiBank and receives $50,000 in cash.

10 Cash register sales total $43,200, which includes an 8% sales tax.

28 The payroll for the month consists of Sales Salaries $32,000 and Office Salaries $18,000. All wages are subject to 8% FICA taxes. A total of $8,900 federal income taxes are withheld. The salaries are paid on March 1.

28 The company develops the following adjustment data.
1. Interest expense of $375 has been incurred on the note.
2. Employer payroll taxes include 8% FICA taxes, a 5.4% state unemployment tax, and a 0.8% federal unemployment tax.
3. Some sales were made under warranty. Of the units sold under warranty, 350 are expected to become defective. Repair costs are estimated to be $40 per unit.

Instructions

(a) Journalize the February transactions.
(b) Journalize the adjusting entries at February 28.

action plan

✔ To determine sales, divide the cash register total by 100% plus the sales tax percentage.

✔ Base payroll taxes on gross earnings.

✔ Expense warranty costs in the period in which the sale occurs.

Solution to Comprehensive DO IT!

(a)	Feb. 1	Cash	50,000	
		Notes Payable		50,000
		(Issued 6-month, 9%-interest-bearing note to CitiBank)		
	10	Cash	43,200	
		Sales ($43,200 ÷ 1.08)		40,000
		Sales Taxes Payable ($40,000 × 8%)		3,200
		(To record sales and sales taxes payable)		
	28	Sales Salaries Expense	32,000	
		Office Salaries Expense	18,000	
		FICA Taxes Payable (8% × $50,000)		4,000
		Federal Income Taxes Payable		8,900
		Salaries Payable		37,100
		(To record February salaries)		
(b)	Feb. 28	Interest Expense	375	
		Interest Payable		375
		(To record accrued interest for February)		
	28	Payroll Tax Expense	7,100	
		FICA Taxes Payable		4,000
		Federal Unemployment Taxes Payable (0.8% × $50,000)		400
		State Unemployment Taxes Payable (5.4% × $50,000)		2,700
		(To record employer's payroll taxes on February payroll)		
	28	Warranty Expense (350 × $40)	14,000	
		Estimated Warranty Liability		14,000
		(To record estimated product warranty liability)		

The Navigator

SUMMARY OF STUDY OBJECTIVES

1 **Explain a current liability, and identify the major types of current liabilities.** A current liability is a debt that a company can reasonably expect to pay (1) from existing current assets or through the creation of other current liabilities, and (2) within one year or the operating cycle, whichever is longer. The major types of current liabilities are notes payable, accounts payable, sales taxes payable, unearned revenues, and accrued liabilities such as taxes, salaries and wages, and interest payable.

2 **Describe the accounting for notes payable.** When a promissory note is interest-bearing, the amount of assets received upon the issuance of the note is generally equal to the face value of the note. Interest expense accrues over the life of the note. At maturity, the amount paid equals the face value of the note plus accrued interest.

3 **Explain the accounting for other current liabilities.** Companies record sales taxes payable at the time the related sales occur. The company serves as a collection agent for the taxing authority. Sales taxes are not an expense to the company. Companies initially record unearned revenues in an Unearned Revenue account. As the company earns the revenue, a transfer from unearned revenue to earned revenue occurs. Companies report the current maturities of long-term debt as a current liability in the balance sheet.

4 **Explain the financial statement presentation and analysis of current liabilities.** Companies should report the nature and amount of each current liability in the balance sheet or in schedules in the notes accompanying the statements. The liquidity of a company may be analyzed by computing working capital and the current ratio.

5 **Describe the accounting and disclosure requirements for contingent liabilities.** If the contingency is *probable* (likely to occur) and the amount is reasonably estimable, the company should record the liability in the accounts. If the contingency is only *reasonably possible* (it could happen), then it should be disclosed only in the notes to the financial statements. If the possibility that the contingency will happen is *remote* (unlikely to occur), it need not be recorded or disclosed.

6 **Compute and record the payroll for a pay period.** The computation of the payroll involves gross earnings, payroll deductions, and net pay. In recording the payroll, companies debit salaries (or wages) expense for gross earnings, credit individual tax and other liability accounts for payroll deductions, and credit salaries (wages) payable for net pay. When the payroll is paid, companies debit Salaries and Wages Payable, and credit Cash.

7 **Describe and record employer payroll taxes.** Employer payroll taxes consist of FICA, federal unemployment taxes, and state unemployment taxes. The taxes are usually accrued at the time the company records the payroll, by debiting Payroll Tax Expense and crediting separate liability accounts for each type of tax.

8 **Discuss the objectives of internal control for payroll.** The objectives of internal control for payroll are (1) to safeguard company assets against unauthorized payments of payrolls, and (2) to ensure the accuracy of the accounting records pertaining to payrolls.

The Navigator

GLOSSARY

Bonus Compensation to management and other personnel, based on factors such as increased sales or the amount of net income. (p. 495).

Contingent liability A potential liability that may become an actual liability in the future. (p. 491).

Current ratio A measure of a company's liquidity; computed as current assets divided by current liabilities. (p. 491).

Employee earnings record A cumulative record of each employee's gross earnings, deductions, and net pay during the year. (p. 498).

Federal unemployment taxes Taxes imposed on the employer by the federal government that provide benefits for a limited time period to employees who lose their jobs through no fault of their own. (p. 502).

Fees Payments made for the services of professionals. (p. 494).

FICA taxes Taxes designed to provide workers with supplemental retirement, employment disability, and medical benefits. (p. 496).

Full-disclosure principle Requires that companies disclose all circumstances and events that would make a difference to financial statement users. (p. 493).

Gross earnings Total compensation earned by an employee. (p. 495).

Net pay Gross earnings less payroll deductions. (p. 497).

Notes payable Obligations in the form of written promissory notes. (p. 486).

Payroll deductions Deductions from gross earnings to determine the amount of a paycheck. (p. 495).

Payroll register A payroll record that accumulates the gross earnings, deductions, and net pay by employee for each pay period. (p. 499).

Salaries Employee pay based on a specified amount rather than an hourly rate. (p. 494).

Statement of earnings A document attached to a paycheck that indicates the employee's gross earnings, payroll deductions, and net pay. (p. 500).

State unemployment taxes Taxes imposed on the employer by states that provide benefits to employees who lose their jobs. (p. 502).

Wage and Tax Statement (Form W-2) A form showing gross earnings, FICA taxes withheld, and income taxes withheld, prepared annually by an employer for each employee. (p. 504).

Wages Amounts paid to employees based on a rate per hour or on a piece-work basis. (p. 494).

Working capital A measure of a company's liquidity; computed as current assets minus current liabilities. (p. 491).

APPENDIX Additional Fringe Benefits

STUDY OBJECTIVE 9

Identify additional fringe benefits associated with employee compensation.

In addition to the three payroll-tax fringe benefits, employers incur other substantial fringe benefit costs. Two of the most important are paid absences and post-retirement benefits.

Paid Absences

Employees often are given rights to receive compensation for absences when they meet certain conditions of employment. The compensation may be for paid vacations, sick pay benefits, and paid holidays. When the payment for such absences is **probable** and the amount can be **reasonably estimated**, the company should accrue a liability for paid future absences. When the amount cannot be reasonably estimated, the company should instead disclose the potential liability. Ordinarily, vacation pay is the only paid absence that is accrued. The other types of paid absences are only disclosed.[3]

To illustrate, assume that Academy Company employees are entitled to one day's vacation for each month worked. If 30 employees earn an average of $110 per day in a given month, the accrual for vacation benefits in one month is $3,300. Academy records the liability at the end of the month by the following adjusting entry.

Jan. 31	Vacation Benefits Expense	3,300	
	Vacation Benefits Payable		3,300
	(To accrue vacation benefits expense)		

A	=	L	+	OE
				−3,300 Exp
		+3,300		

Cash Flows
no effect

This accrual is required by the matching principle. Academy would report Vacation Benefits Expense as an operating expense in the income statement, and Vacation Benefits Payable as a current liability in the balance sheet.

Later, when Academy pays vacation benefits, it debits Vacation Benefits Payable and credits Cash. For example, if employees take 10 days of vacation in July, the entry is:

July 31	Vacation Benefits Payable	1,100	
	Cash		1,100
	(To record payment of vacation benefits)		

A	=	L	+	OE
		−1,100		
−1,100				

Cash Flows
−1,100

The magnitude of unpaid absences has gained employers' attention. Consider the case of an assistant superintendent of schools who worked for 20 years and rarely took a vacation or sick day. A month or so before she retired, the school district discovered that she was due nearly $30,000 in accrued benefits. Yet the school district had never accrued the liability.

[3] The typical U.S. company provides an average of 12 days of paid vacations for its employees, at an average cost of 5% of gross earnings.

Post-Retirement Benefits

Post-retirement benefits are benefits that employers provide to retired employees for (1) pensions and (2) health care and life insurance. Companies account for both types of post-retirement benefits on the accrual basis. The cost of post-retirement benefits is getting steep. For example, General Motors' pension and health-care costs for retirees in a recent year totaled $6.2 billion, or approximately $1,784 per vehicle produced.

The average American has debt of approximately $10,000 (not counting the mortgage on their home) and has little in the way of savings. What will happen at retirement for these people? The picture is not pretty—people are living longer, the future of Social Security is unclear, and companies are cutting back on post-retirement benefits. This situation may lead to one of the great social and moral dilemmas this country faces in the next 40 years. The more you know about post-retirement benefits, the better you will understand the issues involved in this dilemma.

PENSIONS

A **pension plan** is an agreement whereby employers provide benefits (payments) to employees after they retire. The most popular type of pension plan used is the 401(k) plan. A 401(k) plan works as follows: As an employee, you can contribute up to a certain percentage of your pay into a 401(k) plan, and your employer will match a percentage of your contribution. These contributions are then generally invested in stocks and bonds through mutual funds. These funds will grow without being taxed and can be withdrawn beginning at age 59-1/2. If you must access the funds earlier, you may be able to do so, but a penalty usually occurs along with a payment of tax on the proceeds. Any time you have the opportunity to be involved in a 401(k) plan, you should avail yourself of this benefit!

The accounting for a 401(k) plan by the company is straightforward. When the company makes a contribution on behalf of the employee, it debits Pension Expense and credits Cash for the amount contributed. For example, Mark Hatfield, an employee of Veri Company, contributes $11,000 to his 401(k) plan. Veri Company matches this contribution, and records the expense with the following entry.

Pension Expense	11,000	
Cash		11,000
(To record contribution to 401(k) plan.)		

If the pension expense is not funded during the year, the company credits Pension Liability.

A 401(k) plan is often referred to as a **defined-contribution plan**. In a defined-contribution plan, the plan defines the contribution that an employer will make but not the benefit that the employee will receive at retirement.

The other type of pension plan is a **defined-benefit plan**. In a defined-benefit plan, the employer agrees to pay a defined amount to retirees, based on employees meeting certain eligibility standards. The amount of the benefit is usually based on years of service and average salary over a period of years. Employers are at risk with defined-benefit plans because they must contribute enough to meet the cost of benefits that the plan defines. Many large companies have defined-benefit plans. The accounting for these plans is complex. Many companies are starting to utilize 401(k) plans more extensively instead.

POST-RETIREMENT HEALTH-CARE AND LIFE INSURANCE BENEFITS

Providing medical and related health-care benefits for retirees was at one time an inexpensive and highly effective way of generating employee goodwill. This practice has now turned into one of corporate America's most worrisome financial problems. Runaway medical costs, early retirement, and increased longevity are sending the liability for retiree health plans through the roof.

Companies estimate and expense post-retirement costs during the working years of the employee because the company benefits from the employee's services during this period. However, the company rarely sets up funds to meet the cost of the future benefits. It follows a pay-as-you-go basis for these costs. The major reason is that the company does not receive a tax deduction until it actually pays the medical bill.

SUMMARY OF STUDY OBJECTIVE FOR APPENDIX

9 **Identify additional fringe benefits associated with employee compensation.** Additional fringe benefits associated with wages are paid absences (paid vacations, sick pay benefits, and paid holidays), and post-retirement benefits (pensions and health care and life insurance).

GLOSSARY FOR APPENDIX

Pension plan An agreement whereby an employer provides benefits to employees after they retire. (p. 510).

Post-retirement benefits Payments by employers to retired employees for health care, life insurance, and pensions. (p. 510).

*__Note:__ All **asterisked** Questions, Exercises, and Problems relate to material in the appendix to the chapter.

SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

(SO 1) **1.** The time period for classifying a liability as current is one year or the operating cycle, whichever is:
a. longer.
b. shorter.
c. probable.
d. possible.

(SO 1) **2.** To be classified as a current liability, a debt must be expected to be paid:
a. out of existing current assets.
b. by creating other current liabilities.
c. within 2 years.
d. both (a) and (b).

(SO 2) **3.** Maggie Sharrer Company borrows $88,500 on September 1, 2010, from Sandwich State Bank by signing an $88,500, 12%, one-year note. What is the accrued interest at December 31, 2010?
a. $2,655.
b. $3,540.
c. $4,425.
d. $10,620.

(SO 2) **4.** RS Company borrowed $70,000 on December 1 on a 6-month, 12% note. At December 31:
a. neither the note payable nor the interest payable is a current liability.
b. the note payable is a current liability, but the interest payable is not.
c. the interest payable is a current liability but the note payable is not.
d. both the note payable and the interest payable are current liabilities.

5. Becky Sherrick Company has total proceeds from sales of $4,515. If the proceeds include sales taxes of 5%, the amount to be credited to Sales is: (SO 3)
a. $4,000.
b. $4,300.
c. $4,289.25.
d. No correct answer given.

6. Sensible Insurance Company collected a premium of $18,000 for a 1-year insurance policy on April 1. What amount should Sensible report as a current liability for Unearned Insurance Premiums at December 31? (SO 3)
a. $0.
b. $4,500.
c. $13,500.
d. $18,000.

7. Working capital is calculated as: (SO 4)
a. current assets minus current liabilities.
b. total assets minus total liabilities.
c. long-term liabilities minus current liabilities.
d. both (b) and (c).

8. The current ratio is computed as: (SO 4)
a. total assets divided by total liabilities.
b. total assets divided by current liabilities.

c. current assets divided by total liabilities.
d. current assets divided by current liabilities.

(SO 5) 9. A contingent liability should be recorded in the accounts when:
a. it is probable the contingency will happen, but the amount cannot be reasonably estimated.
b. it is reasonably possible the contingency will happen, and the amount can be reasonably estimated.
c. it is probable the contingency will happen, and the amount can be reasonably estimated.
d. it is reasonably possible the contingency will happen, but the amount cannot be reasonably estimated.

(SO 5) 10. At December 31, Hanes Company prepares an adjusting entry for a product warranty contract. Which of the following accounts is/are included in the entry?
a. Miscellaneous Expense.
b. Estimated Warranty Liability.
c. Repair Parts/Wages Payable.
d. Both (a) and (b).

(SO 6) 11. Andy Manion earns $14 per hour for a 40-hour week and $21 per hour for any overtime work. If Manion works 45 hours in a week, gross earnings are:
a. $560.
b. $630.
c. $650.
d. $665.

(SO 6) 12. When recording payroll:
a. gross earnings are recorded as salaries and wages payable.
b. net pay is recorded as salaries and wages expense.
c. payroll deductions are recorded as liabilities.
d. More than one of the above.

13. Employer payroll taxes do *not* include: (SO 7)
a. federal unemployment taxes.
b. state unemployment taxes.
c. federal income taxes.
d. FICA taxes.

14. FICA Taxes Payable was credited for $7,500 in the entry when Antonio Company recorded payroll. When Antonio Company records employer's payroll taxes, FICA Taxes Payable should be credited for: (SO 7)
a. $0.
b. $7,500.
c. $15,000.
d. some other amount.

15. The department that should pay the payroll is the: (SO 8)
a. timekeeping department.
b. human resources department.
c. payroll department.
d. treasurer's department.

*16. Which of the following is *not* an additional fringe benefit? (SO 9)
a. Post-retirement pensions.
b. Paid absences.
c. Paid vacations.
d. Salaries.

Go to the book's companion website, **www.wiley.com/college/weygandt**, for additional Self-Study Questions.

The Navigator

QUESTIONS

1. Jill Loomis believes a current liability is a debt that can be expected to be paid in one year. Is Jill correct? Explain.
2. Frederickson Company obtains $40,000 in cash by signing a 9%, 6-month, $40,000 note payable to First Bank on July 1. Frederickson's fiscal year ends on September 30. What information should be reported for the note payable in the annual financial statements?
3. (a) Your roommate says, "Sales taxes are reported as an expense in the income statement." Do you agree? Explain.
   (b) Planet Hollywood has cash proceeds from sales of $7,400. This amount includes $400 of sales taxes. Give the entry to record the proceeds.
4. Baylor University sold 10,000 season football tickets at $80 each for its five-game home schedule. What entries should be made (a) when the tickets were sold, and (b) after each game?
5. What is liquidity? What are two measures of liquidity?
6. What is a contingent liability? Give an example of a contingent liability that is usually recorded in the accounts.
7. Under what circumstances is a contingent liability disclosed only in the notes to the financial statements? Under what circumstances is a contingent liability not recorded in the accounts nor disclosed in the notes to the financial statements?
8. What is the difference between gross pay and net pay? Which amount should a company record as wages or salaries expense?
9. Which payroll tax is levied on both employers and employees?
10. Are the federal and state income taxes withheld from employee paychecks a payroll tax expense for the employer? Explain your answer.
11. What do the following acronyms stand for: FICA, FUTA, and SUTA?
12. What information is shown in a W-2 statement?
13. Distinguish between the two types of payroll deductions and give examples of each.
14. What are the primary uses of the employee earnings record?
15. (a) Identify the three types of employer payroll taxes.
    (b) How are tax liability accounts and payroll tax expense accounts classified in the financial statements?
16. You are a newly hired accountant with Batista Company. On your first day, the controller asks you to identify the

main internal control objectives related to payroll accounting. How would you respond?

17. What are the four functions associated with payroll activities?

***18.** Identify two additional types of fringe benefits associated with employees' compensation.

***19.** Often during job interviews, the candidate asks the potential employer about the firm's paid absences policy. What are paid absences? How are they accounted for?

***20.** What are two types of post-retirement benefits?

***21.** Explain how a 401(k) plan works.

***22.** What is the difference between a defined-contribution pension plan and a defined-benefit pension plan?

BRIEF EXERCISES

BE11-1 Buffaloe Company has the following obligations at December 31: (a) a note payable for $100,000 due in 2 years, (b) a 10-year mortgage payable of $300,000 payable in ten $30,000 annual payments, (c) interest payable of $15,000 on the mortgage, and (d) accounts payable of $60,000. For each obligation, indicate whether it should be classified as a current liability. (Assume an operating cycle of less than one year.)

Identify whether obligations are current liabilities.
(SO 1)

BE11-2 Hanna Company borrows $80,000 on July 1 from the bank by signing a $80,000, 10%, one-year note payable.

Prepare entries for an interest-bearing note payable.
(SO 2)

(a) Prepare the journal entry to record the proceeds of the note.
(b) Prepare the journal entry to record accrued interest at December 31, assuming adjusting entries are made only at the end of the year.

BE11-3 Leister Auto Supply does not segregate sales and sales taxes at the time of sale. The register total for March 16 is $15,540. All sales are subject to a 5% sales tax. Compute sales taxes payable, and make the entry to record sales taxes payable and sales.

Compute and record sales taxes payable.
(SO 3)

BE11-4 Emporia State University sells 4,000 season basketball tickets at $180 each for its 12-game home schedule. Give the entry to record (a) the sale of the season tickets and (b) the revenue earned by playing the first home game.

Prepare entries for unearned revenues.
(SO 3)

BE11-5 Yahoo! Inc.'s 2006 financial statements contain the following selected data (in thousands).

Analyze liquidity.
(SO 4)

Current assets	$3,449,533	Current liabilities	$1,204,052
Total assets	10,831,834	Total liabilities	2,265,419

Compute **(a)** working capital and **(b)** current ratio.

BE11-6 On December 1, Diaz Company introduces a new product that includes a one-year warranty on parts. In December, 1,000 units are sold. Management believes that 5% of the units will be defective and that the average warranty costs will be $80 per unit. Prepare the adjusting entry at December 31 to accrue the estimated warranty cost.

Prepare adjusting entry for warranty costs.
(SO 5)

BE11-7 Cindy Neuer's regular hourly wage rate is $16, and she receives an hourly rate of $24 for work in excess of 40 hours. During a January pay period, Cindy works 47 hours. Cindy's federal income tax withholding is $95, and she has no voluntary deductions. Compute Cindy Neuer's gross earnings and net pay for the pay period.

Compute gross earnings and net pay.
(SO 6)

BE11-8 Data for Cindy Neuer are presented in BE11-7. Prepare the journal entries to record **(a)** Cindy's pay for the period and **(b)** the payment of Cindy's wages. Use January 15 for the end of the pay period and the payment date.

Record a payroll and the payment of wages.
(SO 6)

BE11-9 In January, gross earnings in Vega Company totaled $70,000. All earnings are subject to 8% FICA taxes, 5.4% state unemployment taxes, and 0.8% federal unemployment taxes. Prepare the entry to record January payroll tax expense.

Record employer payroll taxes.
(SO 7)

BE11-10 Rodriquez Company has the following payroll procedures.

Identify payroll functions.
(SO 8)

(a) Supervisor approves overtime work.
(b) The human resources department prepares hiring authorization forms for new hires.
(c) A second payroll department employee verifies payroll calculations.
(d) The treasurer's department pays employees.

Identify the payroll function to which each procedure pertains.

Record estimated vacation benefits.
(SO 9)

***BE11-11** At Tagaci Company employees are entitled to one day's vacation for each month worked. In January, 80 employees worked the full month. Record the vacation pay liability for January assuming the average daily pay for each employee is $120.

DO IT! REVIEW

Answer questions about current liabilities.
(SO 2, 3)

DO IT! 11-1 You and several classmates are studying for the next accounting examination. They ask you to answer the following questions:

1. If cash is borrowed on a $70,000, 9-month, 12% note on August 1, how much interest expense would be incurred by December 31?
2. The cash register total including sales taxes is $42,000, and the sales tax rate is 5%. What is the sales taxes payable?
3. If $42,000 is collected in advance on November 1 for 6-month magazine subscriptions, what amount of subscription revenue is earned by December 31?

Prepare current liabilities section and compute liquidity measures.
(SO 4, 5)

DO IT! 11-2 Moth Company has the following account balances at December 31, 2010.

Notes payable ($60,000 due after 12/31/11)	$100,000
Unearned revenue	70,000
Other long-term debt ($90,000 due in 2011)	250,000
Salaries payable	32,000
Utilities payable	13,000
Accounts payable	50,000

In addition, Moth is involved in a lawsuit. Legal counsel feels it is probable Moth will pay damages of $85,000 in 2011.

(a) Prepare the current liability section of Moth's 12/31/10 balance sheet.
(b) Moth's current assets are $570,000. Compute Moth's working capital and current ratio.

Calculate net pay and record payroll.
(SO 6)

DO IT! 11-3 In January, gross earnings in Alexi Company were $60,000. All earnings are subject to 8% FICA taxes. Federal income tax withheld was $14,000, and state income tax withheld was $1,600. (a) Calculate net pay for January, and (b) record the payroll.

Record employer's payroll taxes.
(SO 7)

DO IT! 11-4 In January, the payroll supervisor determines that gross earnings for Bond Company are $110,000. All earnings are subject to 8% FICA taxes, 5.4% state unemployment taxes, and 0.8% federal unemployment taxes. Bond asks you to record the employer's payroll taxes.

EXERCISES

Prepare entries for interest-bearing notes.
(SO 2)

E11-1 Rob Judson Company had the following transactions involving notes payable.

July 1, 2010	Borrows $50,000 from Third National Bank by signing a 9-month, 12% note.
Nov. 1, 2010	Borrows $60,000 from DeKalb State Bank by signing a 3-month, 10% note.
Dec. 31, 2010	Prepares adjusting entries.
Feb. 1, 20011	Pays principal and interest to DeKalb State Bank.
Apr. 1, 20011	Pays principal and interest to Third National Bank.

Instructions
Prepare journal entries for each of the transactions.

Prepare entries for interest-bearing notes.
(SO 2)

E11-2 On June 1, Melendez Company borrows $90,000 from First Bank on a 6-month, $90,000, 12% note.

Instructions
(a) Prepare the entry on June 1.
(b) Prepare the adjusting entry on June 30.
(c) Prepare the entry at maturity (December 1), assuming monthly adjusting entries have been made through November 30.
(d) What was the total financing cost (interest expense)?

E11-3 In providing accounting services to small businesses, you encounter the following situations pertaining to cash sales.

Journalize sales and related taxes.
(SO 3)

1. Warkentinne Company rings up sales and sales taxes separately on its cash register. On April 10, the register totals are sales $30,000 and sales taxes $1,500.
2. Rivera Company does not segregate sales and sales taxes. Its register total for April 15 is $23,540, which includes a 7% sales tax.

Instructions
Prepare the entry to record the sales transactions and related taxes for each client.

E11-4 Guyer Company publishes a monthly sports magazine, *Fishing Preview*. Subscriptions to the magazine cost $20 per year. During November 2010, Guyer sells 12,000 subscriptions beginning with the December issue. Guyer prepares financial statements quarterly and recognizes subscription revenue earned at the end of the quarter. The company uses the accounts Unearned Subscriptions and Subscription Revenue.

Journalize unearned subscription revenue.
(SO 3)

Instructions
(a) Prepare the entry in November for the receipt of the subscriptions.
(b) Prepare the adjusting entry at December 31, 2010, to record subscription revenue earned in December 2010.
(c) Prepare the adjusting entry at March 31, 2011, to record subscription revenue earned in the first quarter of 2011.

E11-5 Hiatt Company sells automatic can openers under a 75-day warranty for defective merchandise. Based on past experience, Hiatt estimates that 3% of the units sold will become defective during the warranty period. Management estimates that the average cost of replacing or repairing a defective unit is $20. The units sold and units defective that occurred during the last 2 months of 2010 are as follows.

Record estimated liability and expense for warranties.
(SO 5)

Month	Units Sold	Units Defective Prior to December 31
November	30,000	600
December	32,000	400

Instructions
(a) Determine the estimated warranty liability at December 31 for the units sold in November and December.
(b) Prepare the journal entries to record the estimated liability for warranties and the costs incurred in honoring 1,000 warranty claims. (Assume actual costs of $20,000.)
(c) Give the entry to record the honoring of 500 warranty contracts in January at an average cost of $20.

E11-6 Brad Hoey Co. is involved in a lawsuit as a result of an accident that took place September 5, 2010. The lawsuit was filed on November 1, 2010, and claims damages of $1,000,000.

Record and disclose contingent liabilities.
(SO 5)

Instructions
(a) At December 31, 2010, Brad Hoey's attorneys feel it is remote that Brad Hoey will lose the lawsuit. How should the company account for the effects of the lawsuit?
(b) Assume instead that at December 31, 2010, Brad Hoey's attorneys feel it is probable that Brad Hoey will lose the lawsuit, and be required to pay $1,000,000. How should the company account for this lawsuit?
(c) Assume instead that at December 31, 2010, Brad Hoey's attorneys feel it is reasonably possible that Brad Hoey could lose the lawsuit, and be required to pay $1,000,000. How should the company account for this lawsuit?

E11-7 Jewett Online Company has the following liability accounts after posting adjusting entries: Accounts Payable $63,000, Unearned Ticket Revenue $24,000, Estimated Warranty Liability $18,000, Interest Payable $8,000, Mortgage Payable $120,000, Notes Payable $80,000, and Sales Taxes Payable $10,000. Assume the company's operating cycle is less than 1 year, ticket revenue will be earned within 1 year, warranty costs are expected to be incurred within 1 year, and the notes mature in 3 years.

Prepare the current liability section of the balance sheet.
(SO 1, 2, 3, 4, 5)

Instructions

(a) Prepare the current liabilities section of the balance sheet, assuming $30,000 of the mortgage is payable next year.

(b) Comment on Jewett Online Company's liquidity, assuming total current assets are $300,000.

Calculate liquidity ratios.
(SO 4)

E11-8 Kroger Co.'s 2007 financial statements contained the following data (in millions).

Current assets	$ 6,755	Accounts receivable	$ 773
Total assets	21,215	Interest expense	488
Current liabilities	7,581	Income tax expense	633
Total liabilities	16,292	Net income	1,115
Cash	189		

Instructions

Compute these values:

(a) Working capital. **(b)** Current ratio.

Calculate current ratio and working capital before and after paying accounts payable.
(SO 4)

E11-9 The following financial data were reported by 3M Company for 2006 and 2007 (dollars in millions).

3M COMPANY
Balance Sheets (partial)

	2007	2006
Current assets		
Cash and cash equivalents	$1,896	$1,447
Accounts receivable, net	3,362	3,102
Inventories	2,852	2,601
Other current assets	1,728	1,796
Total current assets	$9,838	$8,946
Current liabilities	$5,362	$7,323

Instructions

(a) Calculate the current ratio and working capital for 3M for 2006 and 2007.

(b) Suppose that at the end of 2007 3M management used $200 million cash to pay off $200 million of accounts payable. How would its current ratio and working capital have changed?

Compute net pay and record pay for one employee.
(SO 6)

E11-10 Joyce Kieffer's regular hourly wage rate is $15, and she receives a wage of 1½ times the regular hourly rate for work in excess of 40 hours. During a March weekly pay period Joyce worked 42 hours. Her gross earnings prior to the current week were $6,000. Joyce is married and claims three withholding allowances. Her only voluntary deduction is for group hospitalization insurance at $25 per week.

Instructions

(a) Compute the following amounts for Joyce's wages for the current week.
  (1) Gross earnings.
  (2) FICA taxes. (Assume an 8% rate on maximum of $90,000.)
  (3) Federal income taxes withheld. (Use the withholding table in the text, page 497.)
  (4) State income taxes withheld. (Assume a 2.0% rate.)
  (5) Net pay.

(b) Record Joyce's pay, assuming she is an office computer operator.

Compute maximum FICA deductions.
(SO 6)

E11-11 Employee earnings records for Medenciy Company reveal the following gross earnings for four employees through the pay period of December 15.

C. Ogle	$93,500	D. Delgado	$96,100
L. Jeter	$97,600	T. Spivey	$104,000

For the pay period ending December 31, each employee's gross earnings is $4,000. The FICA tax rate is 8% on gross earnings of $100,000.

Instructions
Compute the FICA withholdings that should be made for each employee for the December 31 pay period. (Show computations.)

Prepare payroll register and record payroll and payroll tax expense.
(SO 6, 7)

E11-12 Alvamar Company has the following data for the weekly payroll ending January 31.

	Hours							Federal	
Employee	**M**	**T**	**W**	**T**	**F**	**S**	**Hourly Rate**	**Income Tax Withholding**	**Health Insurance**
M. Hashmi	8	8	9	8	10	3	$12	$34	$10
E. Benson	8	8	8	8	8	2	13	37	25
K. Kern	9	10	8	8	9	0	15	58	25

Employees are paid 1½ times the regular hourly rate for all hours worked in excess of 40 hours per week. FICA taxes are 8% on the first $100,000 of gross earnings. Alvamar Company is subject to 5.4% state unemployment taxes and 0.8% federal unemployment taxes on the first $7,000 of gross earnings.

Instructions
(a) Prepare the payroll register for the weekly payroll.
(b) Prepare the journal entries to record the payroll and Alvamar's payroll tax expense.

Compute missing payroll amounts and record payroll.
(SO 6)

E11-13 Selected data from a February payroll register for Gerfield Company are presented below. Some amounts are intentionally omitted.

Gross earnings:		State income taxes	$(3)
Regular	$8,900	Union dues	100
Overtime	(1)	Total deductions	(4)
Total	(2)	Net pay	$7,660
Deductions:		Accounts debited:	
FICA taxes	$ 800	Warehouse wages	(5)
Federal income taxes	1,140	Store wages	$4,000

FICA taxes are 8%. State income taxes are 3% of gross earnings.

Instructions
(a) Fill in the missing amounts.
(b) Journalize the February payroll and the payment of the payroll.

Determine employer's payroll taxes; record payroll tax expense.
(SO 7)

E11-14 According to a payroll register summary of Ruiz Company, the amount of employees' gross pay in December was $850,000, of which $90,000 was not subject to FICA tax and $750,000 was not subject to state and federal unemployment taxes.

Instructions
(a) Determine the employer's payroll tax expense for the month, using the following rates: FICA 8%, state unemployment 5.4%, federal unemployment 0.8%.
(b) Prepare the journal entry to record December payroll tax expense.

Prepare adjusting entries for fringe benefits.
(SO 9)

***E11-15** Cerner Company has two fringe benefit plans for its employees:

1. It grants employees 2 days' vacation for each month worked. Ten employees worked the entire month of March at an average daily wage of $120 per employee.
2. In its pension plan the company recognizes 10% of gross earnings as a pension expense. Gross earnings in March were $40,000. No contribution has been made to the pension fund.

Instructions
Prepare the adjusting entries at March 31.

Prepare journal entries for fringe benefits.
(SO 9)

***E11-16** Serenity Corporation has 20 employees who each earn $120 a day. The following information is available.

1. At December 31, Serenity recorded vacation benefits. Each employee earned 5 vacation days during the year.
2. At December 31, Serenity recorded pension expense of $100,000, and made a contribution of $70,000 to the pension plan.
3. In January, 18 employees used one vacation day each.

Instructions
Prepare Serenity's journal entries to record these transactions.

EXERCISES: SET B

Visit the book's companion website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Exercise Set B.

PROBLEMS: SET A

Prepare current liability entries, adjusting entries, and current liabilities section.

(SO 1, 2, 3, 4, 5)

P11-1A On January 1, 2010, the ledger of Mane Company contains the following liability accounts.

Accounts Payable	$52,000
Sales Taxes Payable	7,700
Unearned Service Revenue	16,000

During January the following selected transactions occurred.

Jan. 5 Sold merchandise for cash totaling $22,680, which includes 8% sales taxes.
12 Provided services for customers who had made advance payments of $10,000. (Credit Service Revenue.)
14 Paid state revenue department for sales taxes collected in December 2009 ($7,700).
20 Sold 800 units of a new product on credit at $50 per unit, plus 8% sales tax. This new product is subject to a 1-year warranty.
21 Borrowed $18,000 from UCLA Bank on a 3-month, 8%, $18,000 note.
25 Sold merchandise for cash totaling $12,420, which includes 8% sales taxes.

Instructions

(a) Journalize the January transactions.
(b) Journalize the adjusting entries at January 31 for (1) the outstanding notes payable, and (2) estimated warranty liability, assuming warranty costs are expected to equal 7% of sales of the new product. (*Hint:* Use one-third of a month for the UCLA Bank note.)
(c) Prepare the current liabilities section of the balance sheet at January 31, 2010. Assume no change in accounts payable.

(c) Current liability total $84,640

Journalize and post note transactions; show balance sheet presentation.

(SO 2)

P11-2A The following are selected transactions of Winsky Company. Winsky prepares financial statements quarterly.

Jan. 2 Purchased merchandise on account from Yokum Company, $30,000, terms 2/10, n/30.
Feb. 1 Issued a 9%, 2-month, $30,000 note to Yokum in payment of account.
Mar. 31 Accrued interest for 2 months on Yokum note.
Apr. 1 Paid face value and interest on Yokum note.
July 1 Purchased equipment from Korsak Equipment paying $11,000 in cash and signing a 10%, 3-month, $40,000 note.
Sept. 30 Accrued interest for 3 months on Korsak note.
Oct. 1 Paid face value and interest on Korsak note.
Dec. 1 Borrowed $15,000 from the Otago Bank by issuing a 3-month, 8% note with a face value of $15,000.
Dec. 31 Recognized interest expense for 1 month on Otago Bank note.

Instructions

(a) Prepare journal entries for the listed transactions and events.
(b) Post to the accounts Notes Payable, Interest Payable, and Interest Expense.
(c) Show the balance sheet presentation of notes and interest payable at December 31.
(d) What is total interest expense for the year?

(d) $1,550

Prepare payroll register and payroll entries.

(SO 6, 7)

P11-3A Del Hardware has four employees who are paid on an hourly basis plus time-and-a half for all hours worked in excess of 40 a week. Payroll data for the week ended March 15, 2010, are presentd below.

Employee	Hours Worked	Hourly Rate	Federal Income Tax Withholdings	United Fund
Joe Devena	40	$15.00	$?	$5.00
Mary Keener	42	15.00	?	5.00
Andy Dye	44	13.00	60	8.00
Kim Shen	46	13.00	61	5.00

Devena and Keener are married. They claim 0 and 4 withholding allowances, respectively. The following tax rates are applicable: FICA 8%, state income taxes 3%, state unemployment taxes

5.4%, and federal unemployment 0.8%. The first three employees are sales clerks (store wages expense). The fourth employee performs administrative duties (office wages expense).

Instructions

(a) Prepare a payroll register for the weekly payroll. (Use the wage-bracket withholding table in the text for federal income tax withholdings.)
(b) Journalize the payroll on March 15, 2010, and the accrual of employer payroll taxes.
(c) Journalize the payment of the payroll on March 16, 2010.
(d) Journalize the deposit in a Federal Reserve bank on March 31, 2010, of the FICA and federal income taxes payable to the government.

(a) Net pay \$1,944.20; Store wages expense \$1,843
(b) Payroll tax expense \$352.16
(d) Cash paid \$636.80

Journalize payroll transactions and adjusting entries.
(SO 6, 7, 9)

P11-4A The following payroll liability accounts are included in the ledger of Armitage Company on January 1, 2010.

FICA Taxes Payable	\$760.00
Federal Income Taxes Payable	1,204.60
State Income Taxes Payable	108.95
Federal Unemployment Taxes Payable	288.95
State Unemployment Taxes Payable	1,954.40
Union Dues Payable	870.00
U.S. Savings Bonds Payable	360.00

In January, the following transactions occurred.

Jan. 10 Sent check for \$870.00 to union treasurer for union dues.
12 Deposited check for \$1,964.60 in Federal Reserve bank for FICA taxes and federal income taxes withheld.
15 Purchased U.S. Savings Bonds for employees by writing check for \$360.00.
17 Paid state income taxes withheld from employees.
20 Paid federal and state unemployment taxes.
31 Completed monthly payroll register, which shows office salaries \$26,600, store wages \$28,400, FICA taxes withheld \$4,400, federal income taxes payable \$2,158, state income taxes payable \$454, union dues payable \$400, United Fund contributions payable \$1,888, and net pay \$45,700.
31 Prepared payroll checks for the net pay and distributed checks to employees.

At January 31, the company also makes the following accrued adjustments pertaining to employee compensation.

1. Employer payroll taxes: FICA taxes 8%, federal unemployment taxes 0.8%, and state unemployment taxes 5.4%.
***2.** Vacation pay: 6% of gross earnings.

Instructions

(a) Journalize the January transactions.
(b) Journalize the adjustments pertaining to employee compensation at January 31.

(b) Payroll tax expense \$7,810; Vacation benefits expense \$3,300

Prepare entries for payroll and payroll taxes; prepare W-2 data.
(SO 6, 7)

P11-5A For the year ended December 31, 2010, Blasing Electrical Repair Company reports the following summary payroll data.

Gross earnings:	
Administrative salaries	\$200,000
Electricians' wages	370,000
Total	\$570,000
Deductions:	
FICA taxes	\$ 38,800
Federal income taxes withheld	174,400
State income taxes withheld (3%)	17,100
United Fund contributions payable	27,500
Hospital insurance premiums	17,200
Total	\$275,000

Blasing Company's payroll taxes are: FICA 8%, state unemployment 2.5% (due to a stable employment record), and 0.8% federal unemployment. Gross earnings subject to FICA taxes total \$485,000, and gross earnings subject to unemployment taxes total \$135,000.

(a) Wages Payable $295,000
(b) Payroll tax expense $43,255

Instructions

(a) Prepare a summary journal entry at December 31 for the full year's payroll.
(b) Journalize the adjusting entry at December 31 to record the employer's payroll taxes.
(c) The W-2 Wage and Tax Statement requires the following dollar data.

Wages, Tips, Other Compensation	Federal Income Tax Withheld	State Income Tax Withheld	FICA Wages	FICA Tax Withheld

Complete the required data for the following employees.

Employee	Gross Earnings	Federal Income Tax Withheld
Jane Eckman	$59,000	$28,500
Sharon Bishop	26,000	10,200

PROBLEMS: SET B

Prepare current liability entries, adjusting entries, and current liabilities section.

(SO 1, 2, 3, 4, 5)

P11-1B On January 1, 2010, the ledger of Software Company contains the following liability accounts.

Accounts Payable	$30,000
Sales Taxes Payable	5,000
Unearned Service Revenue	12,000

During January the following selected transactions occurred.

Jan. 1 Borrowed $20,000 in cash from Platteville Bank on a 4-month, 6%, $20,000 note.
5 Sold merchandise for cash totaling $9,752, which includes 6% sales taxes.
12 Provided services for customers who had made advance payments of $8,000. (Credit Service Revenue.)
14 Paid state treasurer's department for sales taxes collected in December 2009, $5,000.
20 Sold 900 units of a new product on credit at $44 per unit, plus 6% sales tax. This new product is subject to a 1-year warranty.
25 Sold merchandise for cash totaling $16,536, which includes 6% sales taxes.

Instructions

(a) Journalize the January transactions.
(b) Journalize the adjusting entries at January 31 for (1) the outstanding notes payable, and (2) estimated warranty liability, assuming warranty costs are expected to equal 5% of sales of the new product.
(c) Prepare the current liabilities section of the balance sheet at January 31, 2010. Assume no change in accounts payable.

(c) Current liability total $59,944

Journalize and post note transactions and show balance sheet presentation.

(SO 2)

P11-2B The following are selected transactions of Donn Company. Donn prepares financial statements *quarterly*.

Jan. 2 Purchased merchandise on account from Stein Company, $20,000, terms 2/10, n/30.
Feb. 1 Issued a 12%, 2-month, $20,000 note to Stein in payment of account.
Mar. 31 Accrued interest for 2 months on Stein note.
Apr. 1 Paid face value and interest on Stein note.
July 1 Purchased equipment from Morelli Equipment paying $12,000 in cash and signing a 10%, 3-month, $25,000 note.
Sept. 30 Accrued interest for 3 months on Morelli note.
Oct. 1 Paid face value and interest on Morelli note.
Dec. 1 Borrowed $15,000 from the Federated Bank by issuing a 3-month, 12% note with a face value of $15,000.
Dec. 31 Recognized interest expense for 1 month on Federated Bank note.

Instructions

(a) Prepare journal entries for the above transactions and events.
(b) Post to the accounts, Notes Payable, Interest Payable, and Interest Expense.
(c) Show the balance sheet presentation of notes and interest payable at December 31.
(d) What is total interest expense for the year?

(d) $1,175

Prepare payroll register and payroll entries.

(SO 6, 7)

P11-3B John's Drug Store has four employees who are paid on an hourly basis plus time-and-a-half for all hours worked in excess of 40 a week. Payroll data for the week ended February 15, 2010, are shown at the top of the page 521.

Employees	Hours Worked	Hourly Rate	Federal Income Tax Withholdings	United Fund
J. Uddin	39	$12.00	$ 34	$–0–
B. Conway	42	11.00	20	10.00
S. Becker	44	10.00	51	5.00
L. Blum	46	10.00	36	5.00

Uddin and Conway are married. They claim 2 and 4 withholding allowances, respectively. The following tax rates are applicable: FICA 8%, state income taxes 3%, state unemployment taxes 5.4%, and federal unemployment 0.8%. The first three employees are sales clerks (store wages expense). The fourth employee performs administrative duties (office wages expense).

Instructions

(a) Prepare a payroll register for the weekly payroll.
(b) Journalize the payroll on February 15, 2010, and the accrual of employer payroll taxes.
(c) Journalize the payment of the payroll on February 16, 2010.
(d) Journalize the deposit in a Federal Reserve bank on February 28, 2010, of the FICA and federal income taxes payable to the government.

(a) Net pay $1,521.99; Store wages expense $1,401.00
(b) Payroll tax expense $268.52
(d) Cash paid $443.56

P11-4B The following payroll liability accounts are included in the ledger of Pettibone Company on January 1, 2010.

Journalize payroll transactions and adjusting entries.
(SO 6, 7, 9)

FICA Taxes Payable	$ 540
Federal Income Taxes Payable	1,100
State Income Taxes Payable	210
Federal Unemployment Taxes Payable	54
State Unemployment Taxes Payable	365
Union Dues Payable	200
U.S. Savings Bonds Payable	300

In January, the following transactions occurred.

Jan. 10 Sent check for $200 to union treasurer for union dues.
12 Deposited check for $1,640 in Federal Reserve bank for FICA taxes and federal income taxes withheld.
15 Purchased U.S. Savings Bonds for employees by writing check for $300.
17 Paid state income taxes withheld from employees.
20 Paid federal and state unemployment taxes.
31 Completed monthly payroll register, which shows office salaries $17,400, store wages $22,500, FICA taxes withheld $3,192, federal income taxes payable $2,540, state income taxes payable $500, union dues payable $300, United Way contributions payable $1,300, and net pay $32,068.
31 Prepared payroll checks for the net pay and distributed checks to employees.

At January 31, the company also makes the following accruals pertaining to employee compensation.

1. Employer payroll taxes: FICA taxes 8%, state unemployment taxes 5.4%, and federal unemployment taxes 0.8%.
***2.** Vacation pay: 5% of gross earnings.

Instructions

(a) Journalize the January transactions.
(b) Journalize the adjustments pertaining to employee compensation at January 31.

(b) Payroll tax expense $5,665.80; Vacation benefits expense $1,995

P11-5B For the year ended December 31, 2010, L. Ullman Company reports the following summary payroll data.

Prepare entries for payroll and payroll taxes; prepare W-2 data.
(SO 6, 7)

Gross earnings:		Deductions:	
Administrative salaries	$150,000	FICA taxes	$ 29,600
Electricians' wages	240,000	Federal income taxes withheld	78,000
Total	$390,000	State income taxes withheld (3%)	11,700
		United Fund contributions payable	17,000
		Hospital insurance premiums	12,000
		Total	$148,300

L. Ullman Company's payroll taxes are: FICA 8%, state unemployment 2.5% (due to a stable employment record), and 0.8% federal unemployment. Gross earnings subject to FICA taxes total $370,000, and gross earnings subject to unemployment taxes total $90,000.

(a) Wages Payable $241,700
(b) Payroll tax expense $32,570

Instructions

(a) Prepare a summary journal entry at December 31 for the full year's payroll.
(b) Journalize the adjusting entry at December 31 to record the employer's payroll taxes.
(c) The W-2 Wage and Tax Statement requires the dollar data shown below.

Wages, Tips, Other Compensation	Federal Income Tax Withheld	State Income Tax Withheld	FICA Wages	FICA Tax Withheld

Complete the required data for the following employees.

Employee	Gross Earnings	Federal Income Tax Withheld
R. Lowski	$50,000	$18,300
K. Monez	24,000	4,800

PROBLEMS: SET C

Visit the book's companion website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Problem Set C.

CONTINUING COOKIE CHRONICLE

(*Note:* This is a continuation of the Cookie Chronicle from Chapters 1 through 10.)

CCC11 Recall that Cookie Creations sells fine European mixers that it purchases from Kzinski Supply Co. Kzinski warrants the mixers to be free of defects in material and workmanship for a period of one year from the date of original purchase. If the mixer has such a defect, Kzinski will repair or replace the mixer free of charge for parts and labor.

Go to the book's companion website, **www.wiley.com/college/weygandt**, *to see the completion of this problem.*

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem: PepsiCo, Inc.

BYP11-1 The financial statements of PepsiCo, Inc. and the Notes to Consolidated Financial Statements appear in Appendix A.

Instructions

Refer to PepsiCo's financial statements and answer the following questions about current and contingent liabilities and payroll costs.

(a) What were PepsiCo's total current liabilities at December 29, 2007? What was the increase/decrease in PepsiCo's total current liabilities from the prior year?
(b) In PepsiCo's Note 2 ("Our Significant Accounting Policies"), the company explains the nature of its contingencies. Under what conditions does PepsiCo recognize (record and report) liabilities for contingencies?
(c) What were the components of total current liabilities on December 29, 2007?

Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

BYP11-2 PepsiCo, Inc.'s financial statements are presented in Appendix A. Financial statements of The Coca-Cola Company are presented in Appendix B.

Instructions

(a) At December 29, 2007, what was PepsiCo's largest current liability account? What were its total current liabilities? At December 31, 2007, what was Coca-Cola's largest current liability account? What were its total current liabilities?

(b) Based on information contained in those financial statements, compute the following 2007 values for each company.

  (1) Working capital.

  (2) Current ratio.

(c) What conclusions concerning the relative liquidity of these companies can be drawn from these data?

Exploring the Web

BYP11-3 The Internal Revenue Service provides considerable information over the Internet. The following site answers payroll tax questions faced by employers.

Address: www.irs.ustreas.gov/formspubs/index.html, or go to **www.wiley.com/college/weygandt**

Steps

1. Go to the site shown above.
2. Choose **View Online, Tax Publications**.
3. Choose **Publication 15, Circular E, Employer's Tax Guide**.

Instructions

Answer each of the following questions.

(a) How does the government define "employees"?

(b) What are the special rules for Social Security and Medicare regarding children who are employed by their parents?

(c) How can an employee obtain a Social Security card if he or she doesn't have one?

(d) Must employees report to their employer tips received from customers? If so, how?

(e) Where should the employer deposit Social Security taxes withheld or contributed?

CRITICAL THINKING

Decision Making Across the Organization

BYP11-4 Kensingtown Processing Company provides word-processing services for business clients and students in a university community. The work for business clients is fairly steady throughout the year. The work for students peaks significantly in December and May as a result of term papers, research project reports, and dissertations.

Two years ago, the company attempted to meet the peak demand by hiring part-time help. This led to numerous errors and much customer dissatisfaction. A year ago, the company hired four experienced employees on a permanent basis in place of part-time help. This proved to be much better in terms of productivity and customer satisfaction. But, it has caused an increase in annual payroll costs and a significant decline in annual net income.

Recently, Valarie Flynn, a sales representative of Metcalfe Services Inc., has made a proposal to the company. Under her plan, Metcalfe will provide up to four experienced workers at a daily rate of $75 per person for an 8-hour workday. Metcalfe workers are not available on an hourly basis. Kensingtown would have to pay only the daily rate for the workers used.

The owner of Kensingtown Processing, Donna Bell, asks you, as the company's accountant, to prepare a report on the expenses that are pertinent to the decision. If the Metcalfe plan is adopted, Donna will terminate the employment of two permanent employees and will keep two permanent employees. At the moment, each employee earns an annual income of $21,000. Kensingtown pays

8% FICA taxes, 0.8% federal unemployment taxes, and 5.4% state unemployment taxes. The unemployment taxes apply to only the first $7,000 of gross earnings. In addition, Kensingtown pays $40 per month for each employee for medical and dental insurance. Donna indicates that if the Metcalfe Services plan is accepted, her needs for temporary workers will be as follows.

Months	Number of Employees	Working Days per Month
January–March	2	20
April–May	3	25
June–October	2	18
November–December	3	23

Instructions

With the class divided into groups, answer the following.

(a) Prepare a report showing the comparative payroll expense of continuing to employ permanent workers compared to adopting the Metcalfe Services Inc. plan.

(b) What other factors should Donna consider before finalizing her decision?

Communication Activity

BYP11-5 Jack Quaney, president of the Ramsberg Company, has recently hired a number of additional employees. He recognizes that additional payroll taxes will be due as a result of this hiring, and that the company will serve as the collection agent for other taxes.

Instructions

In a memorandum to Jack Quaney, explain each of the taxes, and identify the taxes that result in payroll tax expense to Ramsberg Company.

Ethics Case

BYP11-6 Daniel Longan owns and manages Daniel's Restaurant, a 24-hour restaurant near the city's medical complex. Daniel employs 9 full-time employees and 16 part-time employees. He pays all of the full-time employees by check, the amounts of which are determined by Daniel's public accountant, Gina Watt. Daniel pays all of his part-time employees in currency. He computes their wages and withdraws the cash directly from his cash register.

Gina has repeatedly urged Daniel to pay all employees by check. But as Daniel has told his competitor and friend, Steve Hill, who owns the Greasy Diner, "My part-time employees prefer the currency over a check. Also, I don't withhold or pay any taxes or workmen's compensation insurance on those cash wages because they go totally unrecorded and unnoticed."

Instructions

(a) Who are the stakeholders in this situation?

(b) What are the legal and ethical considerations regarding Daniel's handling of his payroll?

(c) Gina Watt is aware of Daniel's payment of the part-time payroll in currency. What are her ethical responsibilities in this case?

(d) What internal control principle is violated in this payroll process?

"All About You" Activity

BYP11-7 As indicated in the **All About You** on page 506, medical costs are substantial and rising. But will they be the most substantial expense over your lifetime? Not likely. Will it be housing or food? Again, not likely. The answer is in the *Accounting Across the Organization* box on page 498: taxes. On average, Americans work 74 days to afford their federal taxes. Companies, too, have large tax burdens. They look very hard at tax issues in deciding where to build their plants and where to locate their administrative headquarters.

Instructions

(a) Determine what your state income taxes are if your taxable income is $60,000 and you file as a single taxpayer in the state in which you live.

(b) Assume that you own a home worth $200,000 in your community and the tax rate is 2.1%. Compute the property taxes you would pay.

(c) Assume that the total gasoline bill for your automobile is $1,200 a year (300 gallons at $4 per gallon). What are the amounts of state and federal taxes that you pay on the $1,200?
(d) Assume that your purchases for the year total $9,000. Of this amount, $5,000 was for food and prescription drugs. What is the amount of sales tax you would pay on these purchases? (Many states do not levy a sales tax on food or prescription drugs. Does yours?)
(e) Determine what your Social Security taxes are if your income is $60,000.
(f) Determine what your federal income taxes are if your taxable income is $60,000 and you file as a single taxpayer.
(g) Determine your *total* taxes paid based on the above calculations, and determine the percentage of income that you would pay in taxes based on the following formula: Total taxes paid ÷ Total income.

Answers to Insight and Accounting Across the Organization Questions

p. 492 Contingencies: How Big Are They?

Q: Why do you think most companies disclose, but do not record, contingent liabilities?

A: A *contingent liability may be probable, but often its amount is difficult to determine. If it cannot be determined, the company is not required to accrue it as a liability.*

p. 498 Taxes Are the Largest Slice of the Pie

Q: If the information on 2008 taxation depicted your spending patterns, on what date (starting on January 1) will you have earned enough to pay all of your taxes?

A: *As indicated in the story, it takes 113 (74 + 39) days to pay your taxes. Thus, April 23 is Tax Freedom Day. For the past 26 years Tax Freedom Day has occurred in April, except for the year 2000 when it occurred in May.*

Authors' Comments on *All About You:* Your Boss Wants to Know If You Jogged Today (p. 506)

A company's insurance premiums would be substantially lower if its employees did not smoke and if they were in better shape. Some argue that employees with unhealthy habits increase the share of insurance premiums that all employees have to pay. Also, unhealthy employees miss more days of work and thus burden healthy employees. On the other hand, some argue that this approach discriminates in favor of "healthy" people. Also, it is not illegal to smoke or to be overweight. Should an employer really be able to dictate against non-illegal behavior that employees do on their own time? The cost of health care is a huge problem in the U.S., with no easy answers.

Answers to Self-Study Questions

1. a **2.** d **3.** b **4.** d **5.** b **6.** b **7.** a **8.** d **9.** c **10.** b **11.** d **12.** c **13.** c **14.** b **15.** d ***16.** d

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.

Chapter 12

Accounting for Partnerships

STUDY OBJECTIVES

After studying this chapter, you should be able to:

1. Identify the characteristics of the partnership form of business organization.
2. Explain the accounting entries for the formation of a partnership.
3. Identify the bases for dividing net income or net loss.
4. Describe the form and content of partnership financial statements.
5. Explain the effects of the entries to record the liquidation of a partnership.

✓ *The Navigator*

✓ The Navigator

Scan **Study Objectives**	☐
Read **Feature Story**	☐
Read **Preview**	☐
Read text and answer **DO IT!** p. 532 ☐ p. 538 ☐ p. 541 ☐ p. 544	☐
Work **Comprehensive DO IT!** p. 545	☐
Review **Summary of Study Objectives**	☐
Answer **Self-Study Questions**	☐
Complete **Assignments**	☐

Feature Story

FROM TRIALS TO THE TOP TEN

In 1990 Cliff Chenfield and Craig Balsam gave up the razors, ties, and six-figure salaries they had become accustomed to as New York lawyers. Instead, they set up a partnership, Razor & Tie Music *(www.razorandtie.com)*, in Cliff's living room. Ten years later, it became the only record company in the country that had achieved success in selling music both on television and in stores. Razor & Tie's entertaining and effective TV commercials have yielded unprecedented sales for multi-artist music compilations. At the same time, its hot retail label has been behind some of the most recent original, progressive releases from artists such as Kelly Sweet, All That Remains, EndeverafteR, Angelique Kidjo, Ryan Shaw, Dave Barnes, Twisted Sister, Dar Williams, Danko Jones, and Yerba Buena.

Razor & Tie may be best known for its wildly popular *Kidz Bop* CD series, the top-selling children's audio product in the United States. Advertised on

Nickelodeon, the Cartoon Network, and elsewhere, *Kidz Bop* titles have sold over 7 million copies. Seven of the 11 releases in the series have "gone Gold."

Razor & Tie got its start with its first TV release, *Those Fabulous '70s* (100,000 copies sold), followed by *Disco Fever* (over 300,000 sold).

After restoring the respectability of the oft-maligned music of the 1970s, the partners forged into the musical '80s with the same zeal that elicited success with their first releases. In 1993, Razor & Tie released *Totally '80s*, a collection of Top-10 singles from the 1980s that has sold over 450,000 units. Featuring the tag line, "The greatest hits from the decade when communism died and music videos were born," *Totally '80s* was the best-selling direct-response album in the country in 1993.

In 1995, Razor & Tie broke into the contemporary music world with *Living in the '90s*, the most successful record in the history of the company. Featuring a number of songs that were still hits on the radio at the time the package initially aired, *Living in the '90s* was a blockbuster. It received Gold certification in less than nine months and rewrote the rules on direct-response albums. For the first time, contemporary music was available through an album offered only through direct-response spots. Razor & Tie pursued that same strategy with its 2002 introduction of the *Kidz Bop* titles.

How has Razor & Tie carved out its sizable piece of the market? Through the complementary talents of the two partners. Their imagination and savvy, along with exciting new releases planned for the coming years, ensure Razor & Tie continued growth.

The Navigator

Inside Chapter 12…

- **Limited Liability Companies Gain in Popularity** (p. 530)
- **How to Part Ways Nicely** (p. 533)

Preview of Chapter 12

It is not surprising that when Cliff Chenfield and Craig Balsam began Razor & Tie, they decided to use the partnership form of organization. Both saw the need for hands-on control of their product and its promotion. In this chapter, we will discuss reasons why businesses select the partnership form of organization. We also will explain the major issues in accounting for partnerships.

The content and organization of Chapter 12 are as follows.

Accounting for Partnerships

Partnership Form of Organization
- Characteristics
- Organizations with partnership characteristics
- Advantages/disadvantages
- Partnership agreement

Basic Partnership Accounting
- Forming a partnership
- Dividing net income/loss
- Financial statements

Liquidation of a Partnership
- No capital deficiency
- Capital deficiency

The Navigator

PARTNERSHIP FORM OF ORGANIZATION

A **partnership** is an association of two or more persons to carry on as co-owners of a business for profit. Partnerships are sometimes used in small retail, service, or manufacturing companies. Also accountants, lawyers, and doctors find it desirable to form partnerships with other professionals in the field.

Characteristics of Partnerships

STUDY OBJECTIVE 1
Identify the characteristics of the partnership form of business organization.

Partnerships are fairly easy to form. People form partnerships simply by a verbal agreement, or more formally, by written agreement. We explain the principal characteristics of partnerships in the following sections.


Association of Individuals

ASSOCIATION OF INDIVIDUALS

A partnership is a legal entity. A partnership can own property (land, buildings, equipment), and can sue or be sued. **A partnership also is an accounting entity.** Thus, the personal assets, liabilities, and transactions of the partners are excluded from the accounting records of the partnership, just as they are in a proprietorship.

The net income of a partnership is not taxed as a separate entity. But, a partnership must file an information tax return showing partnership net income and each partner's share of that net income. Each partner's share is taxable at **personal tax rates**, regardless of the amount of net income each withdraws from the business during the year.


Mutual Agency

MUTUAL AGENCY

Mutual agency means that each partner acts on behalf of the partnership when engaging in partnership business. The act of any partner is binding on all other partners. This is true even when partners act beyond the scope of their authority, so long as the act appears to be appropriate for the partnership. For example, a partner of a