

CHAPTER 10

CURRENT LIABILITIES AND PAYROLL

LECTURE OUTLINE

Determinable (Certain) Current Liabilities (LO1)

1. There is no uncertainty as to existence, amount or timing. Liabilities with a known amount, payee, and due date are often referred to as determinable liabilities. Examples include operating lines of credit, notes payable, accounts payable, sales tax payable, unearned revenues, and current maturities of long-term debt. Also included are accrued liabilities such as property taxes, payroll and employee benefits, and interest payable. Accounts payable or trade payables are often the largest current liabilities on a company's balance sheet.

Accounts payable

1. Goods that are purchased from a supplier with an agreement to pay at a later date are considered accounts payable. May also be referred to as **trade payables**. Given most suppliers require payment within 30 days, A/P are considered current liabilities.

TEACHING TIP

Page 4 provides an example of a journal entry for the purchase of goods on account.

Unearned Revenues

1. Unearned revenues are the result of receiving a payment in advance of a good being provided or a service being performed. This is common for many businesses in the publishing, entertainment, and travel industries.

2. Companies account for unearned revenues in two steps: firstly, when a company receives the payment in advance, it debits Cash and credits the current liability account – Unearned Revenues. Secondly, when the goods are provided or the service is performed, the company recognizes the revenue by crediting the Revenue account and debiting the Unearned Revenue account.

TEACHING TIP

Page 5 provides an example of the journal entries required for the recognition of unearned revenue when an advance cash payment is received and the subsequent journal entry required to recognize revenue once the obligation has been satisfied.

Operating Line of Credit and Bank Overdraft

1. An operating **line of credit** allows a company to borrow money from their bank, up to a pre-authorized limit. This helps them manage temporary cash shortfalls. Security, called **collateral**, is usually required by the bank as protection in case the company is unable to pay the loan.
2. Money borrowed through a line of credit is normally borrowed on a short-term basis and is repayable immediately upon request, that is, on demand, by the bank. In reality, repayment is rarely demanded without notice.
3. A line of credit makes it easy for a company to borrow money.
4. Some companies have a negative, or overdrawn, cash balance at year end. Overdraft amounts are reported and disclosed as a current liability, called **bank indebtedness**, **bank overdraft** or **bank advances**. No special entry is required. Appropriate note disclosure is also necessary. Interest is usually charged on the overdraft amount at a floating rate, such as prime plus a specified percentage.

Short-term Notes Payable

1. Obligations in the form of written promissory notes are known as **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 required to collect the debt.
2. Notes payable usually require the borrower to pay interest (interest due monthly or at maturity) and are frequently issued instead of accounts payable or to meet short-term financing needs.
3. Notes due for payment within one year of the balance sheet date are classified as current liabilities.

TEACHING TIP

Page 6 provides an example of a journal entry for an interest-bearing note payable. Remind students that at maturity, the amount paid is equal to the face value of the note plus accrued interest.

4. Interest accrues over the life of the note and the interest must be recorded in the period when the borrowed money is used.

TEACHING TIP

Page 6 provides an example of a journal entry for accrued interest for one month. Emphasize with the students that interest rates are always stated in annual terms not for the term of the note.

The next example is when the note is due and provides an example of an adjusting entry for interest for three months and the payment of the note in full plus all interest.

Sales Taxes

1. Sales taxes collected from customers are a liability because the company has an obligation to pay the amount collected to the appropriate government body.
2. Sales Tax is expressed as a stated percentage of the sales price. Goods and services tax (GST) is applied at 5% across Canada. Provincial sales tax (PST) rates vary from 0% to 9.975% depending on jurisdiction. In the province of Québec, the provincial sales tax is known as the QST.
3. In some provinces, PST and GST have been combined into one harmonized 13% to 15% sales tax (HST). GST (or HST) paid is deducted from GST (or HST) collected. The retailer collects the tax from the customer when the sale occurs, and periodically remits the amounts owing to the appropriate collecting authority (Receiver General for GST (or HST) and Minister of Finance/Treasurer for PST). In the case of GST, HST and QST, collections may be offset against payments.

TEACHING TIP

Page 8 provides an example of a journal entry for a cash sale that incorporates HST.

4. When the sales taxes are remitted, the account HST Payable is debited and Cash is credited. Sales taxes collected from customers are a liability because the company must forward the amount collected to the appropriate government collecting authorities.
5. It is important to be careful when extracting sales tax amounts from total receipts, because of the varying rate combinations that may be in use in different parts of the country.

TEACHING TIP

If sales taxes are included in the sales price, then the sales tax collected is equal to the selling price \times the sales tax % *divided by* 100% *plus the sales tax %*

Property Taxes

1. Property taxes must be paid annually. They are based on a calendar year and typically include a specified rate for every \$100 of assessed property value. The exact amount of the taxes for the year is generally not known until part way through the year. There are many ways to record the property taxes, depending on how often adjusting entries are prepared.

TEACHING TIP

Page 8 provides examples of journal entries for property taxes.
Pages 8 & 9 provides examples of the property taxes being adjusted on May 31 and another entry for December 31.

2. Some companies might debit Property Tax Expense when the bill is recorded and avoid a later adjusting entry. Some companies may prepare monthly or quarterly adjusting entries. Regardless, at year end the companies would have the same ending balances.

Current Maturities of Long-Term Debt

1. When a portion of long-term debt comes due in the current year, it should be reported as a current liability on the balance sheet. A journal entry is not required. The proper statement classification of each liability account is recognized when the balance sheet is prepared.

TEACHING TIP

The BEFORE YOU GO.ON...**DO IT** – Reporting Current Liabilities section on page 9 and 10 provides students with an opportunity to practice recording for current liabilities. Instructors may want to work through this on the board with students.

Uncertain Liabilities (LO2)

Provisions

1. Provisions or estimated liabilities are liabilities that are known to exist, but whose amount and timing are uncertain. We know that we owe someone, but we are not sure how much and when. We may not even know to whom we owe. Common provisions include product warranties, customer loyalty programs and gift cards.

Product Warranties

1. Product warranties are promises made by the seller to a buyer to repair or replace the product if it is defective or does not perform as intended. Warranties are used by manufacturers. There is a promise to repair the item, replace it, or refund the buyer under certain conditions within a specific period of time after the date of sale of the item.
2. Warranties will lead to future costs for the repair or replacement of defective units. Although at the time of the sale it is not known which units will become defective, the liability still exists. Also, the amount and timing of the future warranty cost are not known, but the cost can be reasonably estimated.
3. Recording the estimated cost of product warranties as an expense and a liability in the period where the sale occurs ensures that the company recognizes the full cost of the sale in the period the sale occurs. This is known as matching of expenses with revenues.
4. In future periods, all costs incurred to honour warranty contracts from previous years' sales are debited to Warranty Liability. The Warranty Liability account will be carried forward from year to year, increased by the current year's estimated expense and decreased by the actual warranty costs incurred.

TEACHING TIP

Page 11 provides the company's estimated calculation for warranty repair costs.

Then the adjusting entry is provided debiting Warranty Expense and crediting warranty Liability for the estimate. This is another example of an accrued expense as students learned about in Chapter 3. The only difference is the need to estimate.

The final entry provides an entry illustrating repair work for the year.

Customer Loyalty Programs

1. Many companies offer **customer loyalty programs** to attract or retain customers. Examples include airline frequent flyer mileage programs and discount coupons on future sales. The most successful loyalty program is Canadian Tire "money".
2. While there are a few exceptions, accountants have decided that when a loyalty program results in a reduced selling price, it should be accounted for as a reduction of revenue, and not as an expense. This treatment prevents revenue from being artificially inflated.
3. A further complication is that companies do not know for certain, at the time of sale, the extent to which customers will redeem the reward. As a result, it is necessary to estimate the redemptions in order to record them in the same period as the sales revenue. The estimate is recorded with a debit to Sales Discounts for Redemption Rewards Issued and a credit to Redemption Rewards Liability. Sales Discounts for Redemption Rewards Issued is a contra revenue account that is deducted from Sales to

arrive at Net Sales. This is the same treatment as sales returns and allowances. The Redemption Rewards Liability account is reported as a current liability.

TEACHING TIP

Page 12 provides an example of a journal entry that accrues the estimated redemption rewards.

The next journal entry on page 12 provides the journal entry for when rewards are redeemed.

4. When the coupons are redeemed, the liability account is debited. The cash received is less than the sales revenue recognized, and the difference is debited to the liability account.

Gift Cards

1. Gift cards are similar to unearned revenue (may also be referred to as **deferred revenue**) in that the company receives cash in advance of providing the goods or service. When the gift card is issued, an Unearned Revenue account (liability) is credited. When the gift card is redeemed, the company will then record the revenue and debit the Unearned Revenue account.

2. The difficulty is that it is unknown when and if the card will be redeemed. Recent changes to Canadian law prohibits expiry dates on gift cards, therefore the company should in theory report the unused balances on the gift cards as a liability indefinitely. However, the company needs to estimate an appropriate balance of the liability as it is unlikely that all gift cards will be redeemed. The company would use past experience to estimate the appropriate balance of the liability account.

Contingencies

1. Contingencies are events with uncertain outcomes. It cannot be known if a loss (and related liability) will result from the situation until one or more future events happen or do not happen. With contingencies, there is uncertainty as to the timing, the amount as well as the existence of a liability. Lawsuits are good examples of contingencies. The existence of a loss and related liability depends on the outcome of the lawsuit.

Contingent Liabilities

1. Under ASPE, a liability for a contingent loss is recorded if **both** of the following conditions are met:

- The contingency is likely, and
- The amount of the contingency can be reasonably estimated.

2. Under IFRS, the term contingent liability refers only to possible obligations that are not recognized in the financial statements. Probable events are deemed as being “more likely than not”, rather than “likely”. IFRS has a lower threshold for recording these liabilities. Under ASPE, only “highly likely” contingent losses are recorded.
3. Under ASPE, these liabilities are called “contingent liabilities”. Under IFRS, these liabilities are called “provisions” and would be recorded.
4. Under ASPE, if the contingency is likely but the amount of the loss cannot be reasonably estimated, or if the likelihood of occurrence is not determinable, then it need only be disclosed in the notes accompanying the financial statements.
5. If the contingency is unlikely to occur, it need not be recorded or disclosed, unless the event could have a substantial negative effect on the company. An example of a contingency that should be disclosed is a loan guarantee even if the chance of paying the loan is small.

Payroll (LO3)

Employee Payroll Costs

1. Determining the payroll costs for employees involves calculating:
 - Gross pay,
 - Payroll deductions, and
 - Net pay.

Gross Pay

1. Gross pay, or earnings, consists of wages or salaries, plus any bonuses and commissions. It is the total compensation earned by an employee.
2. Total wages for an employee are determined by multiplying the hourly rate of pay by the number of hours worked. Overtime is often calculated at 1.5 times the regular hourly rate. Overtime is often paid if an employee works beyond a standard work week. The standard work week varies but is typically 40 hours.
3. Salaries are generally based on hourly, weekly, biweekly, monthly, or yearly rates. The salary is prorated to the payroll period.

Payroll Deductions

1. Payroll deductions do not result in an expense to the employer because the company only serves as a collection agency for the government or another third party.
2. Mandatory deductions consist of CPP (QPP in Québec), EI, and income tax. Voluntary deductions include charitable donations and insurance, pensions and/or union dues.

Canada Pension Plan (CPP)

1. All employees, including self-employed individuals, between the ages of 18 and 70 must contribute to **Canada Pension Plan (CPP)**. Rates are set by the federal government and may be adjusted each January if there are increases in the cost of living. There is a basic yearly exemption, and an annual maximum amount of pensionable earnings.

Employment Insurance (EI)

1. EI is designed to provide income protection for a limited time to employees who are laid off, on parental leave, or lose their jobs. There is an annual maximum amount of insurable earnings. Beginning January, 2013, self-employed individuals can choose to pay EI to qualify for certain special benefits. Each year the federal government determines the contribution rate and the maximum amount of premiums for the year.

Personal Income Tax

1. Employers are required to withhold **income tax** from employees each pay period. The amount to be withheld is determined by three variables:

- the employee's gross pay,
- the number of credits claimed by the employee, and
- the length of the pay period.

2. There is no limit on the amount of earnings subject to income tax.

Voluntary Payroll Deductions

1. 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.

Net pay

1. Net pay is determined by subtracting payroll deductions from gross pay.

TEACHING TIP

Illustration 10-8 provides an example of calculating net pay.

Employer Payroll Costs

Canada Pension Plan

1. The employer must match each employee's CPP contribution. CPP Payable is credited for both the employee's and employer's CPP contributions.

Employment Insurance

1. The employer must contribute 1.4 times each employee's EI contributions. EI Payable is credited for both the employee's and employer's EI contributions.

Workplace Health, Safety, and Compensation

1. Workplace Health, Safety, and Compensation (the name of the plan varies by province) provide supplemental benefits for workers who are injured in the workplace. While CPP and EI are paid by both the employee and employer, WHSC is paid only by the employer. Employers are assessed a rate – usually between .25% and 10% of their gross payroll (based on risk of injury of employees and past experience).

Additional Employee Benefits

1. Additional fringe benefits associated with wages are paid absences and post-retirement benefits.

Paid Absences

1. Employees often have rights to receive compensation for absences under certain conditions (e.g., paid vacations, sick pay benefits, and paid holidays).

2. A liability should be estimated and accrued for future paid absences. Ordinarily, vacation pay is the only paid absence that is accrued.

Post-Employment Benefits

1. Post-employment benefits include payments by employers to retired or terminated employees for health care, dental care, life insurance, and pensions. Employers must use accrual base accounting for post-employment benefits.

Recording the Payroll

Payroll Records

1. To comply with provincial and federal laws, an employer must keep a cumulative record of each employee's gross pay, payroll deductions, and net pay during the year. The record that provides employee information and other essential data is the employee earnings record. The cumulative payroll data on the earnings record are used by the employer in:

- determining when an employee has earned the maximum earnings subject to CPP and / or EI,
- filing payroll information returns with CRA,
- providing each employee with a statement of gross earnings and tax withholdings for the year.

TEACHING TIP

ILLUSTRATION 10-9 provides an example of an employee earnings record. Employee Earning Records are used to assist employers in producing employee T4s.

2. The journal entry to record employee payroll costs includes a debit to Salaries and Wages Expense for the gross earnings and credits for the mandatory and voluntary deductions and for Salaries and Wages Payable.

TEACHING TIP

ILLUSTRATION 10-10 provides an example of a payroll register. Clarify with students that the payroll register is all of the employees in one pay period. The employee earnings record is one employee but all the pay cheques in the year.

Recording Payroll Expenses and Liabilities

Employee Payroll Costs

1. Specific liability accounts are credited for the required and voluntary deductions made in the pay period as shown in the example on page 21. Separate expense accounts may be used for gross pay because office workers are on salary and other employees are paid an hourly rate.

Employer Payroll Costs

1. Employer payroll costs are usually recorded when the payroll is journalized. These liability accounts are classified as current liabilities since they will be paid within the next year. Page 21 shows an example of a journal entry to record the employer payroll costs.

Recording Payment of the Payroll

1. After the payroll has been paid, the cheque numbers are entered in the payroll register. Many companies use a separate bank account for payroll. Only the total amount of each period's payroll is transferred, or deposited, into that account before it is distributed.
2. When the company's report and remit their payroll deductions, they combine withholding of income tax, CPP, and EI.
3. Generally, the withholdings must be reported and remitted monthly on a Statement of Account for Current Source Deductions (PD7A remittance form) and no later than the 15th day of the month following the month's pay period. For example, WHSC are remitted quarterly to the Workplace Health, Safety, and Compensation Commission.
4. See page 22 for an example of an entry to record the remittance of payroll deductions.

TEACHING TIP

The BEFORE YOU GO ON...**DO IT** – Payroll section on page 23 provides students with an opportunity to practice recording payroll entries. Instructors may want to work through this on the board with students.

Financial Statement Presentation (LO4)

1. The Current Liabilities category is the first liability category on the balance sheet.
2. Current liabilities can be listed in order of liquidity, by maturity date. However, this is not always possible due to varying maturity dates that may exist for specific obligations such as notes payable. Many companies show bank loans, notes payable and accounts payable first.

TEACHING TIP

ILLUSTRATION 10- 11 provides an example of a common listing order for the financial statement presentation of current liabilities.

TEACHING TIP

The BEFORE YOU GO ON...**DO IT** – Current Liabilities on the Balance Sheet section on page 25 provides students with an opportunity to practice recording and listing current liabilities on the balance sheet. Instructors may want to work through this on the board with students.

Appendix 10A – Payroll Deductions (LO5)

Mandatory Payroll Deductions

Canada Pension Plan

1. CPP contributions are based on a maximum ceiling or limit less a basic yearly exemption, and on the contribution rate set each year by the federal government. Pensionable earnings are the gross earnings less the basic yearly exemption.

TEACHING TIP

ILLUSTRATION 10- A1 provides the formulas for CPP contributions.

Employment Insurance

1. EI contributions are based on a maximum earnings ceiling and the contribution rate is set by the federal government each year. There is no basic yearly exemption for EI.

TEACHING TIP

ILLUSTRATION 10- A2 provides the formulas for EI contributions.

Personal Income tax deductions

1. Personal Income tax deductions are based on income tax rates set by the federal and provincial governments. Generally governments use a progressive tax scheme when calculating income taxes. Basically the higher the pay or the earnings, the higher the income tax percentage.

Using Payroll Deduction Tables

1. Payroll deduction tables are prepared by CRA and can be downloaded from the CRA website. There are separate payroll deduction tables for determining federal and provincial tax deductions, CPP and EI.

TEACHING TIP

ILLUSTRATION 10- A3 provides the excerpts of the CRA tables for CPP, EI and income tax deductions.

HIGHLIGHTS OF IFRS CHANGES

The key differences include the conditions necessary to record a liability for a contingent loss under IFRS vs ASPE. Under IFRS the liability will be recorded if the chance of occurrence is “probable” or “more likely than not”. Under ASPE the liability will be recorded if it is “likely”.