Chapter 12

Current liabilities and payroll

Current liabilities are obligations that the business has to discharge within 12 months or its operating cycle if longer than one year. Obligations that are due in more than 12 months are known as non-current liabilities.

LEARNING OUTCOME 1: ACCOUNT FOR CURRENT LIABILITIES OF KNOWN AMOUNT

The most common current liabilities are accounts payable or also known as trade creditors. These are amounts that are owed to suppliers of goods or services that have been purchased on credit. These debts are normally payable within 14 to 30 days and do not carry interest.

Short-term bills payable are a form of financing where the debt carries interest and must be repaid within 12 months.

LEARNING ACTIVITY 1

Reading Textbook Horngren, Harrison, etc pages 470 to 473

Another common current liability will be goods and services tax (GST) payable. The rate of GST is 10%. When a business makes a sale it must also collect the GST and account for it to the Australian taxation Office (ATO). The quoted sale price usually includes the GST. So an item tha is sold for $1,100 will have $100 GST included in it. The entries would be:

Dr Cash at Bank $1,100		
	Cr Sales Revenue	$1,000
	Cr GST Clearing Account	$100.

The GST is a liability. The Sales Revenue is shown in the financial statements net of any GST.

Where the business has expenses and these have GST in them then the GST is debited to the Clearing Account as it can be reclaimed from the ATO.

If a business has a long-term debt that is being repaid in instalments the amount that has to be repaid within 12 months must be shown in current liabilities and the amounts that are to be repaid i more than 12 months must be shown in non-current assets.

Accruals, or accrued expenses that haven't been paid yet or accrued liabilities are all the same thing. They represent benefits that the business has received and therefore has an obligation to pay for in the future. The benefits must appear as an expense and the liabilities must appear as a liability. Examples of these are interest payable, salaries payable, and power, water, electricity and telephone payable.

Unearned revenues are also liabilities as the business has received cash in advance for an obligation that it must at some stage discharge. A liability is created when the monies are received and a liability is created. The liability is only reduced when the service is performed or the goods are delivered and the sale can be acknowledged as having taken place.

LEARNING ACTIVITY 2

Reading Textbook Horngren, Harrison, etc pages 473 to 475

LEARNING OUTCOME 2: ACCOUNT FOR CURRENT LIABILITIES THAT MUST BE ESTIMATED

Where a business knows that a liability exists but does not know the exact amount it must still be brought into current liabilities if a reliable estimate can be made. A warranty by a manufacturer against the goods being faulty or ceasing to work properly is an example. By offering a warranty it is regarded as part of the cost of making the sale and the warranty expense must be matched against the sale proceeds. When a warranty claim is made the estimated warranty payable is discharged.

Contingent liabilities will not exist as liabilities unless an event occurs that creates the liability. For example a guarantor for a loan will not be asked to repay the loan unless the original borrower defaults on the loan. So the liability is contingent upon the borrower defaulting. If the possibility of this happening is remote then you would ignore it. If it is possible and the amount can be estimated with reasonable accuracy it should be disclosed in the notes to the accounts. If it is probable and the amount can be estimated with reasonable accuracy it should be treated as an actual liability.

LEARNING ACTIVITY 3

Reading Textbook Horngren, Harrison, etc pages 475 to 478

Work through the Decision Guidelines and the Summary problem for your review.

LEARNING OUTCOME 3: CALCULATE PAYROLL AMOUNTS

Labour costs are important and need to be recorded carefully. They can be expressed in a number of ways, salaries, wages, fees, commissions, bonuses, benefits etc. Whatever their description there are two pay amounts that need to be ascertained. The gross pay and the net or take-home pay. The gross pay is the total amount earned in a pay period. The net pay or take-home pay is the amount that will be paid to the employee and is the gross pay less all deductions. Deductions for income tax is a required deduction whereas all other deductions are optional. Payroll tax is a tax that is levied on the employer by the state or territory government.

LEARNING ACTIVITY 4

Reading Textbook Horngren, Harrison, etc pages 478 to 481

Look at the Exhibits 12-3 and 12-4

LEARNING OUTCOME 4: RECORD BASIC PAYROLL TRANSACTIONS

There are three types of expense to be created Salary Expense, Benefits Expense and Payroll Tax Expense and the relevant liability accounts.

Dr Salary Expense
    Cr Income tax payable
    Cr Donations payable (if the employee had opted to have donations as a deduction)
    Cr Salary payable (take-home pay)

Dr Superannuation Expense
    Cr Employee benefits payable (with any benefits that the employer is paying)

Dr Payroll Tax Expense
    Cr Payroll Tax Payable

LEARNING ACTIVITY 5

Reading   Textbook   Horngren, Harrison, etc pages 481 to 482

Look at the Exhibit 12-5

LEARNING OUTCOME 5: USE A PAYROLL SYSTEM

Employees need to be paid accurately and on time. For this the business will need a payroll record which sets out the amount of Gross Pay, Deductions, and Net Pay for each employee, showing the hours worked, ordinary time pay, overtime pay, total gross pay, the deductions for income tax and any other agreed deductions and the total deductions, the amount of the net pay and the cheque number for each employee or EFT number.

There will also need to be payroll cheques or EFT transfers, and employee earnings record for each employee. This is known as the PAYG payment summary, a copy of which must be given to each employee at the end of each financial year. This shows the gross wages for the year and the total tax deducted for the same period.

When the payroll liabilities are paid the liability accounts, Salary Payable, Benefits Payable and Employee Income Tax payable are debited and Cash at Bank is credited.

It is important to maintain internal control over the payroll otherwise it is possible to pay employees an incorrect amount or to pay phantom employees wages which should not be paid. The chief controls are separation of duties. Ensure that Human Resources hire and fire, Payroll keeps employees records, Accounting records the financial effects of the transactions, and Finance arranges the payments to the employees.

LEARNING ACTIVITY 6

Reading   Textbook   Horngren, Harrison, etc pages 482 to 487

Look at the Exhibits 12-6, 12-7, 12-8, and 12-9

LEARNING OUTCOME 6: REPORT CURRENT LIABILITIES ON THE BALANCE SHEET

At the end of the financial period the current liabilities are listed on the balance sheet and the most immediate liability is shown first.

As an accountant it is important to do the right thing by behaving ethically. Mis-stating expenses and liabilities by omitting them in order to make the profits is unethical and it can mislead loan providers and investors and ruin a business's reputation.

LEARNING ACTIVITY 7

Reading

Textbook Horngren, Harrison, etc pages 487 to 489.

Study Exhibit 12-10 and the Decision guidelines and summary problem for your review.

Provide answers to Starters S12-6, S12-7, S12-8, S12-10, S12-12, E12-1, E12-2, E12-3, E12-4, E12-8, & P12-1.

Chapter 16

Debentures are loans which bear interest and can be from many lenders. Debentures can be described as notes, bonds, or loan stock. A debenture will state the amount borrowed, that is the principal of the loan, how much is to be repaid at maturity when the loan is to be repaid. The interest or coupon rate must also be stated and when the interest or coupon payments are to be made.

Term debentures all mature at the same date. Serial debentures are repaid in instalments. Debentures can be secured by a mortgage in which case they can be called mortgage debentures. If they are not secured by a mortgage or a legal charge they are called unsecured notes.

Although a debenture can be described as having a maturity value of, say, $1,000, the price that it is issued at depends upon the market's expectations of the return required. The rate of interest, or coupon rate, will need to take into consideration the risk and the type of return expected in this type of industry, the interest rate in the economy, the time to maturity and the credit rating of the borrower. If market's expectations match the coupon rate the debenture will be issued at par. That means that the business will receive exactly the same amount as the maturity value that they will have to repay at the end of the loan.

If the market demands a higher rate of interest than the one offered by the borrower then the issue price will be lowered, or issued at a discount, so that the actual returns will now match the rate required.

If the market demands a lower rate than the one offered the issue price will be increased, or issued at a premium, so that the actual returns will now match the rate required.

A quote of 99.5 means that a $1,000 debenture sells for $1,000 × 0.995, or $995.

Present value represents the amount that you would have to invest today at a given interest rate to arrive at a maturity value at the maturity date. So if the maturity value was $105 in one year's time and the rate of interest was 5% the we would need to invest $100 today. So $100 is the present value of $105 in one year's time at a rate of interest of 5%.

LEARNING ACTIVITY 8

Reading   Textbook   Horngren, Harrison, etc pages 594 to 599

Look at the Exhibits 16-1 and 16-2

LEARNING OUTCOME 7: ACCOUNT FOR DEBENTURES PAYABLE TRANSACTIONS

When debentures are issued at par cash at bank is debited with the amount received and the liability account debentures payable is credited with the maturity amount. When the interest is paid interest expense is debited and cash at bank is credited. At maturity the liability is extinguished by debiting debentures payable and cash at bank is credited.

Where debentures is issued at a discount cash at bank will be debited with the amount received. Discount on debentures will be debited with the discount and the maturity value will be credited to debentures payable. Discounts on debentures is a contra account that will appear on the balance sheet as a deduction from the maturity value to give the carrying amount.

LEARNING ACTIVITY 9

Reading   Textbook   Horngren, Harrison, etc pages 599 to 601

LEARNING OUTCOME 8: MEASURE INTEREST EXPENSE BY THE EFFECTIVE INTEREST METHOD

The discount on debentures will need to be expensed over the life of the debenture and this is done by adding the amortisation amount to the interest expense. Under the straight-line amortisation method the discount will be divided by the number of interest payment periods. This amount will be added to the interest expense when it is debited and cash at bank will be credited and discount on debentures will be credited. When the debentures are repaid the liability will be debited and cash at bank will be credited.

The premium on debentures will also be spread over the life of the debenture in a similar manner to the discount, except that in this case the cash at bank will be debited with the monies received, the maturity value will be credited to debentures payable and the premium will be credited to the premium account. In the balance sheet the premium will be added to the maturity value. There will also be amortization over the life of the debenture. The amortization will be deducted from the interest expense. The entry when the interest is paid will be to debit interest expense, which will be the total interest expense less the premium amortization, debit the amortization to the premium on debentures, and credit the cash at bank.

LEARNING ACTIVITY 10

Reading   Textbook   Horngren, Harrison, etc pages 601 to 604

Work through the Decision Guidelines and the Summary problem for your review.

LEARNING OUTCOME 9: ACCOUNT FOR REDEMPTION AND CONVERSION OF DEBENTURES

Redemption means repayment and conversion occurs when the debentures instead of being repaid are converted into shares at a given rate of exchange.

When the interest payment date does not align with the financial year end date an accrual must be recognised for the interest that has arisen since the previous interest payment date up until the financial year end date. This will bring in an interest expense and an interest payable. There must also be an adjustment for the amount of amortisation on the discount from the last calculation date.

Interest Expense is debited, Interest Payable is credited and Discount on Debentures is credited

When the interest is paid in the period following the Interest Expense is debited as is Interest Payable and Cash and Discount on Debentures Payable is credited.

Where debentures are issued between interest payment dates it is necessary to recognise the accrued interest that arisen since the last payment.

Where debentures are redeemed early the loan comes to an end and the liability is extinguished. This can be done by the borrower purchasing the debenture on the open market. This would happen if the market price was less than the maturity value. That way the borrower could save money. Another method is where the borrower has a call option which allows them to buy back the debentures at a specified price at or after a specified date. The journal entry would be the same in either case.

Convertible debentures (or notes) give the holder the option of exchanging the debenture for a specified number of ordinary shares.

If a debenture is converted into ordinary shares, shareholders' equity is increased by the carrying amount of the debentures converted.

LEARNING ACTIVITY 10

Reading

Textbook Horngren, Harrison, etc pages 605 to 607.

LEARNING OUTCOME 10: REPORT LIABILITIES ON THE BALANCE SHEET

Where you have a long-term debt like a debenture and it is repayable in instalments it will be necessary to show the liability one the balance sheet in two places. The amount payable within 12 months of the balance sheet date must appear in current liabilities and the amount that is payable in more that 12 months must appear as a non-current liability.

LEARNING ACTIVITY 11

Reading

Textbook Horngren, Harrison, etc pages 607 to 608.

LEARNING OUTCOME 11: SHOW THE ADVANTAGES AND DISADVANTAGES OF BORROWING

The cost of borrowing is largely made up of interest payments. These interest payments can be deducted for tax purposes. So the cost of the interest payments will be reduced by the tax allowance making the overall cost of borrowing cheaper. If you raise funds by issuing shares the dividends that are paid to the shareholders are funded out of post tax profits. This means that the dividends are not an allowable deduction for tax and so can be more expensive to service than debentures.

LEARNING ACTIVITY 12

Reading Textbook Horngren, Harrison, etc pages 608 to 611.

Work through the Decision Guidelines and the Summary problem for your review.

Provide answers to Starters S16-1, S16-2, S16-3, S16-4, S16-7, S16-11, S16-12.