Section 3

ACCRUED EXPENSES (ACCRUED LIABILITIES)

Introduction

Accrued expenses are expenses that have been incurred, but not yet paid for. To put it another way, an accrued expense is paid *after* being recorded on the books. Every adjusting entry for accrued expenses debits an expense account, increasing expenses on the income statement and reducing net income, and credits a payable account, increasing liabilities on the balance sheet.

How to Record Accrued Expenses

The general entry to record an accrued expense is:

[Various Titles] Expense (income statement expense account)
    [Various Titles] Payable (balance sheet liability account)
To accrue ____________ expense

Examples of Accrued Expenses

Accrued expenses include the following:

- Interest owed but not yet paid on borrowed funds.

  Interest Expense
      Interest Payable

- Rent owed, but not yet paid.

  Rent Expense
      Rent Payable

- Commissions and royalties owed but not yet paid.

  Commission [or Royalty] Expense
      Commission [or Royalty] Payable

- Utility and telephone bills owed, but not yet paid:

  Utilities [or Telephone] Expense
  Utilities [or Telephone] Payable

- Salary and wage expense owed, but not yet paid.

  Salaries Expense*
  Salaries Payable

  *Many companies use “Salaries Expense” for employees paid by the week and “Wages Expense” for employees paid by the hour.

- Property and other taxes owed, but not yet paid.

  Property [or Federal Income, State Income, etc.] Tax Expense
  Property [or Federal Income, State Income, etc.] Tax Payable

How Failure to Make the Adjustment Affects the Financial Statements

Failure to record an adjusting entry will have the following impacts on the financial statements:

- Liabilities will be understated on the balance sheet (because the omitted entry increases a liability account);

- Expenses will be understated on the income statement (because the entry increases an expense account); and, as a result,

- Net income will be overstated on the income statement.

Sample Problems

PROBLEM 1: GuCo pays sales reps a 5% commission on sales. GuCo had 19X5 sales of $500,000, but paid only $21,000 in commissions. How much does GuCo accrue in commissions on December 31?

SOLUTION 1: To compute: $500,000 sales for 19X5 x 5% = $25,000 commissions payable in 19X5. $25,000 payable – $21,000 actually paid = $4,000 accrued commissions. The adjusting journal entry is:

Commissions Expense	4,000	
Commissions Payable		4,000
To accrue 19X5 commissions		

PROBLEM 2: On December 31, SuCo receives a $740 phone bill that it will pay the following month. What entry does SuCo record on December 31?

SOLUTION 2: On December 31, SuCo records the following adjusting entry:

Telephone Expense	740	
Telephone Payable		740
To accrue telephone expense		

PROBLEM 3: RaCo pays employees weekly on Friday. But 19X7 ends on a Wednesday. If, for the last week of the year, gross payroll is $10,000, how much does RaCo accrue for salary expense?

SOLUTION 3: RaCo must accrue 19X7 salary expense for 3 of the 5 days, Monday, Tuesday, and Wednesday, which is 60% (3/5) of the week. To compute accrued payroll expense (payroll expense incurred but not paid) for the last week of 19X7: $10,000 x 60% = $6,000 accrued payroll expense for 19X7. (The remaining $4,000 of payroll expense for the week will be incurred in 19X8.)

RaCo's accrued payroll expense is recorded with an adjusting entry in the general journal as of the last day of the business year:

Salaries Expense	6,000	
Salaries Payable		6,000
To accrue salaries at year end		

Without this entry, the company's 19X7 net income would be overstated because the expense would not have been recorded for 19X7. Also, 19X7 liabilities would be understated.

Accruing Interest Payable

Interest payable is accrued in the same way as interest receivable. On a short-term note, the interest accrues (builds up) and is usually paid along with the principal on the note's due date. On a long-term note, the interest is paid periodically, such as each month. If the accounting period ends before the interest is paid, interest expense is accrued on the last day of that period.

The formula to compute interest for a period is:

Face amount (principal) x annual interest rate x fraction of year = accrued interest

When a company gives a note to borrow money, the first entry is for the note:

Cash
    Note Payable
To record note payable

Subsequently, interest expense is accrued with the following entry:

Interest Expense
    Interest Payable
To accrue interest expense

PROBLEM 4: On November 1, 19X6, MiCo, which uses a calendar year, borrows $100,000 at 12% interest. How much interest expense should MiCo accrue as of December 31, 19X6, and how does it record the accrual on that day?

SOLUTION 4: To compute interest accrued as of December 31:

$100,000 principal x 12% annual interest = $12,000 x 2/12 (for November and December) = $2,000 accrued interest as of December 31. The adjusting entry in the general journal on December 31 is:

Interest Expense	2,000	
Interest Payable		2,000

To accrue 2 months' interest ($100,000 x 12% x 2/12)

The interest expense is recorded as of December 31 because the expense is incurred (owed, but not paid) as of the last day of the period.

Note that in all three problems, the adjusting entry increases an expense account, which reduces net income on the income statement, and increases a liability account, which increases liabilities on the balance sheet.

QUIZ 1 ACCRUED EXPENSES (ACCRUED LIABILITIES)

Problem I.

Make the following adjusting journal entries:

1. Accrue interest expense of $3,000
2. Accrue property tax expense of $1,200
3. Accrue salaries expense of $10,000

Problem II.

1. Your company has a 6-day workweek and payday is Saturday. Weekly salaries are $12,000, and your company contributes to each employee's pension by contributing 3% of salaries to the Pension Fund account. Make the adjusting journal entries when the accounting period ends on a Tuesday.
2. What adjusting entry (if any) do you record if the accounting period ends on a Saturday?

Problem III.

Your payroll for the last week of the year (your company uses a 5-day workweek) is $40,000 and December 31 falls on a Thursday. Record the adjusting journal entry at year end.

Problem IV.

Your company borrows $50,000 on a 6-month, 12% note on October 1. Year end is November 30. Record the accrued interest at November 30.

Problem V.

Multiple choice. Circle the correct answer.

1. What kind of account is Taxes Payable?

a. asset
b. liability
c. revenue
d. expense

2. If a company forgets to accrue utilities expense at year end, how does it affect net income?

a. Net income will be overstated.
b. Net income will be understated.
c. Net income will be unaffected.

3. If a company fails to record an adjusting entry for property taxes, then net income will be . . .

a. unaffected
b. understated
c. overstated
d. understated or overstated depending on the amount

4. An accrued expense is one that is incurred but not yet paid.

a. True b. False

5. With an accrued expense, payment follows recognition of the expense.

a. True b. False

Problem VI.

Fill in the blanks.

1. An accrued expense is one that has been ____________ but not ____________.
2. An expense is accrued by debiting a(n) ____________ account and crediting a(n) ___________ account.
3. An adjusting entry to accrue an expense (increases/decreases) net income.
4. An expense recorded as incurred but not paid is presented as a(n) ____________ on the balance sheet.

Problem VII.

Record the adjusting entries and any transaction entries on December 31 for each of the following:

1. On December 31, 19X1, FaCo incurs wage expense of $8,000 for December 29-31 that has not been either recorded or paid.
2. Rent for December of $2,300 will be paid on January 2.
3. Of the $1,000 in commissions payable on December 31, only $400 was paid.

QUIZ 1 Solutions and Explanations

Problem I.

1.

Interest Expense	3,000	
Interest Payable		3,000
To accrue interest expense		

2.

Property Taxes	1,200	
Property Taxes Payable		1,200
To accrue property tax expense		

3.

Salaries Expense	10,000	
Salaries Payable		10,000
To accrue salaries expense		

Problem II.

1.

Salaries Expense	4,000*	
Salaries Payable		4,000
To accrue salaries expense		

*$12,000 weekly payroll/6 days = $2,000 per day x 2 days (Monday and Tuesday) = $4,000

Pension Expense	120*	
Pension Payable		120
To accrue pension expense		

*$4,000 accrued salaries expense x 3% pension contribution = $120 pension expense

2. If the workweek ends on a Saturday, the company will pay salaries for the entire week, so no salaries accrue (accrued expenses are expenses incurred *before* they are paid). Thus, no adjusting entry is recorded; only an ordinary transaction entry is needed. However, pension contributions might accrue depending on the rules of the particular plan.

Problem III.

Wages (or Salaries) Expense	32,000*	
Wages (or Salaries) Payable		32,000
To accrue wages (or salaries)		

*$40,000 payroll x 4/5 of the week (Monday – Thursday) = $32,000 payroll expense accrued for the week.

Problem IV.

Interest Expense	1,000	
Interest Payable		1,000
To accrue 2 months' interest expense ($50,000 x 12% x 2/12)		

Problem V.

1. b
A payable account is a liability.

2. a
When a company does not record an expense, expenses are understated (too low) on the income statement, and net income is overstated (too high).

3. c
Because not all expenses are on the books, net income will be overstated.

4. a

5. a

Problem VI.

1. incurred, paid

2. expense, payable (or liability)

3. decreases

4. liability

Problem VII.

On December 31, 19X1, FaCo records the following adjusting entries:

1. $8,000 in accrued wages (stated in the data) have been accrued:

Wages Expense	8,000	
Wages Payable		8,000
To accrue wages expense		

2. $2,300 in accrued rent:

Rent Expense	2,300	
Rent Payable		2,300
To accrue rent expense		

3. There is a transaction entry for the commissions paid:

Commissions Expense	400	
Cash		400

There is an adjusting entry for accrued commissions:

Commissions Expense	600*	
Commissions Payable		600
To accrue commissions expense		

*$1,000 commissions owed – $400 paid = $600 accrued.

QUIZ 2 ACCRUED EXPENSES (ACCRUED LIABILITIES)

NOT SHOWN