

# PRINCIPLES OF FINANCIAL ACCOUNTING

CHAPTER 8 THIRD EDITION

MUĞAN & AKMAN



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## Liabilities

- obligations of an entity to make a future payment or to deliver goods or services to the third parties in the future in return for cash borrowed or service used or goods acquired
- provide cash via borrowing, or savings of cash
- classified according to their due dates
  - due within one year or the operating cycle are classified as current liabilities
  - loans or credits that mature in more than one year are classified as long-term liabilities

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## Recognition of Liabilities

- recognized when the obligation occurs for an entity
- when a loan is not recorded, both the liabilities and the assets are understated
- to satisfy the matching and periodicity principles, adjustments are made at the end of the accounting periods

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## Valuation of Liabilities

- valued at the cash amount necessary to pay back the liability or at the fair value of the goods or services to be provided
- may be estimated

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## Current Liabilities

1. Short Term Bank Loans
2. Current Portion of Long-term Debt
3. Accounts Payable
4. Notes Payable
5. Accruals
6. Unearned Revenues
7. Payroll Liabilities
8. Corporate Income Taxes
9. Value Added Taxes
10. Product Warranty Liability

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## Notes Payable

- arise as a result of written promissory note to pay a certain amount at a certain date to a third party
- notes are issued to borrow cash or to make purchases on credit or to settle an accounts payable
- accounting treatment of notes differs
  - the interest is stated separately on the note
  - included in the face value of the note

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## Accounting for Notes Payable-A1

Aycan Industries issued a TL18.000 note for short-term financing of the operations, maturing in 90 days with an interest rate of 22%.

### Case A: Interest rate stated on the face of the note

Kavaklıdere/Ankara 31 August 2007

Ninety days after the date of the note I promise to pay

UBZ Bank the sum of TL 18.000 plus the interest at the rate of 22%.

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## Accounting for Notes Payable-A2

### Case A: Interest rate stated on the face of the note

Date	Account Title and Description	Debit	Credit
31-Aug-07	Cash	18.000	
	Notes Payable		18.000
	To record the note issued to UBZ Bank		

### 29 November 2007, when the note is repaid

Date	Account Title and Description	Debit	Credit
29-Nov-07	Notes Payable	18.000	
	Interest Expense*	990	
	Cash		18.990
	To record payment of notes issued		

\*TL18.000 x 22% x 90 /360= TL 990

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## Accounting for Notes Payable-B1

### Case B: Interest Included in the Face Value of the Note

- note is discounted

Kavaklıdere/Ankara 31 August 2007

Ninety days after the date of the note I promise to pay

UBZ Bank the sum of TL 18.000

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## Accounting for Notes Payable-B2

Date	Account Title and Description	Debit	Credit
31-Aug-07	Cash	17,010	
	Discount on Notes Payable	990	
	Notes Payable		18,000
	To record the note issued to UBZ Bank		

### 29 November 2007, when the note is repaid

Date	Account Title and Description	Debit	Credit
29-Nov-07	Notes Payable	18,000	
	Interest Expense	990	
	Cash		18,000
	Discount on Notes Payable		990
	To record payment of notes issued		

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## Accruals by Aycan - payee

### • Case A

Assume 30  
Sept. end of  
fiscal year

Date	Account Title and Description	Debit	Credit
30-Sep-07	Interest Expense	330	
	Interest Payable		330
	To accrue interest on notes payable		

### • Case B

$$18,000 \times 22\% \times \frac{30}{360}$$

Date	Account Title and Description	Debit	Credit
30-Sep-07	Interest Expense	330	
	Discount on Notes Payable		330
	To accrue interest on notes payable		

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## Accruals by - lender

### Case A

Date	Account Title and Description	Debit	Credit
30-Sep-07	Interest Receivable	330	
	Interest Revenue		330
	To accrue interest on notes receivable		

### Case B

Date	Account Title and Description	Debit	Credit
30-Sep-07	Discount on Notes Receivable	330	
	Interest Revenue		330
	To accrue interest on notes receivable		

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## Payroll Related Liabilities

- An employee usually receives a payment that is less than the **gross pay** of that employee- the **net pay**
- Deductions:
  - Required deductions that must be paid by the employee according to tax and social security regulations
  - Optional deductions authorized by the employee for special purposes (such as private pension plans)

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## Payroll Liabilities

- Employee Income Taxes
- Stamp Duty
- Social Security Premiums
- Unemployment Insurance Premium

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EMPO CORPORATION

PAYROLL OF NOVEMBER 2008

NAME	DAYS WORKED	GROSS PAY	EMPLOYEE UP	EMPLOYEE SSKP	EMPLOYEE EXEMPTION	TAX TAX BASE	CUMULATIVE TAX BASE	INCOME TAX BASE	INCOME TAX	STAMP DUTY	TOTAL DEDUCTIONS	NET PAY	EMPLOYER SSKP	EMPLOYER UP
ALI GELIR	30	2.000	40	290	188	9.266	1.493	224	12	555	1.444	390	60	
TOTAL		2.000	40	290	188	9.266	1.493	224	12	555	1.444	390	60	

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## Value Added Taxes

- amount of **VAT paid** for goods and services purchased is deducted from the amount of **VAT received** on deliveries of goods and services provided
  - if VAT on sales > the VAT on purchases → the entity is required to pay the difference to the Tax Office
  - if VAT on purchases exceeds the VAT on sales → the difference is carried forward to the next month

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## Accounting for VAT transactions

- 14 April: Purchased 10 items for TL17.110 on credit including 18% VAT  
 20 April: Sold 22 items for TL 37.642 on credit including 18% VAT  
 20 May: Filed the VAT return  
 26 May: Paid the necessary amount

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## VAT entries

Date	Account Title and Description	Debit	Credit
14-Apr	Merchandise Inventory	14.500	
	VAT Deductible	2.610	
	Accounts Payable		17.110
	To record merchandise purchased on credit		
20-Apr	Accounts Receivable	37.642	
	Sales		31.900
	VAT Payable		5.742
	To record sales made on April 20		
26-May	VAT Payable	5.742	
	VAT Deductible		2.610
	Cash		3.132
	To record VAT return filed for April; and payment for VAT		

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## Product Warranty Liabilities-1

- matching principle - warranty expenses of sales in a period should be recorded in the same period

**Strong Home Products, TVs one year warranty**

**Past experience: 3% of products had defective parts**

**Average cost of replacement TL 750; Company sold 15.000 units in 2008**

The estimated defective parts from 2008 sales =  $15.000 \cdot 3\% = 450$  units

The estimated cost of the defective parts =  $450 \cdot 750 = TL337.500$

Date	Account Title and Description	Debit	Credit
31-Dec-08	Product Warranty Expense	337.500	
	Product Warranty Liability		337.500
	To record estimated product warranty liability for the year 2008		

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## Product Warranty Liabilities-2

4 January 2009, one of the customers brought back a TV set purchased in 2008, and the Company agreed to replace the part of the set that was defective. The cost of the replaced part was TL 775 on 4 January 2009.

Date	Account Title and Description	Debit	Credit
4-Jan 2009	Product Warranty Liability	775	
	Merchandise Inventory		775
	To record replaced defective part		

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## Contingent Liabilities

- a potential liability arising from a past transaction and that depends on a future event
- could be disclosed in the body of the balance sheet with the liabilities
- could be disclosed within notes to financial statements
- certainty of the amount and the payment date determines where they will be disclosed

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# Common Financial Ratios

$$\text{Net Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

$$\text{Average Accounts Payable} = \frac{\text{Beginning Acct.Pay.} + \text{Ending Acct.Pay.}}{2}$$

$$\text{Accounts Payable Turnover} = \frac{\text{Cost of Goods Sold} \pm \text{Changes in Inventory}}{\text{Average Accounts Payable}}$$

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