EXPLANATION NOTES

Purchases and Purchases Returns:
Purchases refer to the goods purchased that are meant to be used in producing the products that an enterprise deals in or are those goods which are meant for resale with or without any value addition. Purchases made during the year, includes both cash and credit purchases of goods. When goods purchased are returned to the suppliers due to any reason, it is called *purchases returns* or *returns outward*. Purchases can be divided into two types, namely gross purchases and net purchases.

(i) Gross Purchases:
It includes both cash and credit purchases of goods before subtracting the purchase returns.

(ii) Net Purchases: When purchases returned are subtracted from the gross purchases, the balance is known as net purchases. Only the net purchases are shown in the trading account. The following example shows the debit side of the trading account that must be considered in this regard:

To Purchases 100
Less: Purchases Returns 25 75

In the trial balance, the purchases account appears on the debit side while the purchases returns account appears on the credit side.
Certain other items apart from purchases returns are also deducted from gross purchases to arrive at net purchases. These items are as under:

(a) Drawings made in Goods:
Drawings made in goods refer to the goods that have been withdrawn from the business by the proprietor for personal use. Such withdrawn goods are recorded by debiting the Drawings Account and crediting the Purchases Account with the actual value of the purchase.
(b) Goods taken for Staff Use: Sometimes, the proprietor withdraws the goods for the welfare of the staff of the organisation. Such goods withdrawn for the staff welfare are also recorded by debiting the 'Staff Welfare Expenses' and crediting the 'Purchases Account.'
(c) Goods given as Samples: Samples refer to the goods that have been given away for usage as a representative of the whole. Such goods are also debited to the Samples Expenses Account or Advertisement Expenses Account and credited to the Purchases Account with the actual value of the purchase.
(d) Goods given as Charity: Goods given as charity are also credited to the Purchases Account hence they are also deducted from the purchases.

Adjusted Purchases: The opening and closing stocks may be adjusted by firms through the Purchases Account. When this happens, the following entries are passed.
The Opening Stock can be adjusted through the entry:

Purchases A/c Dr.
To Opening Stock A/c

The closing stock can be adjusted through the entry:

Closing Stock A/c Dr.
To Purchases A/c

Thus, **Adjusted Purchases = Net Purchases + Opening Stock – Closing Stock.**
Once the above adjustments are made, the opening stock does not appear in the Trial Balance. The balance of the Adjusted Purchases A/c is shown on the debit side of the Trading Account while the closing stock appears on the assets side of the balance sheet.

Capital Receipts and Revenue Receipts

It is also necessary to make distinction between capital receipts and revenue receipts, because revenue receipts are credited to Trading A/c or Profit and Loss A/c while capital receipts are shown either on liabilities side or deducted from the fixed assets on assets side of the Balance Sheet. Without proper distinction between these two, true and accurate profit or loss cannot be presented by Profit and Loss A/c and true financial position cannot be depicted by the Balance Sheet.

Capital Receipts: Capital receipts are those receipts which either increase the liability of the business or reduce asset of the business. Hence, profit or loss of the firm is not directly affected by the capital receipts received by the business. Capital receipts are not earned during the normal course of the business. In other words, they are the amounts received by the enterprise but are not incomes.

Capital receipts are of following types:
(1) Additional capital introduced in the business.
(2) Amount obtained from sale of fixed assets.
(3) Amount obtained from debtors.
(4) Amount obtained by way of loans.
(5) Amount obtained from issue of shares and debentures and premium thereof.
(6) Amount received from insurance company as compensation for loss of fixed assets.

Revenue Receipts: Revenue receipts are those receipts that are earned during the normal course of activities of a business. They arise from the operating activities of the business. They are income for the business.

Revenue receipts are:
(1) Amount obtained by sale of goods or services.
(2) Amount received as interest, commission, discount, income on investments, interest on drawings and income from other sources, etc.
(3) Amount received from debtors
(4) Bad debts recovered.

EXPLANATION NOTES

Difference between Trading Account and Profit and Loss Account

Basis	Trading Account	Profit and Loss Account
1. Purpose	Ascertains the gross profit earned or gross loss incurred by the business.	Ascertains the net profit earned or net loss incurred by the business.
2. Nature of Items	Presents a statement of items that are directly incidental to the main activities of the business.	Presents a statement of items that are not directly incidental to the main activities of the business.
3. Relation	Part of Profit and Loss Account.	Present main account of income statement.
4. Account Balance	Account balance consisting of gross profit or gross loss is transferred to Profit and Loss A/c.	Account balance consisting of net profit or net loss is transferred to Capital Account.
5. Examples of Items	Stock, purchases and purchases returns, direct expenses, sales and sales returns, etc.	Operating and non-operating expenses, operating and non-operating incomes, etc.

Difference between Gross Profit and Net Profit

Basis	Gross Profit	Net Profit
1. Nature	Ascertained from all direct revenue earned and direct expenses incurred by the firm.	Ascertained from gross profit earned, miscellaneous income and all office (indirect) expenses.
2. Purpose	To help ascertain gross profit or gross loss.	To help ascertain net profit or net loss.
3. Related Report	Determined from Trading A/c.	Determined from Profit and Loss A/c.
4. Balance Transfer	Transferred to Profit and Loss A/c.	Added to Capital Account.
5. Constituents	Includes only direct revenue earned and not any income from other sources.	Includes income from all sources and not just direct sources.
6. Relationship	Directly related to net profit but does not depend on it.	Derived from Gross Profit.
7. Formula	Gross Profit = Sales – Cost of Goods sold.	Net Profit = Gross Profit + All Other Income – Indirect Expenses and Losses

Operating Profit and Net Profit

Profit earned may be further classified into two categories: operating profit and net profit. *Operating profit* refers to the profit earned from a firm's normal course of business operations.

Thus, operating profit is derived by deducting the operating expenses from gross profit. Operating expenses include office and administrative expenses, selling and distribution expenses, cash discount allowed, interest on bills payable, rent, repairs, bad debts, etc. Operating profit is also known as *Earnings before Interest and Tax* or *EBIT.*

Operating Profit is calculated as follows:

Operating Profit = Net Sales – Operating Cost

Or

Operating Profit = Net Sales – Cost of Goods Sold – Operating Expenses

Or

Operating Profit = Gross Profit – Operating Expenses

Operating Expenses includes Administration and office expenses, Selling and Distribution Expenses, etc.

EXPLANATION NOTES

Operating Profit = Net Profit + Non-operating Expenses – Non-operating Incomes

Net profit is a measure of firm's net income or net earnings during a given period of time. It is calculated by deducting all operating and non-operating expenses from all operating and non-operating incomes. Non-operating Expenses and Non-operating Incomes are indirect to the main business operation of a business organisation. *Non-operating Expenses* include interest on loan and borrowings, loss on sale of fixed assets, donations, losses due to fire and stock. *Non-Operating Incomes* include interest received, dividend received, rent received and gain on sale of fixed assets.

Sometimes Profit and Loss Account may be bifurcated to show operating profit and net profit separately as per the requirements of the question.

Assets

Assets are properties of business. It represents everything which a business owns and has money value. Assets are always shown as debit balances; therefore it is shown on the right hand side of the balance sheet. Assets are classified on the basis of their nature. The various types of assets are as under:

(i) Fixed assets: Fixed Assets are the assets which are acquired and held permanently and used in the business with the objective of making profits and not for resale. Land and building, Plant and machinery, Furniture and Fixtures are examples of fixed assets.

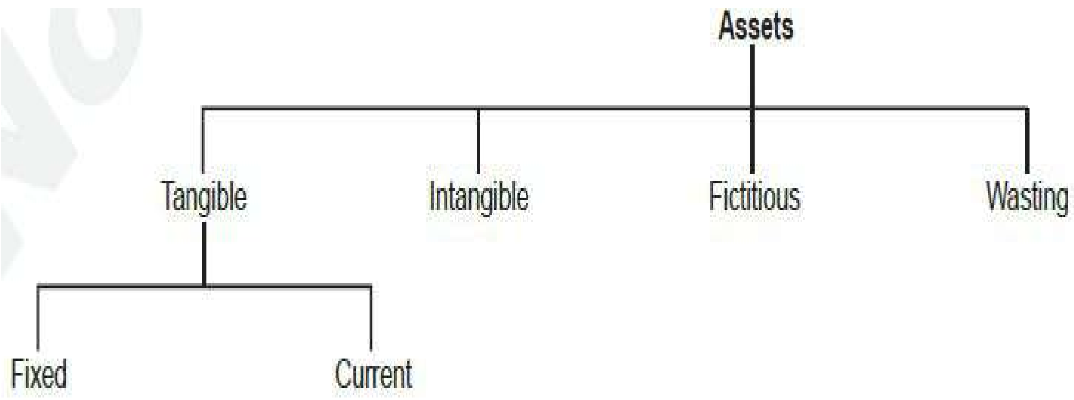
(ii) Current assets: The assets of the business in the form of cash, debtors, bank balances, bill receivable and unsold stock are called current assets as they can be realised within an operating cycle or one year to discharge liabilities. In other words, current assets can be converted into cash within a period of one year or its normal operating cycle. They may vary time-to-time due to temporary in nature. So, they are also termed as floating or circulating assets.

(iii) Tangible assets: Tangible assets have definite physical shape or identity and existence; they can be seen, felt and have volume such as land, cash, stock, etc. Thus, tangible assets can be both fixed assets and current assets.

(iv) Intangible assets: The assets which have no physical shape or existence and cannot be seen or felt but have value are called intangible assets. Goodwill, patents, trade marks and licenses are examples of intangible assets. They are usually classified under fixed assets.

(v) Fictitious assets: Fictitious assets are not assets but are losses and deferred revenue expenses yet to be written off. Advertisement suspense account and debit balance of profit and loss account, etc. are the examples of fictitious assets.

(vi) Wasting assets: These assets are also called depleting assets. Assets such as mines, timber
forests, quarries, etc., which become exhausted in value by way of excavation of the
minerals, cutting of wood, etc., are known as wasting assets. Such assets are usually natural
resources with physical limitations.



Difference between Tangible Assets and Intangible Assets

Point of Distinction	Tangible Assets	Intangible Assets
1. Physical Existence	Tangible Assets have physical existence. They can be seen and touched.	Intangible Assets do not have physical existence. They cannot be seen and touched.
2. Fixed and Current	Tangible assets can be fixed or current.	Intangible Assets generally falls into the category of fixed assets.
3. Depreciation or Amortisation	Depreciation is charged on Tangible Assets to take into account the fall in the value of assets due to normal wear and tear.	Intangible Assets are amortised to take into account the fall in the value of assets.
4. Risk of Loss	These assets have a risk of loss due to fire, theft and accidents.	These assets cannot have a risk of loss due to fire or theft.
5. Acceptance as a Security	Lenders easily accept tangible assets as security.	Lenders do not accept Intangible Assets as security.
6. Examples	Examples of Tangible Assets are Land, Building, Plant, Machinery, Stock, etc.	Examples of Intangible Assets are Goodwill, Patents, Trademarks, etc.

Liabilities

A liability is an amount which a business firm is 'liable to pay' legally. All the amounts which are
the claims by outsiders on the assets of the business are known as liabilities. They are credit balances
in the ledger. The capital and liabilities of the business are shown on the left hand side in the balance
sheet. Liabilities are classified into the categories as given below:

(i) Owner's capital: Capital is the amount contributed by the owners of the business. In addition to initial capital introduced, proprietors may introduce additional capital and withdraw some amounts from business over a period of time. Owner's capital is also known as 'net worth'. Net worth is the total fund of proprietor on a particular date. It consists of capital, undistributed profits and reserves and interest on capital subject to reduction of drawings and interest on drawings. The difference between assets and liabilities is capital.

(ii) Long-term Non-Current Liabilities: Liabilities repayable after specific duration of long period of time are called long-term liabilities. They do not become due for payment in the ordinary 'operating cycle' of business or within a short period of time usually a year. Examples are long term loans and debentures. Long term liabilities may be secured or unsecured, though usually they are secured.

(iii) Current liabilities: Liabilities which are repayable during the operating cycle of business,
usually within a year, are called short term liabilities or current liabilities. They are paid out of current assets or by the creation of other current liabilities. Examples of current liabilities are trade creditors, bills payable, trade payables, outstanding expenses, bank overdraft, taxes payable and dividends payable.

(iv) Contingent liabilities: Contingent liabilities will result into liabilities only if certain events
happen. Examples are bills discounted from bank and bills endorsed which may be dishonoured, unpaid calls on investments, disputed claims, etc. They are not shown in the Balance Sheet, but are disclosed by way of a note.

BALANCE SHEET EQUATION

An important point to note about the Balance Sheet is that, the total value of the assets is always
equal to the total value of the liabilities and capital.

This is because the liability to the owner — capital, is always made up of the difference between
assets and liabilities. Thus, it can be expressed as follows in the form of a Balance Sheet equation:

Assets = Liabilities + Capital
or
Capital = Assets – Liabilities