

## TOPIC - 2

# FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

(No. of Questions Covered – 3)

### **Q. 1: Historical Cost Capital Maintenance**

*A trader commenced business on 01/01/20X1 with Rs 12,000 represented by 6,000 units of a certain product at Rs 2 per unit. During the year 20X2 he sold these units at Rs 3 per unit and had withdrawn Rs 6,000.*

Thus:

Opening Equity = Rs 12,000 represented by 6,000 units at Rs 2 per unit.

Closing Equity = Rs 12,000 (Rs 18,000 – Rs 6,000) represented entirely by cash.

Retained Profit = Rs 12,000 – Rs 12,000 = Nil

The trader can start year 20X3 by purchasing 6,000 units at Rs 2 per unit once again for selling them at Rs 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

### **Q. 2: Financial Capital Maintenance**

*In the previous example A, suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.*

*Opening Equity = Rs 12,000 represented by 6,000 units at Rs 2 per unit.*

*Opening equity at closing price = (Rs 12,000 / 100) x 120 = Rs 14,400 (6,000 x Rs 2.40)*

*Closing Equity at closing price = Rs 12,000 (Rs 18,000 – Rs 6,000) represented entirely by cash.*

Retained Profit = Rs 12,000 – Rs 14,400 = (-) Rs 2,400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund Rs 12,000 is not sufficient to buy 6,000 units again at increased price Rs 2.40 per unit. In fact, he should have restricted his drawings to Rs 3,600 (Rs 6,000 – Rs 2,400).

Had the trader withdrawn Rs 3,600 instead of Rs 6,000, he would have left with Rs 14,400, the fund required to buy 6,000 units at Rs 2.40 per unit.

### **Q. 3: Physical Capital Maintenance**

*In the previous example A, suppose that the price of the product at the end of year is 2.50 per unit. In other words, the specific price index applicable to the product is 125.*



**Current cost of opening stock = (Rs 12,000 / 100) x 125 = 6,000 x Rs 2.50 = Rs 15,000**

**Current cost of closing cash = Rs 12,000 (Rs 18,000 – Rs 6,000)**

**Opening equity at closing current costs = Rs 15,000**

**Closing equity at closing current costs = Rs 12,000**

Retained Profit = Rs 12,000 – Rs 15,000 = (Rs 3,000)

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund Rs 12,000 is not sufficient to buy 6,000 units again at increased price Rs 2.50 per unit. The drawings should have been restricted to Rs 3,000 (Rs 6,000 – Rs 3,000).

Had the trader withdrawn Rs 3,000 instead of Rs 6,000, he would have left with Rs 15,000, the fund required to buy 6,000 units at Rs 2.50 per unit.

**Capital maintenance can be computed under all three bases as shown below:**

**Financial Capital Maintenance at historical costs**

	Rs	Rs
Closing capital (At historical cost)		12,000
Less: Capital to be maintained		
Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	Nil	(12,000)
Retained profit		Nil

**Financial Capital Maintenance at current purchasing power**

	Rs	Rs
Closing capital (At closing price)		12,000
Less: Capital to be maintained		
Opening capital (At closing price)	14,400	
Introduction (At closing price)	Nil	(14,400)
Retained profit		(2,400)

**Physical Capital Maintenance**

	Rs	Rs
Closing capital (At current cost)		12,000
Less: Capital to be maintained		
Opening capital (At current cost)	15,000	
Introduction (At current cost)	Nil	(15,000)
Retained profit		(3,000)



## Student Notes:-





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