The effect of Profits or Losses on Capital

The basic accounting equation

\[
\text{Assets} = \text{Capital} + \text{Liabilities}
\]

*Assets* = The resources in the business  
*Capital* = The amount of resources supplied by the owner  
*Liabilities* = The amount of money owing to people outside the business for the use of their resources e.g. The bank for the use of its money.

The nature of profit or loss

To an accountant *profit* means the amount by which *revenues* are greater than *expenses* for a set of transactions.

**Example**

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Goods and services supplied to our customers for the sum of</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses</td>
<td>Value of all the assets used up to enable us to supply the above goods and services</td>
<td>$70,000</td>
</tr>
<tr>
<td>Profit is therefore</td>
<td></td>
<td>$30,000</td>
</tr>
</tbody>
</table>

On the other hand, it could also be possible that our expenses may exceed our revenues for a set of transactions. In this case the result is a loss.

**Example**

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Value of all the assets used up to supply goods and services to our customers</th>
<th>$80,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Revenues</td>
<td>What we have charged to our customers in respect of all the goods and services supplied to them</td>
<td>$60,000</td>
</tr>
<tr>
<td>Loss is therefore:</td>
<td></td>
<td>$20,000</td>
</tr>
</tbody>
</table>
The effect of profit or loss on capital

We can now look at the effect of profit or loss on capital:

\[
\text{Old capital} - \text{Loss} = \text{New Capital} \\
\text{Old capital} + \text{Profit} = \text{New Capital}
\]

**Example**

On 1\textsuperscript{st} January the assets and liabilities are:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Fixtures $10,000</th>
<th>Stock $7,000</th>
<th>Cash at Bank $3,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities:</td>
<td>Creditors $2,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

On the 31\textsuperscript{st} January the assets and liabilities had become:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Fixtures $10,000</th>
<th>Stock $0</th>
<th>Cash at Bank $14,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities:</td>
<td>Creditors $2,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Calculate:

One) Old Capital
Two) New Capital
Three) Profit or Loss for the month of January

**Drawings Account**

Sometimes the owner will want to take cash or stock for his or her own private use. Taking out cash for personal use reduces the amount of capital invested in the company. Similarly, taking out stock for personal use will reduce the owner's investment because the stock will have been paid for with money from the firm.

Accountants use the term *Drawings* to signify a sum of money taken from the capital invested by the owner. Obviously if the capital is reduced by a drawing from the firm this will affect the old capital figure in the basic accounting equation:

\[
\text{New Capital} = \text{Old Capital} + \text{Profit} - \text{Drawings}
\]

Or

\[
\text{New Capital} = \text{Old Capital} - \text{Loss} - \text{Drawings}
\]