The effect of Profits or Losses on Capital

The basic accounting equation

Assets = Capital + 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

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Revenues	Goods and services supplied to our customers for the sum of	100,000
Expenses	Value of all the assets used up to enable us to supply the above goods and services	70,000
Profit is therefore		30,000

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

		$
Expenses	Value of all the assets used up to supply goods and services to our customers	80,000
Less Revenues	What we have charged to our customers in respect of all the goods and services supplied to them	60,000
Loss is therefore:		20,000

The effect of profit or loss on capital

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

Old capital - Loss = New Capital

Old capital + Profit = New Capital

Example

On 1st January the assets and liabilities are:

Assets :	Fixtures $10,000	Stock $7,000	Cash at Bank $3,000
Liabilities:	Creditors $2,000		

On the 31st January the assets and liabilities had become:

Assets :	Fixtures $10,000	Stock $0	Cash at Bank $14,000
Liabilities:	Creditors $2,000		

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:
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New Capital = Old Capital + Profit - Drawings

Or

New Capital = Old Capital - Loss - Drawings