CHAPTER 3

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3.1 INTRODUCTION

3.1.1 In the practical affairs of trade, industry and finance; no concept is more fundamental, or more familiar, than profit. An enterprise is required to earn sufficient profits for its existence and expansion only. Thus, profit making is the fundamental objective of every business, hence profitability is the yardstick for measuring the efficiency of such firms. Profit is indeed a magic eye that mirrors all the aspects of entire business operations. The larger the profit, the more efficient and profitable a business is deemed to be. For private enterprises, profits are the end of policy; while for Government, they are sometimes a result, sometimes a guide, sometimes a target and sometimes an instrument of national economic policy. Social criteria of business performance usually relate to quality of products, rate of progress, and behaviour of prices. But, these are tests of the desirability of the whole profit system. Within that system, profits are the acid test of the individual firm's performance.¹

3.1.2 The aspects of profitability discussed in this chapter are

¹ Dean, Joel, (1992), Managerial Economics, Prentice-Hall of India Private Limited, New Delhi, p. 3.
3.2 PROFIT DEFINED

3.2.1 The word 'profit' may be defined as the difference between total revenues and total costs over a period of time. There is almost universal agreement with the general definition that profit is 'primarily a residue or surplus of prices over expenses of production or leaving above costs.' But, this definition is not very useful because it neither tells us how profits arise nor does it tell us why they arise; and it is open to controversy over the meaning of terms which enter into the definition of profit, namely; prices, expenses of production, costs and so on. So far, the law has not defined profit.

3.2.2 Profit is necessarily a residual sum. Land, labour and capital are frequently used under contracts whereby they receive a predetermined return. Net profit is a sum over and above the ordinary cost of business, including such contractual payments. No body contracts to pay the entrepreneur the residual sum, i.e., net profit. Therefore, profit is the payment received by a factor of production called the organiser. He organises land, labour and capital, produces

good, sells them and bears an uninsurable risk which others are unwilling to bear, and if he successfully manages the risk, he receives a reward called profit. Thus, profits are non-contractual income and therefore, they may be positive or negative, whereas the contractual income of other factors of production is always positive and never negative. This may be called as the functional definition of profit.

3.2.3 The word profit has got different meanings for businessmen, accountants, tax collectors, workers, and economists, and it is often used in a loose, polemical sense that buries its real significance and destroys the basis for discussion. It is sufficient to say that profit in economics, as in accounting practice, has invariably been regarded as the difference between the costs that a firm incurs for producing and selling goods or services and the revenues that it receives from their sale per unit of time. This differential view looks quite objective and precise.

3.2.4 As profit theory is regarded as the most unsatisfactory and controversial division, it would be appropriate to discuss the concept of profit used in accounting literature, economic literature, and also in the social context in the following lines.

3.3 CONCEPT OF PROFIT

Keeping in view the confusion and controversy in profit theory, we have divided the concept of profit into three broad categories viz., (a) Accounting concept, (b) Economic concept
3.3.1 ACCOUNTING CONCEPT

In accounting, the word profit is used almost invariably with some qualifying words or phrases. In the report of a special committee of the American Institute of Accountants, the word 'profit' is modified in thirty different ways. According to this report, the accountant usually means by the term 'profit', the excess of the selling price over the cost of anything. The accounting income (profit) is defined as 'the difference between the realised revenues arising from the transactions of the period and the corresponding historical costs.' This definition satisfies most of the accounting principles.

On the basis of the discussion memorandum issued by the Financial Accounting Standards Board (FASB) in 1976, which highlights important items on accounting concepts, the most central of which is, of course, the conceptual view of income, only two aspects of this have been emphasised viz., the assets and liabilities view, and the revenues and expenses view. In a very broad term, in the assets and liabilities view, earnings are determined as a measure of change (but not necessarily the entire change) in the net economic resources of a business.

enterprise for a period. In the revenues and expenses view, earnings (i.e., profits) are equal to the difference between the revenues and costs of earning those revenues. Here, earnings are a direct measure of the effectiveness of an enterprise in using its inputs to obtain and sell output and are not necessarily based on or limited to change in net economic resources. In this sense, accounting profit is known as the excess of total revenues over their total costs during a given period. Those who are in favour of adopting this view to profit measurement are inclined to argue that the concepts of revenues and expenses can be defined more precisely than the concepts of assets and liabilities.

Thus, accounting profit lies in the difference between the current value of sales and the historic cost of expenses. There has been a lack of agreement regarding a single concept of net income in accounting theory because of the consequences of the generally accepted multiple accounting principles for arriving at revenues and expenses. For the above reasons, search for a single income concept has been abandoned by some theorists in favour of measuring and reporting several concepts of income. Besides, different concepts of income exist because there are a variety of users of accounting information such as investors, shareholders, creditors, employees, the Government, etc. Sometimes, it may include other incomes and capital gains and thus, it takes several forms.

Types of Accounting Profit

The meaning of accounting profit varies according to the purpose for which it is used. For example, the owners are interested in net profit whereas the creditors are interested in earnings before interest and tax. The terms 'profits', 'earnings' and 'incomes' are similar and they are used interchangeably. Accounting also distinguishes between the revenue profit and the capital profit. Examples of capital profits are profit on sale or revaluation of fixed assets, premium on issue of shares or debentures, profit on reissue of shares, profit on redemption of preference shares, etc. Generally, the income statement can be a 'multiple step' income statement or a 'single step' income statement. The profit under multiple step income statement is determined in a number of steps like gross profit, operating profit, non-operating profit, profit before interest and tax, profit before tax, profit after tax (net profit) and profit retained. However, we have discussed some important forms of accounting profit in the following lines.

1. GROSS PROFIT

The excess of net sales over cost of goods sold is called gross profit. Cost of goods sold consists of stocks consumed, wages and direct expenses.

2. OPERATING PROFIT

Operating profit includes all net income before tax
produced by operating assets and excludes any item of non-operating income. In other words, operating profit is the difference between the gross profit and the operating expenses. Operating assets produce a stream of income known as the operating income.

3. NON-OPERATING PROFIT

This section shows the effect of operations not incidental to the usual course of business, such as, profit or loss on sale of investment, interest or dividend received, transfer fees received, etc. Non-operating expenses when deducted from non-operating incomes give non-operating profit.

4. PROFIT BEFORE TAX

The pretax profit is arrived at by adding/deducting the non-operating profit/loss as the case may be to/ from the operating profit. It is chargeable to income tax.

5. PROFIT AFTER TAX / NET PROFIT

The net profit is arrived at after deducting the provision for tax from the pretax profit. Kohler defines 'Net profit as the profit remaining from revenues after deducting related costs.' Thus, it is the residual income left after meeting all the contractual and non-contractual expenses. This net profit is available for dividend.

3.3.2 ECONOMIC CONCEPT

In the whole economic theory, perhaps no topic has been in such a confused and tangled state as the theory of profit. There is no complete agreement among the economists about the true nature and origin of profits.

Economic profit is a profit over and above what could be earned in the best alternative use of resources. Economic profit equals accounting profit minus the opportunity cost of the resources used in the business.\(^7\) To determine economic profit, a competitive or normal rate of payment for services of capital supplied by the firm must be subtracted from the profit for the period as determined by a conventional accounting method. The capital supplied by the firm is the market value of land, plant, equipment, the working capital net of amounts borrowed against the physical assets.\(^8\)

In the theory of income distribution, economists classify all income of the economy into types, according to the nature of its source. Wages are income from direct labours; interest is the income from letting other people use one's money; rent is the excess of the value produced by a productive factor over the payment needed to induce it to work; and profit is the excess of income over cost of production. Wages, interest, and


rent have had a firm standing in theory for well over a century, but profit has always been a centre of controversy. When does it appear? Who produces it? Who gets it?  

Thus, what is by accounting convention, labelled as net profits in a firm's income statement is not profits as the economists view them. Instead, it is a hybrid which includes elements of interest and perhaps wages, rent and economic profits. To break this into its components, it would require extensive study of the history of capital structure and activities of the firm. In this sense, economic profit is the residue of income after all the contractual and non-contractual payments have been made from the revenue realised during a given period of time.

The economists have different concepts about profit. For Thunen (1826) profit was a residue over interest, insurance for risk and wages of management. H. Vonv Mangoldt (1855) defined profit as a surplus over all costs, including at the same time payment for wages and risk in actual profit. However, it was John Bates Clark, who worked out profit (pure) as an excess in the income of a business as a whole in comparison with the income of the productive factors used in it. Some group of economists view profit as a result of frictions and imperfections in the market mechanism. Thus, profits are the result of disequilibrium and imperfect competition.  

Hawely argues that profit accrues because the entrepreneur subjects himself to risk and responsibilities of business. But, according to F.H. Knight, it is uncertainty bearing rather than risk taking that leads to profit. Risk is calculable with some degree of accuracy, whereas uncertainties cannot be predicted. It has been held by Joseph A. Schumpeter that the main function of the entrepreneur is to introduce innovations in the economy and profits are the reward to him for performing this function.

The above discussion on the economic concept of profit reveals that there is no single explanation of profit that is adequate; each omits some crucial points and fails to bring some important economic phenomena having a relationship with profits. Therefore, "Prof. B.S. Keirstead has expressed the view that 'Profits may come to exist as a result of monopoly or monopsony, as a reward for innovation, as a reward for the correct estimate of uncertain factors, either particular to the industry or general to the whole economy'." 11

3.3.3 SOCIAL CONCEPT

Social profit may be defined as the difference between social benefit and social cost. If the Government were to own all means of production, any profit from operations could then be distributed among all the members of the society by means of a social dividend. But, at the same time, we should remember that it is entrepreneurial ability and not property ownership

that gives rise to economic profit. Moreover, the chief executive of a large corporation has the problem of reconciling the demands of employees for more wages and improved benefit plans; customers for lower prices and greater values; shareholders for higher dividend and greater capital appreciation -- all within a framework that will be constructive and acceptable to the society.

Various techniques/accounting methodologies adopted for measuring contributions towards social responsibilities and community are not yet established with relative degree of accuracy. However, an attempt has been made by some companies to present their expenses under suitable heads with a view to conveying its direct contribution towards society. Value added is one of such examples.

3.4 FUNCTIONS OF PROFIT

The basic function of profit is to provide businessman with an incentive to produce what the consumers want, when and where they want it at the lowest feasible cost. This includes innovation of new products and new methods. In fact, profit motive is the kingpin of private enterprises and every business activity. In addition, as pointed out by Peter Drucker, profit serves three main purposes.\textsuperscript{12}

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(1) MEASURE OF PERFORMANCE

Profit measures the net effectiveness and soundness of a business effort. A higher profit is an indicator that the business is being run successfully and effectively. It is true that profit is far from being a perfect measure of business efficiency but it is probably the best indicator of the general efficiency of a firm.

(2) PREMIUM TO COVER COST OF STAYING IN BUSINESS

Profit is the premium that covers the cost of staying in business -- replacement, obsolescence, market and technical risk, and uncertainty. The management of a business has to provide adequately for these costs by generating sufficient profits.

(3) ENSURING SUPPLY OF FUTURE CAPITAL

Huge funds are needed for innovations or expansions in business activities. Such funds can be acquired directly, i.e., by self-financing out of retained profits or indirectly by providing inducement for new external capital by earning profits now.

In addition to the above three functions of profit, there is one more function of profit known as the social function of profit.

(4) SOCIAL FUNCTION OF PROFIT

Profit helps in resource allocation. In a free enterprise
economy, commodity prices are determined by the interaction of supply and demand. So, the entrepreneur may reap profit in some commodities, while it may lose in some other commodities. If the entrepreneurs are allowed to keep their profits, there is a clear incentive for them to shift from the production of those commodities, in which losses are sustained, to the profitable ones. Furthermore, to the extent the economy is competitive, this will definitely represent a social desirable shift because price -- and hence profits -- indicate the desire of the consumers. Consequently, profit operates as a resource allocator, directing resources into those lines of production most desired by the consumers and away from the production of those goods least desired.

3.5 MEASUREMENT OF PROFIT

3.5.1 It would be quite simple to measure the profit for the entire life of a business firm. From the sum of amounts received, the amounts paid or invested in the business during the firm's entire life will be deducted. The difference thus obtained would be the profit or loss. But, the problem of measurement of periodic profit of a going concern has always been a cumbersome affair. Such a problem arises because of the difficulty in allocating current costs and revenues to that given accounting period. In addition to this difficulty, the periodic measurement of profit requires one to distinguish and choose between ex-post and ex-ante concepts of profit. Conventional accounting is largely concerned with the past events. Thus, the profit it measures is essentially ex-post in
nature and content. Again, there is a wide variety of generally accepted accounting principles which provide for different methods of treatment for certain items, viz., (1) Depreciation; (2) Stock — regarding valuation; (3) Deferred expenses — regarding allocation over time periods; and (4) Capital gains and losses. The problem is made more acute by the fact that the values involved may be so large in comparison with trading profits that relatively small variations in values can make a substantial difference in reported profit. In recent years, the tendency in business practice has been to discard the word ‘profit’ and to use such a natural expression as ‘business income’.

3.5.2 As against this, economists disagree with the conventional technique and define the term functionally. For an economist, profit is an ex-ante concept. It is a surplus in excess of all opportunity costs or the difference between the cash value of an enterprise at the beginning and end of a period. They also claim that the true profitability of a business operation cannot be accurately determined until it is wound up. For any intervening period, profits can only be estimated arbitrarily.

3.5.3 When it comes to the actual measurement of profit, the economists and accountants mostly disagree on: (1) the inclusiveness of cost; (2) the treatment of depreciation; (3) the treatment of capital gains and losses; and (4) current Vs. historical costs.
Regarding the inclusiveness of costs, accountants deduct only explicit or actual costs, while economists opt for deduction of imputed or implicit costs in addition to explicit costs from the total revenue to get profit. The remaining three disputes arise because of conceptual conflict. The role of futurity in economic values and business decisions underlies the last three disputes in measuring profits.13 Economic idea of income, assets and net worth all look to the future for their meaning, while the corresponding financial accounts are all histories of past transactions. However, so long as the accounting records are the only sources of data on business profits, economists are under greater pressure to bring their concept of profit closer to that of the accountant, though the latter has to make his own attempts at reconciliation.14

3.6 CONCEPT OF PROFITABILITY

3.6.1 The concept of profit refers to the absolute quantum of profit. It does not speak what the reason for profit is, how it is scattered, and what the relationship of one figure is with another. All these questions can be answered by the concept of profitability.

3.6.2 Profitability is a relative measure. It refers to the ability to earn profit. The profitability of a company is the

net result of a large number of policies and decisions taken by an enterprise. It is the primary measure of the overall success of a business. It measures how effectively the firm has utilised its resources.

3.6.3 The word profitability is composed of two words 'profit' and 'ability'. The word ability refers to the 'earning power' or 'operating performance' of the investment concerned. The concept of 'profitability' may be defined as the ability of a given investment to earn a return from its use.\(^\text{15}\)

Profitability refers to the ability of a firm to generate revenues in excess of expenses.\(^\text{16}\) Increase in profit does not necessarily increase the profitability of a concern.

3.6.4 One striking feature of the concept of profitability is its varying nature. Profitability is not a constant and static phenomenon that remains unaffected by changes in its determinants but to a great extent, a changing and varying one. Changes in its determinants result in change of profitability. It is reasonable as well as convincing to compare profitability with weather. The comparison of profitability with weather can be strengthened by three arguments given below:

Firstly, the state of profitability is a variable phenomenon like the weather of a day. The weather can change or


will change according to change in humidity, temperature and other relevant factors. Similarly, profitability will change owing to change in its determinants.

Secondly, the study of the weather on a particular day makes it possible to forecast the weather on the following day. In the same manner, analytical study of profitability in a concern or business, in other words, scientific study of the current trends of its profitability, provides us with the base to forecast possible future trends of profitability.

Thirdly, the study of the determinants of profitability by an accountant/financial advisor/analyst can also be likened to temperature reading and study of humidity by a meteorologist.

3.6.5 The concept of profitability has three broad variations:

(1) Social Profitability; (2) Commercial or Accounting profitability; and (3) Value-Added Profitability.

3.6.5.1 Social Profitability. From the point view of the society, social profitability is a much better measure of performance as compared to the other forms of profitability. It is also referred to as the national economic profitability. The measurement of social profitability is undertaken within the frame work of social cost-benefit analysis. In other words, when all outputs and inputs are evaluated at their social opportunity costs, and when all external effects on the
domestic economy are given social valuation and included in the measure, we get a measure of net social profitability. The measurement of social profitability poses a number of problems such as estimation of social opportunity cost, valuation of tangible and intangible benefits, etc. The overall performance of an enterprise certainly includes profitability. Some social objectives reinforce commercial profitability whereas others may reduce the commercial profitability.

3.6.5.2 Commercial or Accounting Profitability. In general terms, efficiency of a business is measured by the input-output analysis. Commercial Profitability is the traditional measure of the performance. By measuring the output as a proportion of the input and comparing with the results of other similar firms or periods, the relative changes in its profitability can be measured.

The income (output) as compared to the investments (input) indicates the profitability of a firm. This is known as return on investment. This return on investment acts as a measure of overall profitability which has two components: (1) Profit margin; and (2) Investment turnover ratio. If the management wants to improve its profitability, it can do so by improving profit margin or investment turnover ratio or both.

3.6.5.3 Value-Added Profitability. The excess of turnover plus incomes from services over the cost of purchase of goods or services is termed as value-added. It indicates the net value or wealth created by the manufacturer during a given
period. No enterprise can survive and grow if it fails to generate wealth. There are two approaches of calculating value-added: (1) Subtractive approach, and (2) Additive approach. Gross value-added can be regarded as sales less purchase cost, while it can also be calculated as profit before tax plus employee cost, depreciation and interest. Gross value-added as reduced by the amount of depreciation is known as the net value-added. Net value-added is shared by four parties, viz., (1) Workers, (2) Providers of capital, (3) Government and (4) Owners. Thus, value-added is a concept broader than profit. Therefore, the concept of value-added can be directly linked with the concept of social profitability. The measure of value-added must be applied in addition to profitability to measure the performance of a business.

3.7 SIGNIFICANCE OF PROFITABILITY

3.7.1 The objective of a business is to provide goods and services which the society needs at an affordable price. Profit is merely a measure of the approval of the society for the work being done for it. Profits are necessary for the existence of business. Lord Keynes has rightly said, 'Profit is the engine that drives the business enterprises'. Profits and profitability play the same role in business as 'blood' and 'pulse' in the human body. The survival of a human being is not possible in the absence of adequate blood and ability to generate blood. The same may be applied to business. A business needs profits not only for its existence but also for the expansion and diversification of its activities. Profit and
profitability are, therefore, the nerve-knot of a business and without it, the existence of a firm is like a body without soul.

3.7.2 A business enterprise can discharge its obligations to the various segments of the society only through earning profit. But, at the same time one should distinguish profit earning from profiteering. Where the amount of profit made exceeds a socially acceptable limit by questionable methods, it is a case of profiteering.17 We are talking about profit earning only and not profiteering. Profit is the barometer of the success of business. It is, indeed, a magic eye that mirrors all aspects of entire business operations including the quality of output.18 Thus, profits are a useful measure of overall efficiency of a business. Profits to the management are the test of efficiency and measure of control; to the owners, a measure of the worth of their investments; to the creditors, the margin of safety; to the employees, a source of fringe benefits; to the Government, a measure of tax-paying capacity and the basis of legislative action; to customers, a hint to demand for better quality and price-cuts; to an enterprise, a less cumbersome source of finance for growth and existence; and finally to the country, profits are an index of economic

If an enterprise fails to earn profit, invested capital is eroded and if this situation prolongs, the enterprise may ultimately cease to exist. Therefore, the overall objective of a business is to earn at least a satisfactory return on the funds invested in it, consistent with maintaining a sound financial position.

3.8 TECHNIQUES OF ANALYSING PROFITABILITY

Analysis of profitability means such a treatment of the information contained in the financial statements so as to afford a full diagnosis of the profitability of the firm concerned. To have a clear understanding of the profitability, the data provided in the financial statements should be methodically classified and comparisons be made in tune with the objective of analysis. Then only by using the techniques of analysis, we can answer the pertinent questions which are being raised. There are various techniques for analysing profitability. The following are some of them:

(1) Comparative statements
(2) Trend percentages analysis
(3) Common-size percentages analysis
(4) Funds flow analysis
(5) Ratio analysis

These methods have been discussed briefly in the following lines:

3.8.1 COMPARATIVE STATEMENTS

Financial data becomes more meaningful when compared with similar data of a previous period or a number of prior periods. Statements prepared in a form that reflect financial data for two or more periods are known as comparative statements. The comparative income statement gives an idea of the progress of a business over a period of time. The changes in absolute data in money values and percentages can be determined to analyse the profitability of the business. It is an important tool of horizontal financial analysis.

3.8.2 TREND PERCENTAGES ANALYSIS

Trend percentages analysis is also an important tool of horizontal financial analysis. Trend percentages are index figures indicating the percentage relationship that each statement item bears to the same item in the base year. The information for a number of years is taken up and one year, generally the first year, is taken as the base year. The figures of the base year are taken as 100 and trend ratios for other years are calculated on the basis of the base year. The trend percentages give a bird's eye view of the comparative data by presenting it in a form easy to interpret. By showing the relative changes, it discloses unequal changes whose significance has to be analysed and interpreted. This kind of analysis is particularly applicable to the items of profit and
3.8.3 COMMON-SIZE INCOME STATEMENT ANALYSIS

Common-size financial statements are devices for studying financial statements and the changes therein. It is prepared by expressing the components of the balance sheet as a percentage of total assets and the components of the income statement as a percentage of total revenue. It is a kind of vertical analysis.

The common-size profit and loss statement shows what percentage of total revenue is absorbed by each individual cost or expense and what is the percentage that remains as net profit. A comparison of the year to year percentages indicates whether a relatively smaller or larger proportion of total revenue was utilised for meeting particular cost or expense.

3.8.4 FUNDS FLOW ANALYSIS

Funds flow analysis is a valuable aid to the financial executive and creditors for evaluating the uses of funds by the firm and in determining how these uses were financed. A fund flow statement indicates where funds came from and where they were used during the period under review. Analysis of funds from operation helps in evaluating the profitability of the company.

3.8.5 RATIO ANALYSIS

Among all the techniques used in financial statement analysis, ratio analysis is the most powerful tool of financial
analysis. The relationship between two accounting figures, expressed mathematically is known as a financial ratio (or simply as a ratio).\textsuperscript{20} The following four categories and ratios within each category are meant for analysing the financial statement.

(1) Liquidity ratios
(2) Leverage / Capital structure ratios
(3) Profitability ratios
(4) Turnover ratios

Profitability ratios can be broadly divided into two groups, viz., (1) profitability in relation to sales, and (2) profitability in relation to investment. Profitability in relation to sales includes the gross profit margin, operating profit margin, net profit margin, etc., while profitability in relation to investment includes return on total assets, return on net assets; return on shareholders' equity, earnings per share, etc.

To make ratios more powerful, they have to be further interpreted and compared. A ratio may be interpreted in relation to certain rules of thumb or it may be compared with the past ratios. Another way of comparison is to compare the ratios of one firm with some selected firms in the same industry at the same point of time. Moreover, the ratios can also be compared with the industry average.

3.9 SUMMARY AND CONCLUSIONS

3.9.1 Profit is necessary not only for the existence but also for the expansion and diversification of an enterprise. It is used as a yardstick for measuring the efficiency of a firm. Profit refers to absolute amount of excess of revenue over expenses. It is necessarily a residual sum and also non-contractual income. Hence, it may be positive or negative. The word 'profit' has got different meanings to businessmen, accountants, economists, workers, and tax collectors.

3.9.2 Broadly, there are three concepts of profit, viz., (1) Accounting, (2) Economic and (3) Social concept. Accounting profit lies in the difference between the realised value of revenues and historic cost of expenses, and it may include items of capital gains. It may take several forms, viz., gross profit, operating profit, non-operating profit, profit before tax, profit after tax, etc. Economic profit equals accounting profit minus the opportunity cost of the resources used in business. This concept of profit reveals that profit may come to exist as a result of monopoly, as a reward for innovation, or as a reward for the correct estimate of uncertain factors. Social profit is the difference between social benefits and costs of a business.

3.9.3 The basic function of profit is to provide an incentive to the entrepreneur to produce what consumer wants and make it available when they want it at the lowest feasible cost. Besides this function, profit has certain other functions,
viz., measure of performance, as a premium to cover cost of staying in business, ensuring future supply of capital, social function, etc.

3.9.4 No doubt, it is quite easy to measure profit for the entire life of a business, but one has to face practical difficulties in measuring the periodic profit of a going concern owing to the problems of allocating the cost to that period and various accepted accounting policies. Such difficulty also arises owing to the differential opinion of the accountants and economists with regard to the various concepts. For an accountant, profit is an ex-post concept whereas for an economist, it is an ex-ante concept. The role of futurity in economic values and business decisions underlies the differences in measuring profit.

3.9.5 Profitability is a relative measure and it is defined as the ability of the business enterprise to generate profits. Increase in profit does not necessarily increase the profitability of a concern. The concept of profitability has been divided into three categories, i.e., (a) Social profitability; (b) Commercial or Accounting profitability; and (c) Value-added profitability. When all inputs and outputs are evaluated at their opportunity cost, and all the effects on the economy are given social valuation and included in the measure, we get social profitability. But, accounting profitability measures the difference between revenue and cost, as a proportion of the input, i.e., investment. Value-added profitability is the excess of turnover plus income from
services over the cost of purchasing goods and services.

3.9.6 Profit and profitability play the same role in business as 'blood' and 'pulse' in the human body. We have also seen profit as a mirror that reflects all the aspects of a business including the quality of output. Thus, profit and profitability play an important role in a business concern.

3.9.7 The profit disclosed in the financial statement has to be analysed and interpreted by using various tools and techniques such as comparative statement, trend percentages analysis, common-size percentages analysis, fund flow analysis and ratio analysis. However, ratios are the most powerful tools of financial analysis and there are various types of ratios for analysing the profitability of a concern.