CHAPTER – III

Profitability : A Conceptual Framework
Introduction:

Profit is the principal motivating force for any kind of economic activity. It is the report card of the past, the incentive gold star for the future. If an enterprise fails to make profit, capital invested in it is eroded and if this situation prolongs the enterprise ultimately ceases to exist \(^1\). Profit is the soul of the enterprise without which it is lifeless. In fact, profit is the useful intermediate beacon towards which a firm’s capital should be directed \(^2\). Profit is necessary not only to sustain in the business but also to expand and diversify the same in the future. No company can survive long without profit; hence profit is the ultimate measure of its effectiveness. In other words, the crucial measure of the effective performance of a business is profit, which really is a measure of how well a business performs economically. Although the word “Profit” is often considered to be dirty word, the term profitability of a business may be the only guideline that can be used to measure the efficiency of the management team. The efficiency of the management is measured by the profitability of the business, the greater the profitability more the efficiency. Profit is a signal for the allocation of resources and a yardstick for judging managerial efficiency. It is wrong to believe that the importance given to profit planning is overemphasized. In fact, it is the Growth of the profit, which enables a firm to pay a higher dividend to its owners/ and or keep a large chunk of it for future expansion, diversification programmes. Against this backdrop, the present chapter discusses the concepts of profit and profitability, their objective, function, measurement etc. in the following paragraphs.
Concept of Profit

A business enterprise is required to earn profit for its survival and growth. Profit is essential but it would be wrong to assume that every action initiated by the management of the company should be aimed at maximization of profit, irrespective of social consequences. It is the unfortunate that the word ‘profit’ is looked upon as a term of abuse since some firms always act to maximize profit at the cost of employees, customers and society\(^{(3)}\). Except such infrequent cases, it is a fact that sufficient profit must be earned to sustain the operation of the business and able to obtain funds from investors for expansion and to contribute towards the social overheads for the welfare of the society. There are three measurable concepts of profit viz., accounting profit, economic profit and social profit. A brief discussion of the aforesaid profit concepts is discussed below:

Accounting profit:

In the report of a special Committee of American Institute of Accountants, the word of profit is modified in 30 different ways. According to this report the accountants usually mean the term profit as the excess of the selling price over the cost of anything \(^{(4)}\). On the basis of the discussion memorandum Issued by FASB in 1976, which highlights the important issues on accounting concepts the most central of which is, of course, the conceptual view of income/profit. FASB has suggested three views of income but only two of them i.e the ‘assets and liabilities’ view and the ‘revenue and expenses’ view have been emphasized \(^{(5)}\). 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 net income resources of a business enterprise for a period. In case of the revenue expenses

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view, earnings (profit) are equal to the difference between revenue and cost of earnings that revenue as also ascertainment of this cost in bulk of the job of (financial) accounting. Here, earnings are a direct measure of the effectiveness of an enterprise in using its inputs to obtain and sell outputs and are not necessarily based on a limited to change in net economic resources. In this sense, accounting profit is known as the excessive of total revenue over their total costs during a given period. Thus, accounting profit lies on the difference between the current value of sales minus the historical cost of expenses plus the retained capital gains i.e. the difference between the proceeds from irregular disposal of assets minus historical cost minus depreciation of irregularly disposed assets.

**Economic profit:**

It is observed that the profit is the difference between revenue and cost, which is also known as residual profit. But this attitude does not satisfy the economists. The economists say that both explicit (actual) and imputed costs (the cost that would have been in the absence of self owned factors) are to be deducted from the total revenue to determine the economic profit.

The entrepreneur’s wages, interest on own capital, rent for the use of his own premises are to be taken in to consideration in calculating economic profit. Thus the profit arrived at after deducting both explicit and imputed costs may be called as economic profit. From managerial point of view, economic profit is a very important because this alone shows the viability of a firm. A firm may show accounting profit but it may incur economic loss. Such a firm cannot be considered viable.
Social profit:

Social profit may be defined as the difference between social benefits and social costs. The chief executive of a business undertaking faces problems of reconciliation the demands of employees for more wages and improved benefit plans; customers for lower prices and greater values; and share holders for higher dividends and greater capital appreciation all within a framework that will be constructive and acceptable to the society. The techniques adopted for measuring contributions towards social responsibilities and community are not yet established with relative degree of confidence and accuracy. However, an attempt has been made by some companies to present the company’s expenses under suitable heads with a view to conveying its direct contribution towards social responsibilities. From the above discussed concepts of profit, only the concept of accounting profit is used in the measurement of profitability because other concepts of profit are difficult to define and put into actual practice. Further, lack of insufficiency in data collection makes it difficult task to compute the economic profit or social profit. Hence, only the accounting profit concept is used in the present study.

Types of Accounting Profit:

Accounting profit may be expressed in number of ways. They are gross profit, operating profit, profit before interest and tax (PBIT), net profit, net profit after tax etc. A brief description on these concepts is made in the following paragraphs.
**Gross profit** :

Gross profit is one of the forms of presenting the profit of an organization. Gross profit is calculated by deducting the cost of production from the net sales revenue. In other words, gross profit is the difference between the net sales revenue and cost of production. If the cost of production exceeds the sales revenue, then there would be gross loss. The significance of the calculation of gross profit is that it would show how much is left to meet the other operating expenses. If the percentage of cost of production to net sales is less, then high margin is left for meeting the other operating expenses.

**Operating profit** :

Operating profit includes all net income before tax generated by operating assets and excludes items of non-operating income, such as rental income, income from leased property and non-operating expenses such as interest payment. In other words, the operating assets produce a stream of income known as operating income (7). In simple words, operating profit is the difference between gross profit and operating expenses.

**Net profit** :

When non-operating incomes are added to operating profit and then non-operating expenses are deducted thereof, the resultant figure is net profit before tax (net profit). Kohler defines net profit as the profit remaining from revenue after deducting related costs (8). It is the residual income left after meeting all the contractual and non-contractual expenses such as manufacturing, administration, selling and financial expenses including depreciation provision and interest. If the provision for tax is deducted from the net profit, the result is net profit after tax.
Profit available to equity shareholders:

If preference dividend is deducted from the net profit after tax, the balance income will be available to equity shareholders. This income or profit is known as profit available to equity shareholders. Of course, a portion of this profit is retained by the company as retained earnings and transferred to general reserve account to meet future expansion, modernization and diversification programmes of the company.

Accounting Profit Vs. Economic Profit:

In accounting parleys deduction of explicit costs from gross income gives accounting profit, because in accounting practice the principle of ‘matching cost’ is very much relevant in determining ‘surplus’ of total revenue over total cost. However, economists are of the opinion that deduction of ‘implicit’ costs as well as ‘explicit’ costs should be made from gross income so as to derive the economic profit. The implicit costs include remuneration to the owner’s interest on owner’s capital and rent for owner’s land and building etc. While explicit costs include payments to the factors of production viz. manufacturing expenses, administration and general expenses, selling and distribution expenses, depreciation, interest on borrowed capital, provisions etc. The difference between accounting profit and economic profit can be presented in the following equation form.

\[
\text{Accounting profit} = \text{Total revenue} - \text{Explicit cost.
}
\]

\[
\text{Economic Profit} = \text{Total revenue} - (\text{Explicit cost} + \text{Implicit cost})
\]

Or

\[
\text{Economic profit} = \text{Accounting profit} - \text{Implicit cost}
\]

Thus, the basic difference between accounting profit and economic profit is due to implicit cost.
Accounting Profit vs. Social Profit:

Accounting profit lies in the difference between the current revenue out of sale proceeds minus the historical costs (expenses) plus the retained capital gains. However, the social profit lies in the difference between the social benefits and social costs. Thus, it is clear that accounting profit includes the cost of all activities of a business concern while social profit includes only the cost of social activities of a business concern.

Nature of profit:

The nature of profit has been the most perplexed and troubled problem for economists. Prof. Taussig in the late nineteenth century referred to it as “that mixed and vexed income”. It is mixed income because it is made up of a number of sources and vexed because economists are unable to decide which sources of profit to include or exclude. Even now, it confessedly remains one of the least satisfactory parts of economic doctrine. The early classical economists regarded profit as accruing to the capitalist who supplied capital and owned the business. They did not distinguish between interest and profit. At best, profits were residually determined after making all necessary payments from the total income of the business.

Marshall gave the first systematic explanation of the nature of the profit in terms of demand and supply of entrepreneurs. He regarded profits, “as the average remuneration necessary to bring into existence and to keep in existence a sufficient supply of entrepreneurs”. In the long run an entrepreneur can earn only normal profits, which form part of the cost of production. Profit is thus akin to wages. But Marshall’s explanation is one sided because it neglects the factors
that determine the demand for entrepreneurs. It fails to explain the nature of high profits persisting in the long run in certain competitive industries, and these earned by monopoly concerns.

Walker looked upon profits as a “determinate return for a production function” performed by the entrepreneurs with a superior ability than others. Entrepreneur is regarded as distinct from labourer and profit is the reward for his organizational and coordinating activities. Hawley described it to entrepreneur’s risk taking; the greater the risk undertaken, the larger the profit. But this analysis mixes up the ownership and control of business concerns. In modern large corporations, ownership rests with the shareholders while active control is in the hands of salaried managers.

Clark, Knight and Schumpeter say, “it is an income which arises out of change, Uncertainly and friction inherent in a dynamic world, and which the belated operation of competitive forces tend to dominate”. In a frictionless static world, all factors receiving rewards equal to the imputed value of their marginal product and the owner does not get any surplus beyond his wages of management. But friction, innovations and uncertainties continually recur in a dynamic state, which lead to a surplus over and above the normal earnings of the management. This is the true profit. This is a non-functional explanation of the nature of profit. Profits arise due to friction, innovation and uncertainly and not on account of a particular entrepreneurial function.

Veblan and Hobson regard profit as unearned income and attribute it to the existence of institutional monopolies established by a few capitalist. Monopoly profit arises because a monopolist is able to restrict output and keep the price of his product much above the average cost of production. According to Hobson,
monopoly element is also traceable under competitive conditions when an entrepreneur profits more at the expense of the other factors of production through his superior bargaining power. It contains much truth. But this approach is not wholly independent of the other factors. When profits arise due to the difference between gross profits and opportunity costs, they fall in to this category. Profits may arise in terms of Marshall’s approach if the size of profit is related to a scarcity of entrepreneurs resulting from the existence of institutional barriers. Even the phenomenon of uncertainty, innovation and friction in dynamic concept of profit are institutional nature. Keeping in view the nature of profit expressed by various authorities, it is felt necessary to discuss about the various theories of profit, which can enlighten more about the nature of profit.

**Theories of profit :**

In order to understand in detail the nature of profit, some of the important theories of profit are discussed below.

**The Dynamic theory :**

Prof. Clark propounded his dynamic theory of profit in 1900. To him, profit is the difference between the price and the cost of production of the commodity. But profit is the result of dynamic changes. In a dynamic state, “five generic changes are going on every one of which reacts on the structure of society” (11). They are

- Population is increasing.
- Capital is increasing.
- Methods of production are increasing.
• The forms of industrial establishments are changing, the less shops are passing from the field, now the most efficient are surviving and
• The wants of consumers are multiplying.

In other words, the profits are the result exclusively of five dynamic changes i.e., change in population, capital, techniques of production and forms of business organization and wants of people. In actuality, however, entrepreneurs earn profits because societies being dynamic, changes constantly occur and adjustments always take place. The lure of profits leads to improvement and improvement tends to raise the standard of wages but actual wages always lag behind the standard rate with the result that profits appear.

**The Innovation Theory:**

A part from five changes mentioned by Clark, there are other changes also which occur in the economy. All the changes which took place and as a result of which profits arise in a dynamic economy may be due to innovations. Prof. Schumpeter attributes profits to dynamic changes resulting from an innovation (12). Innovation represents changes, which are introduced by individual entrepreneurs themselves. The entrepreneurs earn large profits from introducing innovations such as a new product, a new and cheaper method of production, a new method of marketing a product, a new way of advertisement etc. The innovational changes may either reduce cost or increase the demand for the product and thereby bring profits into existence. Those entrepreneurs who introduce successful innovations earn large profits. But as other knows the innovation of entrepreneurs and they adopt those innovations, profits, which arise because of particular innovation, tend to disappear. But the entrepreneurs are continuously introducing new innovations and profits continue to arise out of them.
The Risk theory:

The risk theory of profit is associated with Hawley who regards risk-taking as the main function of entrepreneur\(^{(13)}\). Profit is the residual income, which the entrepreneur receives because he assumes risk. The entrepreneur exposes his business to risk and receives in turn the reward in the form of profit because the task or risk-taking is irksome. Profit is ‘an excess of payment above the actuarial value of the risk’. No entrepreneur will be willing to undertake risk if he/she gets only the normal return. Therefore, the reward for risk-taking must be higher than the actual value of the risk. In Hawley’s words, “the profit of an undertaking of the residue of the product after the claims of land, capital and labour (furnished by others or by the undertaker himself) are satisfied is not the reward of management or coordination, but of risks and responsibilities that the undertaker subjects himself to. As no one, as a matter of business, subjects himself to risk for what he believes the actuarial value of the risk amounts to a net income accrues to enterprise as a whole, equal to difference between the gains derived from undertakings and the actual losses incurred in them. This net income being manifestly an un-predetermined residue must be a profit.”

The Uncertainty Theory:

Prof. Knight regards profit as the reward of bearing non-insurable risks and uncertainties. He distinguishes between insurable and non-insurable risks\(^{(14)}\). Certain risks are measurable in as much as the probability of their occurrence can be statistically calculated. The risks of fire, theft of merchandise and of death by accident is insurable. Such risks are borne by the insurance company. There are certain unique risks, which are incalculable. The profitability of their occurrence
cannot be statistically computed because of the presence of uncertainty in them. Such unforeseen risks relate to changes in prices, demand, supply etc. No insurance company can calculate the loss expected from such risks and hence they are non-insurable. Profit, according to Knight, is reward of bearing non-insurable risks and uncertainties. It is a deviation arising from uncertainty between earnings *ex post* and *ex ante*. Profit is thus, the difference between *ex ante* and *post ante* returns. It is the residue after deducting all contractual income to the other factor of services.

**Shackle’s Theory:**

Prof. Shackle has extended Knight’s theory of profit by introducing expectations under conditions of uncertainty. According to Shackle, expectations are of two types: general and particular\(^{(15)}\). General expectations relate to variables general to the economy as a whole. They are associated with future macro-variables such as the general price level, gross national product, balance of payments etc. On the other hand, particulars expectations relate to variables particular to a firm or industry. They are associated with micro variables such as the future reaction of a particular marketing strategy adopted by a firm, the future pricing policy of a competitive firm etc. The decisions of business community are generally based on general expectations. If it regards them favorable, investments are made. But there is subjective certainty in the case of general expectations. Their time horizon is about 12 months. As the general expectations have subjective certainty and their time horizon is also of reasonable duration, the business community is able to anticipate price and income increases correctly for the economy as a whole, and by adopting appropriate inventory policies, it earns windfall profits. But in case of particular expectations, there is subjective
uncertainty and the time horizon is also quite long ranging between 100 to 150 months. Under particular expectations, a firm or an industry may earn either innovative profits or monopoly profits depending upon its policies.

**Marginal Productivity Theory:**

The determination of remuneration of the entrepreneur, like any other factor, is sought to be explained in terms of its marginal revenue productivity. Edgeworth, Chapman and Stigler, Stonier and Hague have explained the determination of profit with the help of this theory. According to this theory, profit as the reward of an entrepreneur is determined by its marginal revenue productivity. The higher the marginal revenue productivity, the higher is the profit and lower the marginal revenue productivity, the lower is the profit of an entrepreneur.

**Objectives of Profit:**

Modern business firms are always profit oriented. In fact profit seeking is the motive stressed upon by all businessmen. The success of the enterprise depends upon profit making. The volume of profit made by it is regarded as the primary measure of success. In economic theory, we find that the fundamental aim of any business is to maximize profits. Doubts have been raised in recent years about whether profit maximization is the only motive, which governs the behavior of the rational entrepreneur or whether it is the best policy for him. This assumption does not always hold good. Profit is, no doubt, necessary without which the economy cannot attain stable growth. Keeping profit in view, the modern business people have placed other objectives in the forefront such as attainment of leadership in the industry, restructuring potential competition,
government interference, maintaining consumer's goodwill, avoiding higher wages for workers, maintaining sufficient liquidity in the firm, avoiding risk etc. Peter Drucker says that profit serves the following objectives of the business. Profit reflects the level of performance the firm. It indicates the soundness of the business. A higher profit suggests that the firm is being managed efficiently. Profit is a true measure of performance. It shows that the organization is in sound financial condition (17).

**Functions of Profit:**

Profit is an essential factor for capital formation. Whenever a firm gets profit continuously over a long period, its economic strength increases. The entrepreneur will be in a position to make great improvement of his business. This will be an incentive for hard work and innovation. Profit serves as a premium, which covers the cost of business firm. Profit indicates the economic strength of business. The firm can stay on in business and produce the product continuously. Profit is thus as the cost of being and staying in business. The management of a company is required to provide for those costs by earning sufficient profit. Ensuring the adequate supply of capital is the most important function of profit. A certain percentage of net profit is set apart for innovation, better management and modernization or the renovation of business. The fundamental objective of a business undertaking is to ensure its own survival. In order to survive, it should earn a substantial profit. When a firm is making good profits, it can make changes whenever required. It can plan for reasonable growth. It is stated that profits are natural concomitant of growth of business overtime. In fact, profits are essential as a means to an end. They are not end in themselves although essential for the continuity and growth of the firm.
In recent years the profit maximization hypothesis has been criticized from various angles. Most companies want to limit short-run profits in order to maximize profits in the long run. There are various reasons for aiming at limited rather than maximum profits. The most important reasons for limiting profits are:

- To discourage potential competition.
- To develop public relations
- To restrain wage demands of organized labour
- To maintain customer goodwill
- To maintain control
- To maintain pleasant working conditions.

Because the above stated reasons the companies do not seek for maximum profit but they are interested to set standards or targets of reasonable profits. The formulation of standards for reasonable profits depends upon on the purpose for which it is required. If the objective is to discourage potential competitor, revenue on investment is the relevant standard, of course, if entrants have similar costs. But if the objective is to please the customers or to beat down suppliers, percentage or margins over unit cost in relation to the rupees they spent, is usually appropriate. In this connection, four major criteria are used for setting profit standards. They are (a) Capital attracting rate of return (b) plough-back rate, (c) normal earnings and (d) reasonable earnings. The profit standard on the basis of capital attracting rate of return can be formulated in terms of cost of new capital in the capital market. The capital attracting rate, however, depends on the company’s capital structure. The second standard, i.e the plough-back rate
is in terms of the aggregate profits that must be retained in the business to finance a desired rate of growth without restoring to the capital market. The third criterion of reasonable profits is normal earning of the company or of any industry group conceived in terms of some average level over a normal period. In this context, a strictly autonomous standard such as the firm’s own past earnings has enough validity. The final criterion i.e. reasonable earning is based on the result of surveys to find the public’s idea of fair profit. The above mentioned forms of profit standard can be formulated for individual products or the whole product line for multi-product firm.

**Role of Profit in Mixed Economy:**

Profits, as noted earlier yield a socially desirable benefit to those who have capital to invest. Without profit there would be no reason for the existence of business in a private enterprise economy. Even in socialist countries profit in a measure of how a business is serving the society. Moreover, a major portion of business profit is taxed away. The revenue from profits is often used to finance many government programmes. The objective is social improvement. Profit is the basic criterion for measuring a firm’s success in a few enterprise systems. In the ultimate analysis, the survival of a firm and the continued employment of management and labour depend on the firm’s ability to cover all of its costs initially and make a profit thereafter. Despite the overwhelming importance of profit in a market oriented economy system, profit still remains ambiguous concept. *Prima facie*, the profits cannot be defined precisely. There is also controversy regarding the function that profit serves in the free enterprise system. Finally, there are several accounting problems connected with the measurement of profit.
Profit is after all, the most pervasive objective of business. A firm’s survival depends on its ability to make profit. Profit is measure of success. However there is much controversy over the role of profit in a mixed economy like India. It is sometimes alleged that one of the causes of inflation is the adding up of a marl-up above costs in fixing the price of a product. However there is no denying the fact that profit and loss play an important role in guiding and directing the private sector of a mixed economy. Patterns of consumer demand are ever changing. Producers are eager to produce those products which consumers demand heavily. As a result, many new products have appeared in the market. Similarly, many old products have disappeared and substantial shifts have occurred in the proportions in which many are now demanded and supplied. In this connection, the role of profit in a mixed economy assumes greater importance.

The following are the important role of profit in a mixed economy\(^{19}\).

1. **Direction and redirection of productive capacity**

   Profit and loss is the guiding and directing mechanism that re-channels productive capacity in the direction that consumers want it to go. As a demand pattern shifts price rise relative for firms producing the items for which demand has increased. Price fall relative to costs for firms that produce the items from which demand had turned. The former become profitable and latter become losable. True enough, profit is the economic signal showing the area where productive capacity should be expanded to meet growing demand. In a like manner, loss is a signal showing the area where productive capacity has to be concentrated.
2. **Investment and capacity creation**

Relative rates of profits of different industries are the areas where there is scope for making additional investment. However, investment is a long-term decision and in the long-run, the higher than average rate of return on investment in profit making areas attract additional investment and productive capacity follows into them. On the contrary, the loss making areas discourage investors, inducing investment and productive capacity to leave. With an expansion of capacity in the former areas, the profits fall towards zero. Similarly, with contraction of productive capacity, prices rise and the losses move toward zero.

3. **Innovation**

Profit is the prime mover of the capitalist economy. Profits influence both the level of resource utilization and allocation of resources among alternative uses. It is profit, or the expectation of profit, which induce firms to innovate. Innovation, in its turn, stimulates investment, total output and employment. Fluctuations in profits lead to income fluctuations or business cycle.

**Concept of Profitability:**

The word ‘profitability’ is composed of two words i.e. profit and ability. On this basis, the concept of profitability may be defined as the ability of a given investment to earn a return from its use. This ability is also referred to as ‘earning power’ or ‘operating performance’ of the concerned investment. The concept of profit is related to absolute figures. It does not tell about the reason, scattered and how it takes place or the relationship between one figure with another one. These questions can be answered by a peep in to the profitability of an entity. Profitability is relative term and profit and its relation with the other objects by which the profit is affected can achieve its measurement. According to
Goodman, “profit is residual. It is a static historical term more geared to a reporting function than to decision making”\(^{(21)}\). He further differentiates profit from profitability saying, profit is owner-oriented concept and is tied into the ownership shares of national income and the provision. On the other hand, as the concept is akin to levels of profit, which lead themselves to be least number of alternative accounting measures, the profit is directly attributable to the existence of a product and identifies marginal contribution. It is essentially an internal measure of new wealth creation. Thus, whereas the accounting concept of profit measures what have been accumulated, the analytical concept of profitability is concerned with further accumulation of wealth \(^{(22)}\).

Bayer and Trawicki have observed that segment profitability implies segment revenue less segment cost; this cost however, may range from variable cost to what is traditionally referred to as full cost \(^{(23)}\). They further state that it is an appropriate measure of profitability and therefore, the appropriate costs will differ depending on this specific purpose for which the information is being used \(^{(24)}\). When considered from accounting point of view, profit reflects the excess of earnings over expenses or costs. If the costs are more than earnings, it will mean a positive loss. According to Langley, “profit is not the surplus of receipts over payments, but the surplus of revenue over the expenses. If total expenses are greater than revenue, there will be loss. By revenue is meant what the business earns in the period under review usually what goods and services it has sold” \(^{(25)}\).

**Types of Profitability:**

Profitability as observed from the above discussion is a measure to know the overall efficiency of a firm. In general term, the efficiency in business is measured by the input-output analysis. By measuring the output as a proportion of
the input and comparing results of similar other firms or periods the relative change in its profitability can be established. Primarily, there are three measurable concepts of profitability. They are: i) accounting profitability, ii) value added profitability and iii) social profitability. A brief description on the aforesaid concepts of profitability is made in the following paragraphs.

**Accounting Profitability :**

The output (income) when compared to the input (capital employed) indicates profitability of a firm. This is known as Return on Investment (ROI) or Return on Capital Employed (ROCE). The ROI can be calculated by the following formula.

\[
\text{ROI} = \text{Profit margin multiplied by Assets turnover} \quad \text{or}
\]

\[
\text{ROI} = \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total assets}} \quad \text{or}
\]

\[
\text{ROI} = \frac{\text{Profit}}{\text{Total assets}}.
\]

Return on investment is viewed as a measure of overall profitability of a firm. It is an indicator of efficiency and performance in relation to the scale of resources/ funds required to produce goods and services. In other words, the given amount of profit should be evaluated in terms of the percentage as a return on the investment \(^{(26)}\). Further, the return on capital/ investment used depicts the effectiveness of all the operating decisions from the routine to the critical levels or from shop foreman to president made by the organization \(^{(27)}\). These decisions aimed at improving organizational performance and maximizing profit on continuing basis.
**Value added profitability:**

Value added is an important measure to judge the efficiency of an enterprise. It indicates the net value or wealth created by the manufacturer during a specific period. No enterprise can survive or grow if it fails to generate wealth. An enterprise may exist without making profit but cannot survive without adding value. The enterprise, not making profit, is bound to become sick but not adding value may cause its death over a period of time \(^{(28)}\). Thus, value added is a concept broader than profit, which just forms a part of the value added. In fact, value added at a particular level of operating capacity and claims as value added can expose the efficiency or inefficiency of a business \(^{(29)}\).

The investment made by an organization comprises investment from owners and outsiders like financial institutions and public. If such investment does not generate growth i.e, value added, it means that it is a misuse of public funds. Therefore, the concept of value added can be directly linked with the concept of social profitability of business undertaking. The measure of value added should be studied in addition to profitability measure for determining the performance of business organization. Thus, the concept of value added measures the performance of the organization, which also helps the management to find out how productivity is increased when the same or better outputs are produced with reduction in resources.

**Social profitability:**

There is general consensus that the primary goal of a business organization is to maximize the long-term wealth or economic welfare of its members consistent with social and economic responsibility of the firm towards the community in which it operates. Cardinar rightly observed that the light of a
new kind of social responsibility has dispelled the darkness of a varice \(^{(30)}\). Some social objectives reinforce profitability by attracting customers while others may be directly counter-active, e.g., the elimination of population may well and directly cost to the company’s operations and reduce its profitability but it increases social profitability. The overall performance of an enterprise certainly includes profitability. Moreover, wide community needs social pressures, employment of labour and location of factory environment, consideration on elimination of pollution, conservation or resources and treatment of wastes etc., which are also included in it. In the words of Dale, “These social objectives appear to urge the executive to assume an infinitely broad-gauge burden of responsibilities to all of the various public with whom he deals”\(^{(31)}\). Therefore, it should be indispensable for every business undertakings to state its financial, personnel, marketing and social objectives in a simple and concise form well in advance and these objectives should be updated in the light of day-to-day changes. They should also be published so that they may enable every employee to know as to what the objectives are and judge how they influence his/her job.

**Profit Vs. Profitability :**

The profit of an enterprise does not give any clear-cut idea of the adequacy of income or of charges in efficiency during a particular period of time. Further, the profit figure does not convey about the organization’s efficiency or performance even though the figure is compared with the previous year’s profit or with the profit figure of similar firms operating under the same industry group. It is basically due to the variation in the size of investment and derives the quantitative relationship in the form of either ratio or percentage. Such ratios or percentages are easy to analyze and interpret about the performance of the organization. Ratios selected
to measure the relative profit position of an organization are known as profitability ratios. From the above discussion, it is clear that profit is an absolute connotation, where as profitability is a relative concept. However, they are closely related and mutually independent. Profit and profitability are two different concepts. In spite of their generic nature, each one of them has a distinct role in the business. Profit in two separate business concerns may be identical yet many a time it usually happens that their profitability varies when measured in terms of size of investment \(^{(32)}\). Similarly, sales volume in two separate enterprises may be equal, yet their profitability may not be identical because of unequal profit margin. An analysis of the profitability reveals as to how the profit position stands as a result of total transaction made during a year. It needs not to be stressed that profitability is analyzed through the computation of profit ratios \(^{(33)}\). The analysis of profitability requires a careful decision regarding two vital questions:

1. What should be the basis of profitability? And
2. How profitability is to be measured?

The profitability can be analyzed either on the basis of operating profit or net profit. It may be noted that operating profit reflects profit from the main business for which the enterprise was established and offer the most reliable measure for the long-term perspective. On the other hand, the net profit reflects the net of the operating and non-operating income. It equips the analyst with the most reliable measure from the short-term point of view \(^{(34)}\). The figure of net profit may assume either the net profit before interest and tax or net profit before tax or net profit after tax. However, the basis of working out profitability would depend on analyst as to what he/ she wants to analyze and focus. Thus, the basis is determined by the objective of the analysis, i.e., whether one wants to judge the
overall financial performance of internal management and control or it is done for the outside agencies like creditors, prospective investors and security dealers or the analysis is made keeping in mind the equity holders of the concerned business enterprise.

**Techniques of Profitability Measurement:**

Generally there are three major approaches through which the profitability of an organization can be measured. They are namely i) accounting profitability, ii) value added profitability and iii) Du Pont Chart. Apart from these, there is another method known as Tobin’s ‘q’ technique by which the profitability of a business undertaking can also be measured. A brief discussion on the above mentioned techniques is made.

**Accounting profitability:**

In accounting sense, the profitability measurement depends on two factors viz. i) the rapidity of turnover of capital employed and ii) the operating margin. Profitability is the product of these two factors and therefore, maximum or optimum profits can be earned only by maximizing each of them. In technical sense, the combination of these two factors is known as the triangular relationship. Its significance exists not only in its use as an analytical tool, but also because the profitability ratio can be calculated directly from the specific earnings and investment base. It is useful in describing the two basic forces bearing upon ultimate results and therefore, establishes the area of business operations. It must be properly controlled, if desired results are to be realized (35). The important precaution in connection with the measurement of profitability is that the investment figure used should be related to its associated income figure. Accountants to measure profitability of the investments have established several
relationships among different types of investments and incomes. In the words of Walker and Banghu, “Business enterprises are organized to earn profit and to realize this objective policy are formulated and promoted in each of the functional areas of distribution, production and finance. To ascertain it and how well the firm is achieving its profit objective, financial management employs various techniques or profit measurement. However, before a profit measurement is made, a standard level of achievement should be established in order to have a means of determining to what degree; the firm has attained its goal. Once a standard has been fixed, actual performance is compared with it. In the event, the analysis reveals that the goal has not been realized, action should be initiated to raise basic policies and procedures” \(^{(36)}\).

The overall profitability ratio has to components, i.e, operating profit margin ratio (operating profit to net sales) and turnover ratio (net sales to capital employed). When these two components are multiplied, the overall profitability of a concern can be determined. The formula for obtaining the overall profitability i.e the ROI is as follows.

\[
\text{Profitability (ROI)} = \frac{\text{operating profit/net sales}}{\text{net sales / capital employed}}
\]

If 100 multiply the above figure then the profitability (ROI) is derived in percentage.

If the management wants to maximize its profitability, it could do so by improving its net profit margin and turnover. The former refers to the margin made in each sale in terms of percentage while the later show the utilization of capital in making the sales.
Value added profitability:

The value added technique to measure the profitability of an enterprise is still at its infancy in India. The concept of value added means the net value or wealth created by the organization during specified period. Profit is a test for shareholders to measure the performance of an enterprise while the valued added is a measure available for all these constituents like owners, workers, government, financing agencies etc. who contribute in the process of generating wealth or value added in the enterprise. Every member of this team contributes to the value added and gets a proportionate share therein. The value added is not only the net income of a company but also its net output. The efficiency with which the management of a company combines the resources needed for the creation of value added is thus a matter of paramount importance not only to the company itself, but also to the nation \(^{(37)}\). Many of the companies in the western countries are now presenting the value added statement in annual reports. This trend is yet to be set in India. The presentation of value added in annual reports is neither statutory nor obligatory for companies in India. Never the less, some companies have started including value added statements in their annual reports. However, in the absence of uniform policies and practices, the measurement of value added is subject to numerous anomalies and fallacies.

To calculate the value added, profit and loss account figures are taken as the base. Value added is an excess of turnover plus income from services over the cost of brought-in of materials and cost of services. The term turn over means the gross sale of goods plus duties and sales tax minus the amount of returns, goods used for self consumption, commission, rebates and discounts etc. The term income from services includes income in the form of dividends from
subsidary companies, rent and compensation and other miscellaneous income etc. The term cost of brought-in material includes the cost of materials consumed, the cost of merchandising of materials consumed and the cost of stores and spare parts consumed during the process of manufacture. The term cost of services includes the cost of procuring services, power, fuel, repairs and maintenance, bank Commission, insurance premium, advertising and publicity, postage and telephones, printing, legal charges and travelling expenses etc. Since the computation of value added is a cumbersome procedure still it is a basic and broad measure of judging the performance of an enterprise.

**Du Pont Chart :**

The Du Pont chart shows the mechanics of profit path, which was originally developed by E.T. Du Pont de Numerous and Company, Wilmington, U.S.A. This chart was first put into operation in 1921, when Irenée Du Pont was president of the company. The chart is one of the most successful ones and a key device used to aid both decision making and performance evaluation.

The Du Pont chart depicts the interrelated component of the profit path shown in figure 3.1. It is observed from the chart that a number of factors contribute a great deal to the final rate of return on investment. The analytical chain in Du Pont chart is developed on the basis of two-tier system. The first starts with turnover determined by dividing net sales by total investments. Total investment represents current assets plus net fixed assets. In the second tier, the sequence starts with the profit margin, calculated by dividing net profit by net sales. Net profit equals to sales less expenses (work expenses, administrative expenses, selling and distribution expenses). While determining the overall profitability, attentions should be paid to these two factors namely, profit margin
and turnover. In other words, improvement can be made either through more effective use of available capital measured through the turn over sequence or through a better relationship between sales and expenses measured by profit margin sequence. For providing standards of evaluation, calculations are made of the ratios of return on investment, assets turnover and profit margins of comparable companies (38).

Top executives in a business enterprise have now accepted Du Pont chart as a strategic device for profit planning and control. It brings to light the various components of the profit and a mere glance over the chart isolates each factor and clearly explains its respective contribution to the mechanics of the profit path, leading to the ultimate goal of maximization of the return on the owner’s capital investment.

\[
\text{Du Pont Chart} \quad \text{Return on Investment} \\
\text{Profit Margin} \quad \times \quad \text{Assets Turnover} \\
\text{Net Profit} \quad ÷ \quad \text{Net Sales} \quad + \quad \text{Net Sales} \quad ÷ \quad \text{Total Assets} \\
\text{Gross Profit} \quad - \quad \text{Operating Cost} \\
\text{Fixed Assets} \quad + \quad \text{Current Assets}
\]

Figure - 3.1
Tobin’s ‘q’ technique: Conventionally, profitability is measured as the ratio of net (after tax) profit to net worth. However, this ratio does not adequately measure profitability in an inflationary situation, for the reasons:

- The numerator is a flow variable for one particular year while the denominator is stock variable and represents the sum of capital formation at different point of time.
- Investment allowance, subsidies and other incentives affect the taxation of profits and hence the rate of return on capital.
- The depreciation on physical assets is not an economic depreciation and thus the net profit does not reflect the real return on capital.
- The risk factor is not taken into account and
- Intangible assets such as goodwill, efficient management and future growth prospects of firm affect its share price and not necessarily its profits.

Moreover, as a consequence of faulty accounting practices the cost of capital and profitability would be affected by security prices of the company. As the above stated points have bearing on the profitability position of a firm. Tobin’s ‘q’ technique has been used because it is used as a link variable between the financial markets and markets for real goods and services. Tobin and Brainard defined ‘q’ as simply the ratio of market valuation of reproducible capital assets to the current replacement cost of assets\(^{(39)}\). The basic objective has been to rely on the observable market variable to summarize all the information regarding technology and market conditions etc.

The Tobin’s ‘q’ index is calculated as follows:

\[
q = \frac{\text{market value of the firm}}{\text{replacement cost of assets}}
\]

Value of the firm consists of the value of the shareholder’s money and the total liabilities of the firm. Replacement cost of the assets is the sum of values of
inventories and fixed assets at current price plus the value of miscellaneous current assets.

The above measure seems to be a better measure as compared to conventional measure of profitability in spite of the difficulties arising with regard to its measurement.

The foregoing discussion on the concepts of profit and profitability and their measurement reveals that profit is an absolute connotation whereas profitability is a relative term. Profit is required not only to sustain in the business but also necessary to expand and diversify the business in the future. Normally, profit can be arrived at by following the accounting procedure i.e., revenue minus cost but it is also equally important to measure the economic profit because it will reveal the true performance of business organization. Further, profit as an absolute figure does not reveal the adequacy of income earned or of changes in the efficiency of the organization during a specified period. Hence, it does not convey the organization's efficiency or effectiveness or the performance when compared with the previous year's profit or with the profit figure of similar firms operating in the same industry. Therefore, it becomes necessary to find out the earning power i.e. profitability of the firm. The profitability is nothing but the ability of the firm in generating profit. There are different methods to measure the profitability of an organization. The important methods are accounting method; value added method, Du Pont chart, Tobin's 'q' technique etc. Each method has its own strength and weakness. The researchers can use any one method depending on the availability of data and information. In the present study, however, the accounting method of measuring profitability has been followed to examine the operational and financial performance of the sample companies selected for the study.
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