CHAPTER - 2

CONCEPTUAL FRAME-WORK OF PROFITABILITY

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CHAPTER - 2
CONCEPTUAL FRAME-WORK OF PROFITABILITY

2.1 Introduction:

With the globalization trends world over, it is difficult for any nation, big or small, developed or developing, to remain isolated from what is happening around. For a country like India, which is one of the most promising emerging markets, such isolation is nearly impossible. More particularly, in the time of these dynamic changes, India has also adopted liberalization, privatization and globalization policy under banking sector reforms in 1991, which has improved the performance of the banks to a large extent. Due to these changes, the concept of banking has drastically changed from a business dealing with money transactions alone to a business related to information on financial transactions.

Banking is a highly personalized service industry; consequently, the expenses of commercial banks are to a great extent fixed, especially in the short run. Banks, like public utilities, bear a certain degree of public interest, and the capacity to serve the public must be available at all times. Nowadays, profitability and social objectives are the two opposing considerations, which a bank is now required to keep in mind.

Profitability is an important criterion for determining the efficiency of banks. This has to be considered in relation to the growth of various selected variables. Raising profitability is one of the important ways by which a bank can vigorously expand its operations on a sustained long – term basis. Profit is the very reason for the continued existence of every commercial organization. The rate of profitability therefore, rightfully considered as indicator of efficiency in the deployment of resources of banks.

2.2 Concept of Profit:

Profit is the main and ultimate aim of every business. In accounting, profit is difference between total revenue and total expenses over a period of time. It is the barometer of the success of the business. Lord Keynes remarked ‘Profit is the engine that drives the business enterprise’. If, it is used in a general sense then, it is responsible for all economic activities in the society. The survival of and business depends upon its earning capacity. Thus, if an enterprise fails to make profit, capital
invested is eroded and if this situation prolongs, the enterprise ultimately ceases to exist. In fact, profits are the soul of the business without which it is lifeless. In the present time, profits are the legitimate object, but it would be wrong to assume that every action initiated by management of a company should be aimed at maximizing profits, irrespective of social consequences. Recently, developed philosophy of the socialistic pattern of society has shifted the importance from economic and accounting profit to the social profit or the national profit.

Indeed, profits are the test of efficiency and a measure of control; to the owners, a measure of worth of their investment; to the creditors, the margin of safety; to the employers, source of fringe benefits; to the Government, measure of taxable capacity and the basis of legislative action; to the customers demand for price cut. In the real sense, profits are an index to the economic progress; national income generated and rises in the standard of living. It is criteria of judging the efficient operations. We are not concerned here with profit as a reward to owner of capital, but with the return on capital as an objective of a firm’s profitability. In short, profit is the legitimate object of an enterprise from the investors. Profit is a yard-stick for judging managerial efficiency and social objectives. Two concepts of profit are discussed below in details.

### 2.2.1 Accounting Profit:

A company’s total earnings, calculated according to Generally Accepted Accounting Principles (GAAP), and include the explicit costs of doing business, such as depreciation, interest and taxes. To an accountant, ‘Profit’ means the excess of revenue over all paid-out costs including both manufacturing and overhead expenses. It is more or less the same as ‘net profit’. For all practical purposes, businessmen also use this definition of profit. For taxation purposes, profit or business income means profit in accountancy sense plus non-allowable expenses. Accounting profits tend to be higher than economic profits as they omit certain implicit costs, such as opportunity costs.

- **Gross Profit**:

  When cost of production is deducted from the total sales proceeds, the residual portion is called Gross Profit. Gross Profit is profit before Selling, General and Administrative costs (SG&A), like depreciation and interest; it is the sales less direct Cost of Goods (or services) Sold (COG).
Calculated as :

**Gross Profit = Total Receipts – Total Expenditure**

A company’s revenue minus its cost of goods sold. Gross profit is a company’s residual profit after selling a product or service and deducting the cost associated with its production and sale.

When analyzing a company, gross profit is very important because it indicates how efficiently management uses labor and supplies in the production process. More specifically, it can be used to calculate gross profit margin. Keep in mind that gross profit varies significantly from industry to industry.

**Operating Profit :**

Operating profit is a measure of a company’s earning power from ongoing operations, equal to earnings before the deduction of interest payments and income taxes. The profit earned from a firm’s normal core business operations. This value does not include any profit earned from the firm’s investments (such as earnings from firms in which the company has partial interest) and the effects of interest and taxes. Operating Profit is also known as “earnings before interest and tax” (EBIT).

Calculated as :

**Operating Profit = Operating Revenue – COGS – Operating Expenses – Depreciation & Amortization**

Operating profit equals sales revenue minus cost of goods sold and all expenses except for interest and taxes. This is the surplus generated by operations. It is also known as Operating Profit before Interest and Taxes (OPBIT) or simply Profit before Interest and Taxes (PBIT).

**Net Profit :**

In the accounting sense of the term, net profit (before tax) is the sales of the firm less costs such as wages, rent, fuel, raw materials, interest on loans and depreciation. Costs such as depreciation, amortization and overhead are ambiguous. Revenue may also be ambiguous when different products are sold as a package, or “bundled”. Within US business, the preferred term for profit tends to be the more ambiguous income.

Net profit after tax is after the deduction of either corporate tax (for a company) or income tax (for an individual).
2.2.2 Economic Profit:

In economics, a firm is said to be making a normal profit when total revenues equal total costs. These normal profits then match the rate of return that is the minimum rate required by equity investors to maintain their present level of investment. Economically, the “normal profit” is thus treated as a cost, and recognized as one of the two components of the cost of capital.

An economic profit arises when its revenue exceeds the total (opportunity) cost of its inputs noting that these costs include the cost of equity capital that is met by “normal profits”. A business is said to be making an accounting profit if its revenues exceed the accounting cost the firm “pays” for those inputs. Economics treats the normal profit as a cost, so when deducted from total accounting profit what is left is economic profit (or economic loss).

All enterprises can be stated in financial capital of the owners of the enterprise. The economic profit may include an element in recognition of the risks that an investor takes. It is often uncertain, because of incomplete information, whether an enterprise will succeed or not. This extra risk is included in the minimum rate of return that providers of financial capital require, and so is treated as still a cost within economics. The size of that return is commensurate with the riskiness associated with each type of investment, as per the risk-return spectrum.

“Normal profits” arise in circumstances of perfect competition when economic equilibrium is reached. At equilibrium, average cost = marginal cost at the profit – maximizing position. Since normal profit is economically a cost, there is no economic profit happens when the firm’s average cost is less than the price of the product or service at the profit – maximizing output. The economic profit is equal to the quantity output multiplied by the difference between the average cost and the price.

Economic profit does not occur in perfect competition in long run equilibrium. Once risk is accounted for, long-lasting economic profit is thus viewed as the result of constant cost-cutting and performance improvement ahead of industry competitors or an inefficiency caused by monopolies or some form of market failure.
Positive economic profit is sometimes referred to as supernormal profit or as economic rent.

The social profit from a firm’s activities is the normal profit plus or minus any externalities that occur in its activity. A polluting oil monopoly may report huge profits, but by doing relatively little for the economy and damaging the environment. It would exhibit high economic profit but low social profit.

To accountants, Economic Profit, or EP, is a single – period metric to determine the value created by a company in one period – usually a year. It is Earnings after Tax less the Equity Charge, a risk – weighted cost of capital. This is almost identical to the economists’ definition of economic profit.

Accounting profits should include economic profits, which are also called economic rents. For instance, a monopoly can have very high economic profits and those profits might include a rent on some natural resource that firm owns, whereby that resource cannot be easily duplicated by other firms.

2.2.3 Accounting Profit vs. Economic Profit:

The two important concepts of profit that figure in business decisions are ‘economic profit’ and ‘accounting profit’. A lot of people get confused about the difference between economic profit and accounting profit. It will be useful to explain the difference between the two concepts of profit. While economic profit includes theoretical estimations of loss based on opportunity cost and value, accounting profit is the actual revenue calculations generated by bookkeepers. In accounting sense, profit is surplus of revenue over and above all paid – out costs, including both manufacturing and overhead expenses. Accounting profit may be calculated as:

**Accounting Profit = TR – (W+R+I+M)**

Where,  
TR = Total Revenue,
W = Wages,
R = Rent,
I = Interest and
M = Cost of materials
Obviously, while calculating accounting profit, only explicit or book costs, i.e. the cost recorded in the books of accounts, are considered.

The concept of ‘economic profit’ differs from that of ‘accounting profit’. Economic profit takes into account also the implicit or imputed costs. The implicit cost is opportunity cost. Opportunity cost is defined as the payment that would be ‘necessary to draw forth the factors of productions from their most remunerative alternative employment’. In simple terms, opportunity cost is the income foregone, which a businessman could expect from the second best alternative use of his resources. For example, if an entrepreneur debentures of other companies or by depositing his money with joint stock companies for a period. Furthermore, if an entrepreneur uses his labour in his own business, he foregoes his income (salary) which he might earn by working as a manager in another firm. Similarly, by using productive assets (land and building) in his own business, he sacrifices his market rent. These forgone incomes – interest, salary and rent are called opportunity costs or transfer costs. Accounting profit does not take into account the opportunity cost.

It should also be noted that the economic or pure profit makes provision also for (a) insurable risks, (b) depreciation, and (c) necessary minimum payment of shareholders to prevent them from withdrawing their capital. Pure profit may thus be defined as ‘residual left after all contractual costs have been met, including the transfer costs of management, insurable risks, depreciation and payments to shareholders, sufficient to maintain investment at its current level. Thus,

**Pure Profit = Total revenue – (explicit costs + implicit costs)**

Pure profit so defined may not be necessarily positive for a single firm in a single year – it may be even negative, since it may not be possible to decide beforehand the best way of using the resources. Besides, in economics, pure profit is considered to be a short term phenomenon – it does not exist in the long run under perfectly competitive conditions.

An entrepreneur brings together various factors of production such as land, labour and capital. He ensures co-ordination between the factors and supervises the productive activity. He looks after purchase of raw materials, production, marketing, recovery of receivable and personnel. The most important function performed by an entrepreneur is, however to undertake risk and uncertainty in business. The reward which is paid to an entrepreneur for discharging this function is called Profit.
2.3 Concept of Profitability:

Simply, profitability implies profit-making ability of a business enterprise. The term ‘profitability’ is a combination of two words ‘profit’ and ‘ability’. To obtain profit, from accounting point of view, total expenses are deducted from total revenues for a given period. The word ‘ability’ means the ‘earning power’ or ‘operating performance’ of the concern on its investment. Thus, profitability may be defined as the ability of a given investment to earn a return from its use. ‘Profit’ as an absolute term above does not give an exact result of the adequacy or change in efficiency as shown by the financial appraisal of enterprise.

Notably, while profit is the residue of income, profitability is the profit-making ability of the enterprise. It may be remarked that the profit-making ability might denote a constant or improved or deteriorated state of affairs during a given period. Thus, profit is an absolute connotation, whereas profitability is a relative concept despite being closely related to and mutually interdependent, as they are profit and profitability are two different concepts. In other words, in spite of their generic nature, each one of them has a distinct role in business. Interestingly, profit in two separate business concerns might be the same and yet more often than note their profitability could differ when measured in terms of the size of investment.

An analysis of the profitability reveals as to how the position of profits stands as a result of total transactions made during a year. It need not be stressed that profitability is analyzed through the computation of profit ratios. The analysis of profitability requires a careful decision regarding two vital questions.

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

In the first case, profitability can be analyzed either on the basis of operating profits or net profits. In operating profit, we generally exclude all non-operating items which may be income or expenditure. On the other hand, in net profit all operating and not-operating income and expenditure are included. The long term view seems to suggest that the most reliable measure of profitability is the operating profit ratios because that alone depict the profits arising out of the main business for which the enterprise was established, while short term view suggests that the net profit ratio is very useful to judge the overall view of the profit position.
2.3.1 Profit and Profitability:

Sometimes, the terms ‘Profit’ and ‘Profitability’ are used interchangeably. But in real sense, there is a difference between the two. Profit is an absolute term, whereas, the profitability is a relative concept. However, they are closely related and mutually interdependent, having distinct roles in business. Profit refers to the total income earned by the enterprise during the specified period of time, while profitability refers to the operating efficiency of the enterprise. It is the ability of the enterprise to make profit on sales. It is the ability of enterprise to get sufficient return on the capital and employees used in the business operation.

As Weston and Brigham rightly notes “to the financial management profit is the test of efficiency and a measure of control, to the owners a measure of the worth of their investment, to the creditors the margin of safety, to the government a measure of taxable capacity and a basis of legislative action and to the country profit is an index of economic progress, national income generated and the rise in the standard of living”, while profitability is an outcome of profit. In other words, no profit drives towards profitability. Firms having same amount of profit may vary in terms of profitability. That is why R. S. Kulshrestha has rightly stated, ‘profit in two separate business concern may be identical, yet, many a times, and it usually happens that their profitability varies when measured in terms of size of investment.

2.3.2 Profitability in Banks:

According to a Credit Rating and Information Services of India (Crisil) study, Lower operating expenses including rationalization of employee costs have improved the profitability of banks, contrary to the popular perception that only trading profits helped the banking sector shore up their bottom lines. The reduction in operating expenses was achieved through large – scale voluntary retirement schemes implemented by public sector banks. Since this reduction in operating expenses seems sustainable, it promises a brighter future for the banking sector.

Although the non – interest income of banks did increase by 0.3% during this period, it was more than offset by a 0.21% increase in provisions and an identical decline in spreads. Compared to the relatively volatile treasury income, the reduction in operating expenses imparts a greater level of comfort in terms of the banking sector’s ability to sustain its profitability in the future.
The banking sector’s overall profitability as measured by the return on average assets (ROAA) has improved to 0.84 percent in 2001-02 from 0.53 percent in 2000-01. An analysis of the incremental change in the various profitability components show that:

In 2001-02, the sector’s non-interest income rose by 32 basis points (bps) over the previous year, primarily due to an increase in treasury profits. On the other hand, the net interest income or interest spread declined by 21 bps in the same period. This was in line with the declining interest rate regime and increasing competition in the sector. At the same time, provision and contingency charges rose by 21 bps. Together, the two more than offset the incremental contribution from the non-interest income.

Operating expenses, however, declined significantly by 41bps in 2001-02 over 2000-01 and this enabled the banking sector to report an overall increase in profitability by 31 bps. The reduction in operating expenses can be attributed to the large-scale voluntary retirement scheme (VRS) being implemented across all public sector banks as well as other cost-cutting measures.

A closer analysis of the different banking groups (public sector banks, old private sector banks, new private sector banks and foreign banks) also shows that the reduction in operating expenses was only experienced by the public sector and foreign banks.

For private sector banks, the profitability improvement was mainly because of the increase in treasury income and not due to any material reduction in operating expenses. But since public sector and foreign banks account for over 80 percent of the total assets of all scheduled banks, a reduction in their core operating expenses contributes significantly in improving the profitability of the entire Indian banking sector.

Crisil believes that the banking sector is now reaping the benefits of rationalizing its employee costs and undertaking other cost-reduction initiatives, which is a welcome sign in terms of the banks’ financial performance. Crisil, however, pointed out that banks’ ability to repeat and sustain such efforts would be critical in maintaining their profitability, given the increasing pressure on interest spreads and rising provisioning levels.
2.3.3 Factor Affecting Bank Profitability:

The erotically factors affecting bank profitability are mainly divided into two categories as internal and external variables. The internal (bank – specific factors) are factors that are related to internal efficiencies and managerial decisions. Internal factors that are related to internal efficiencies and managerial decisions. Such factors include determinants such as bank capital, bank size, asset quality, income diversification, liquidity risk and operational efficiency (expenses management). On the other hand, the market power theory assumes as bank profitability is a function of external market factors. Accordingly, one of the external factors (variables) that can affect bank profitability is industry specific factors. Such factors mainly include industry concentration or market share as a major determinant factor of bank profitability. Finally, the macroeconomic factors that can affect bank profitability include factors such as GDP, money supply growth and inflation rate among others.

2.4 The Measures of Profitability Ratios:

Ratio analysis is a very powerful analytical tool useful for measuring performance of an organization. The ratio analysis concentrates on the inter-relationship among the figures appearing in the aforementioned four financial statements. The ratio analysis helps the management to analyze the past performance of the firm and to make further projections. Ratio analysis allow interested parties like shareholders, investors, creditors, government and analysis to make an evaluation of certain aspects of a firm’s performance.

The profitability ratios are used to measure how well a business is performing in terms of profit. The profitability ratios are considered to be the basic bank financial ratios. In other words, the profitability ratios give the various scales to measure the success of the firm. The profitability ratios can also be defined as the financial measurement that evaluates the capacity of a business to produce yield against the expenses and costs of business over a particular time period. If a company is having a higher profitability ratio compared to its competitor, it can be inferred that the company is doing better than that particular competitor. The higher or same profitability ratio of a company compared to its previous period also indicates that the company is doing well. The return on assets, profit margin and return on equity are the examples of profitability ratios.
The profitability ratio should be compared with the relevant time period. The profitability ratio of the industries that experience operations on the seasonal basis should be compared properly. For example, in case of the retail industry, high revenue is earned during the Christmas season. Hence comparing the profit margin of the fourth quarter with the first quarter of a retailer will not give clear picture of the profitability of the retail business. Hence in order to judge the profitability of the retailer perfectly, the profit margin of the fourth quarter of a retailer should be compared with the profit margin of the fourth quarter of the previous year.

The purpose of study and analysis of profitability ratios are to help assessing the adequacy of profits earned by the company and also to discover whether profitability is increasing or declining. The profitability ratios show the combined effects of liquidity, asset management and debt management on operating result. Profitability ratios are measured with reference to sales, capital employed, total assets employed, shareholders funds etc. the major profitability rates are as follows:

(a) Gross Profit Margin
(b) Operating Margin
(c) Net Profit Margin
(d) Cash Profit Ratio
(e) Return on Net Worth Ratio
(f) Return on Assets Ratio
(g) Interest Spread Ratio
(h) Return on Long Term Fund Ratio
(i) Return on Capital Employed

2.4.1 Gross Profit Margin :

A company’s cost of sales, or cost of goods sold, represents the expense related to labor, raw materials and manufacturing overhead involved in its production process. This expense is deducted from the company’s net sales/revenue, which results in a company’s first level of profit, or gross profit. The gross profit margin is used to analyze how efficiently a company is using its raw materials, labor and manufacturing related fixed assets to generate profits. A higher margin percentage is a favorable profit indicator.
Industry characteristics of raw material costs, particularly as these relate to the stability or lack thereof, have a major effect on a company’s gross margin. Generally, management cannot exercise complete control over such costs. Companies without a production process (ex., retailers and service businesses) don’t have a cost of sales exactly. In these instances, the expense is recorded as a “cost of merchandise” and a “cost of services”, respectively. With this type of company, the gross profit margin does not carry the same weight as a producer – Type Company. Gross profit margin is calculated on the basis of following formula,

\[
\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100
\]

\[
\text{Gross Profit} = \text{Sales} – \text{Cost Of Goods Sold}
\]

### 2.4.2 Operating Margin :

Operating Profit is also known as EBIT and is found on the company’s income statement. EBIT is earnings before interest and taxes. The operating profit margin looks at EBIT as a percentage of sales. The operating profit margin ratio is a measure of overall operating efficiency incorporating all of the expenses of ordinary, daily business activity. The calculation is:

\[
\text{Operating Margin} = \frac{\text{Operating Profit}}{\text{Net Sales}} \times 100
\]

### 2.4.3 Net Profit Margin :

The ratio is designed to focus attention on the net profit margin arising from business operations before interest and tax is deducted. The convention is to express profit after tax and interest as a percentage of sales. A drawback is that the percentage which results various depending on the sources employed to finance business activity; interest is charged above the line while dividends are deducted below the line. It is for this reason that net profit i.e., earnings before interest and tax (EBIT) is used. This ratio reflects net profit margin on the total sales after deducting all expenses but before deducting interest and taxation. This ratio measures the efficiency of operation of the company. The net profit is arrived at from gross profit after deducting administration, selling and distribution expenses. The non-operating incomes and expenses are ignored in computation of net profit before tax, depreciation and interest.
This ratio could be compared with that of the previous years and with that of competitors to determine the trend in net profit margins of the company and its performance in the industry. This measure will depict the correct trend of performance where there are erratic fluctuations in the tax provisions from year to year. It is to be observed that majority of the costs debited to the profit and loss account are fixed in nature and any increase in sales will cause the cost per unit to decline because of the spread of same fixed cost over the increased number of units sold. This ratio is calculated as follows:

\[
\text{Net Profit Margin} = \frac{\text{Net Profit Before Interest and Tax}}{\text{Net Sales}} \times 100
\]

### 2.4.4 Cash Profit Ratio:

Cash profit ratio measures the cash generation in the business as a result of the operations expressed in terms of sales. The cash profit ratio is a more reliable indicator of performance. Where there’re sharp fluctuations in the profit before tax and net profit from year to year owing to difference in depreciation charged. Cash profit ratio evaluates the efficiency of operations in terms of cash generation and is not affected by the method of depreciation charged. It also facility inter-firms comparison of performance since different methods of depreciation may be adopted by different companies. This ratio is calculated as follows:

\[
\text{Cash Profit Ratio} = \frac{\text{Cash Profit}}{\text{Net Sales}} \times 100
\]

### 2.4.5 Return on Net Worth Ratio:

This ratio expresses the net profit in terms of the equity shareholders funds. This ratio is an important yardstick of performance for equity shareholders since it indicates the return on the funds employed by them. However, this measure is based on the historical net worth and will be high for old plants and low for new plants.

The factor which motivates shareholders to invest in a company is the expectation of an adequate rate of return on their funds and periodically, they will want to decide whether to continue with their investment. This ratio is useful in measuring the rate of return as a percentage of the book value of shareholders equity.
The further modification of this ratio is made by considering the profitability from equity shareholder point of view can also be worked out by taking the profits after preference dividend and comparing against capital employed after deducting both long-term loans and preference capital. This ratio is calculated as follows:

\[
\text{Return on Net worth} = \frac{\text{Net Profit after Interest and Tax}}{\text{Net Worth}} \times 100
\]

### 2.4.6 Return on Assets Ratio:

The profitability of the firm is measured by establishing relation of net profit with the total assets of the organization. This ratio indicates the efficiency of utilization of assets in generating revenue. This ratio is calculated as follows:

\[
\text{Return on Assets} = \frac{\text{Net Profit After Tax}}{\text{Total Assets}} \times 100
\]

### 2.4.7 Interest Spread Ratio:

Interest spread is the difference between the interest rate charged to borrower and the interest rate paid to depositors. It reflects efficiency in financial intermediation. Generally every bank tries to increase the spread volume.

\[
\text{Interest Spread} = \text{Interest Income} - \text{Interest Expended}
\]

### 2.4.8 Return on Long Term Fund Ratio:

This ratio establishes the relationship between net profit and the long term funds. The term long – term funds refer to the total investment made in business for long term. It is calculated by dividing Earnings before Interest & Tax (EBIT) by the total long – term funds. Return on long – term funds is calculated on the basis of following formula,

\[
\text{Return on Long Term funds} = \frac{\text{Operating Profit (EBIT)}}{\text{Long-term funds}} \times 100
\]
2.4.9 Return on Capital Employed (ROCE):

Return on capital employed (ROCE) is a measure of the returns that a business is achieving from the capital employed, usually expressed in percentage terms. Capital employed equals a company's Equity plus Non-current liabilities (or Total Assets − Current Liabilities), in other words all the long-term funds used by the company. ROCE indicates the efficiency and profitability of a company's capital investments.

ROCE should always be higher than the rate at which the company borrows otherwise any increase in borrowing will reduce shareholders' earnings, and vice versa; a good ROCE is one that is greater than the rate at which the company borrows.

\[
\text{ROCE} = \frac{\text{Operating Profit (EBIT)}}{\text{Total Asset} - \text{Current Liabilities}} \times 100
\]
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