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CHAPTER 2
CONCEPT OF PROFIT AND PROFITABILITY

The important objective of business is Profit. The profit of business can measure the success of a product and the development of the market. P.V. Kulkani (1981) said that "No company can survive long without profit, for profit is the ultimate measure of its effectiveness. Profit is a signal for allocation of resources and a yardstick for judging managerial efficiency"

Weston and Brigham (1978) pointed out that "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".

2.1 CONCEPT OF PROFIT

Many experts defined the definition of the term "profit" that "Profit" is one of the goals of any entrepreneur. The word profit has been defined by economists, accountants and many other competent experts. Both, the accounting profit and economic profit differs from each other. Both the concepts of profit agree that profit is an excess of revenue over total cost but the meaning of cost differs.

2.1.1 ACCOUNTING PROFIT

The figure of accounting profit is the result of the application of generally accepted accounting principle. The computation of accounting profit is affected by the arbitrary allocation of expenditure between revenue expenditure (expired cost) and capital expenditure (unexpired cost). The accounting definition of profit is based on accrual principle and includes non-cash items. The accounting profit provides the basis for computing the cash flow. Accounting profit is known as the excess of total revenues realised.
during the period of the given two dates.

In accounting profit the terms "explicit and implicit items of expenditure", principles of matching cost, are very significant. Surplus of total revenue over total cost has tabulated. Explicit items are the considerations of raw materials consumed, manufacturing expenses, employees cost, office expenses, selling and distribution expenses etc. There are two types of accounting profit, viz. gross profit and net profit. Gross profit is the result of the relationship between prices, sales volume and cost. Net profit (after interest and taxes) is a deverisation of amount left over after deductions of office expenses, and selling and distribution expenses and provision for debts and advances.

2.1.2 ECONOMIC PROFIT

The meaning of "The economic profit is the compensation received by a firm for its managerial function. It is a reward earned by the entrepreneur for bearing the rate. The economist points out that in addition to the deduction of explicit costs, implicit costs should also be deducted. For example entrepreneur's wages, rental income on self-owned land employed in the business and interest on self-owned capital. The Economic Profit is arrived at by deducting implicit costs from accounting profit. This can be called as economic profit.

Economic profit. The term 'implicit costs' is also appropriate and applicable here. They are know as 'opportunity costs' also. It can be put in a formula as following:

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

OR

\[
\text{Economic profit} = \text{Total Revenue} - (\text{Explicit Cost} + \text{Implicit cost}
\]
2.1.3 ACCOUNTING PROFIT V/S ECONOMIC PROFIT

It should be noted that the accountant's concept of profit is different from that of the economist's. The following diagram is self-explanatory to conclude the relationship of 'Accounting Profit' and 'Economic Profit'.

2.2 VALUE ADDED CONCEPT

Value added indicates the net value of wealth created by the manufacture during a given period. It is a generation of wealth without which an enterprise fails to survive. It is a modern practice in western countries that their annual reports include value added statements. The value added amount is an excess of turnover (or sales
revenue) over the cost of goods and services. Value added is a consideration of income from services, cost of bought in of materials, the cost of services. Income from services includes reward for services in the form of dividends from it, rent, compensation and miscellaneous income etc.

The term 'cost of bought in materials' includes the raw material consumed, stores, spares and containers consumed plus purchase of finished goods. The 'cost of services' include the cost of procuring services like power and fuel, repairs and maintenance of machinery, manufacture and labour charges, laboratory and research expenses etc. Employees cost include salaries, wages bonus and gratuity and contribution to provident and welfare expenses.

2.3 CONCEPT OF PROFITABILITY

Profitability measures over all efficiency of a business enterprise. The operating efficiency of a firm its ability to ensure adequate return to its investors depend on the profits earned by it. It also indicates public acceptance of the product and shows that the firm can produce competitively. Profitability is the relationship between profit and investment mode.

2.4 TECHNIQUE OF MEASURING PROFITABILITY

Following techniques may be used to measure profitability:

2.4.1 RATIO ANALYSIS

Springfield Mass G. & C. Merrian (1975) point out that "Ratio analysis is a powerful tool of financial analysis. A ratio is defined as the indicated quotient of two mathematical expressions and as the relationship between two or more things".

A ratio is used as an index for evaluating the financial position and performance of a firm. The absolute accounting figures
reported in the financial statements do not provide a meaningful understanding of the performance and financial position of a firm. An accounting figure conveys meaning when it is related to some other relevant information. This relationship is an index which permits a qualitative judgement to be formed about the firm's ability to meet its current obligations. It measures the firm's liquidity. The greater the ratio, the greater would be the firm's liquidity and vice versa. The ratio indicates a quantitative relationship, which can be, in turn, used to make a qualitative judgement.

RATIO ANALYSIS

Ratio can be classified in four groups

(i) Liquidity ratios
(ii) Leverage ratios
(iii) Activity ratios
(iv) Profitability ratios

(i) Liquidity ratio

Liquidity ratios measure the ability of the firm to meet its current obligations. Liquidity needs the preparation of cash budgets and cash and fund flow statements.

(ii) Leverage Ratios

These ratios indicate funds provided by owners and lenders. Leverage ratio judge the long-term financial position of the firm.

(iii) Activity Ratios

Activity ratios are employed to evaluate the efficiency with which the firm manages and utilises the assets. Activity ratios are also called turnover ratios.
(iv) Profitability ratios

The management of the firm is naturally eager to measure its operating efficiency of a firm and its ability to ensure adequate return to its shareholders. Profitability is a measure of efficiency and the search for it provides an incentive to active efficiency. These ratios also indicate public acceptance of the product and the firm can produce competitively. The profitability ratios are designed to provide answers to questions such as:

1. What is the earning per share?
2. What amount was paid in dividends?
3. What is the rate of return to equity holders?
4. What rate of return does it represent?
5. Is the profit earned by the firm adequate?

The management is mainly interested in finding out the volume of profit compared with sales and capital employed. These ratios are:

1. Net profit margin
2. Operating ratio
3. Operating profit ratio
4. Gross profit margin
5. Return on net capital employed
6. Return on gross capital employed
7. Return on shareholders' equity.

From shareholders point of view: The higher the amount of earnings the higher the rate of dividend will be. These ratios generally calculated are:

1. Earning Per Share (E.P.S.)
2. Dividend per share
(iii) Pay-out ratio
(iv) Price earning ratio

From creditors point of view: Trade creditors, bankers and money lenders are generally interested in the profitability of the business as the earnings of their investment depends on it.

The profitability ratios in relation to sales are:
(a) profit margin (gross and net)
(b) Expenses ratio (operating ratio).

This ratio in relation to investment is measured by:
(a) return on assets
(b) return on capital employed and
(c) return on shareholder's equity.

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<th>Sales</th>
<th>Operating Income</th>
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<td>Operating Sales</td>
<td>Operating Assets</td>
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DU PONT CHART

The DU-PONT chart is a useful tool for evaluating inter industry profitability. This chart was originally developed by DU PONT de Nemours & Company Wilmington, U.S.A. and was put in 1921.

DU-PONT chart showing Inter-Relationship of factors Affecting Return on Investment.
RATE OF RETURN INVESTMENT

NET PROFIT AS PERCENTAGE OF SALES

TOTAL INVESTMENT DIVIDED BY SALES

GROSS PROFIT = SALES LESS COST OF GOODS SOLD

INVESTMENT TURNOVER

SALES DIVIDED BY TOTAL ASSETS

FIXED ASSETS Plus CURRENT ASSETS

Minus

EXPENSES SELLING

OFFICE

OTHERS

Minus

INCOME TAX

Alternatively

SHAREHOLDERS EQUITY

Plus

LONG TERM BORROWED PROFIT

Plus

CURRENT LIABILITIES
2.4.2 COMPARATIVE AND COMMON SIZE INCOME STATEMENT ANALYSIS

Comparative and common size income statement analysis is significant in as much as it shows that a large particular amount of net sales figure was used in meeting cost. "It is a technique under which the total of assets or liabilities in case of balance sheet and the figure of net sales in case of profit and loss account are taken equal to 100, and the percentage of individual items are calculated. The technique of analysis is useful when we wish to compare one company with another, for presentation of the data in percentage form, eliminates problems relating to differences in organisation size"

2.4.3 TREND ANALYSIS

Trend analysis makes it easy to understand the changes in an item or a group of items over a period of time and to draw conclusions regarding changes in data. For the purpose a base year is chosen and the amount of that item relating to base year is taken equal to 100. It is a dynamic method of analysis showing the changes over a period of time. This method of analysis indicates the direction in which a concern is going and on this basis forecast for future can be made" (N.P. Agrawal & S.K. Mangal (1988).

2.4.4 VALUE ADDED ANALYSIS

This analysis is generally prepared to show the generation of value added and the application of value added. Value added is calculated by deducting the total of the cost of bought in of materials and services from the amount of sales and income from
services. The value generated belongs to workers, government, providers of finance and business firm. This statement also reflects the percentage increase/decrease in value added over years.

2.4.5 OTHER TECHNIQUES OF ANALYSIS

The use of various statistical techniques is also made frequently for financial analysis. The tools generally applied are moving average, index numbers, range, standard deviation, diagrammatic and graphic, presentation are often used in financial analysis.

2.5 OBJECTIVES OF THE STUDY

(I) To make an effort to analyse the profitability of selected automobile companies in Thailand.

(II) To study and analyse the reason of low profitability.

(III) To analyse balance sheets and utilisation of assets.

(IV) To evaluate the value of the selected companies.

(V) To suggest measures to increase profitability.

(VI) To study the trend of profit in selected companies during five years under study (1993 to 1997)

2.6 HYPOTHESIS

We have to take the following hypothesis for analysing profitability of selected companies under study:

To develop the conceptual basis of profitability, the hypothesis is that "profit" is only measurable variable that can be used for the analysis of profitability of an industry.

"Return of Investment" is a basic measure of profit; ability of an industry. The assets turnover constitutes an essential parts of inter-related and inter-dependent variables which are taken to the account for computing return on investment.
Some of the automobile companies in Thailand do not achieve the expected profitability because of certain reasons like under utilisation of the increased capacity, heavy expenditure on sales and administration and low assets turnover ratio. If these obstructions are removed and companies have been managed properly, the companies would achieve better profit.

2.7 METHODOLOGY OF THE STUDY

The companies which are selected for this study are:

1. Toyota Motor co.Ltd.
2. Isuzu co.Ltd.
3. Nissan co.Ltd.
4. Mitsubishi co.Ltd.
5. Mazda co.Ltd.

The data relating to the profitability position of all the five selected companies have been collected from the published annual reports and accounts of these companies for five years 1993 to 1997. These reports were obtained from the offices of these respective companies. Other relevant informations have been collected from Thailand Automobile Guide, Financial Express, and the Journal of Industry and Trade.

For analysing the profitability of the companies selected the profit and loss accounts and balance sheets of the companies under study have been recasted and produced in a condensed form. The figures have been rounded off up to two decimal places in million of Bahts. (1 Rupees equal to 1.00 Baht) The techniques of Ratio Analysis, Trend Analysis, Common Size Income Statement Analysis and Value Added Analysis have been adopted.

Note: "Baht" is the Thai Currency Note. 1 Baht = 1 Rupee