CHAPTER -2

CONCEPTUAL FRAMEWORK OF FINANCIAL PERFORMANCE
## CHAPTER: 2

### CONCEPTUAL FRAMEWORK OF FINANCIAL PERFORMANCE

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CONCEPTUAL FRAMEWORK OF FINANCIAL PERFORMANCE

2.1. INTRODUCTION

Financial Performance is the snapshot of a position of concern and ability to withstand the ever-changing environment. It is the blueprint of the financial affair of the concern and reveals how a business has prospered under the leadership of a management personnel. In fact, it can be said that financial Performance is the medium of evaluation of management efficiency.

The overall object of business is to earn satisfactory returns on the funds Invest in it. Consistent with maintaining a sound financial position, an evaluation of such performance is done in order to measure the efficiency of operations or profitability of the organization and to appraise the financial strength as compared with a similarly situated concern.

Thus, financial Performance is generally directed towards evaluating the Liquidity, stability and profitability of a concern which put together symbolize the financial Performance of a concern.

2.2. CONCEPT OF PERFORMANCE EVALUATION / EFFICIENCY

Performance Evaluation is closely related to the surety of the working system of a company as a whole. According to Sudha Nigam “Efficiency is a technique to evaluate past, current and projected performance of a concern.” It is a powerful applied tool to examine, to measure to interpret and to weigh critically and draw outputs.
Efficiency is done by different specialist who examines the specific problem with their company. Efficiency can be divided into two parts (1) Internal (2) External. According to Pitt Francis “Internal efficiency of the company not only making some of having adequate human, physical and financial resources but seeing that they are optimally employed.”

Thus, the concept of efficiency means to evaluation and performance of a Concern included in the appraisal. The word efficiency as defined by the Oxford dictionary state that “Efficiency is the accomplishment of or the ability to accomplish a job with a minimum expenditure of time and effort. It refers to the internal process that leads to output. It focuses on the means to achieve the desired end. As expressed by Peter Drucker “Doing the things the right way is efficiency.” This denotes the fulfillment of the objective with minimum

2.3. OBJECTIVES OF FINANCIAL PERFORMANCE EVALUATION/ EFFICIENCY

Financial efficiency is a technique to evaluate past, current and projected Performance of a concern. Generally, financial efficiency is concerned with the Analysis of financial statements. This analysis can be applied to any kind of detailed information of financial data. The main purpose of this analysis is to evaluate past performance for earnings, ability to pay interest and debt on maturity and profitability of a concern. R.F. Salmanson, R.H. Hermanson and J.D. Ewards have stated that, “a modern business firm has many objectives or goals, including some social objectives such as providing job opportunities and comfortable working conditions for its employees.

According to S.K. Das “The Primary objectives of efficiency of financial statements are to determine the measure of efficiency of operations or the profitability from its income statement and to appraise financial strength as compared with similarly situated concern.”
A study in order to be useful should be object oriented. Objectives work as a compass for an analyst. Thus the efficiency of financial statements should always be turned to the objectives.

In the words of R.N. Anthony “The overall objectives of a business return on the funds invested in it, consistent with maintaining a sound financial position.

2.4. THE MEASUREMENT OF PERFORMANCE EVALUATION

Concept of Measurement

According to P. C. Tripathi “Measurement may be defined as “The assignment of numerals to characteristics of objects, persons, states or events according to rules. What is measured is not the object, person, state or event itself, but some characteristics of it. When objects are counted, for example, we do not measure the object itself, but only its characteristic of being present. We never measure people, only their age, height, weight or some other characteristics.”

According to Michael Mascon “Performance is dependent on the efforts, abilities, traits and the individual’s perception of his role.”

While measuring the performance/efficiency of a firm or an enterprise, we need measuring units. Human aims and beliefs are realized through the Establishment of diverse kinds of associations. All associations were established in fulfillment of some goals and objectives. This association needs efficiency Measurement to find out as to how much is organization has achieved in its course of action for its targets.

The financial efficiency is a vital unit to measure the efficiency of firms. Therefore, financial statements are prepared to serve the objective.
According to Eldon S. Hendriksen “The primary focus of financial reporting information is about an enterprise’s performance provided by measure of earnings and its components.”

Erich A. Helfert rightly remarks, “The measurement of business efficiency is more complex and difficult. Since it must deal with the effectiveness with which capital is employed, the efficiency and profitability of operations and the value and safety of various claims against the business.”

The main object of preparing financial statement is to show the result achieved by an enterprise through its operations the revenue and the expenditure accrued to fulfill that revenue and the actual financial position for the particular period on a particular date. In order to analyze financial statement properly, users must have a basic Understanding of the concept and principles underlying their preparation. Without such an understanding users will not recognize the limits of financial statements. In any business enterprise, accounting provides financial data through income statements, balance sheet and sources and uses of fund statements.

According to sanely B. “The financial manager must know how to interpret and use these statements in the allocation of the firm’s financial resources to generate the best return possible in the long run. Finance is the link that integrates the economic theory with the numbers of accounting.”

Measurement of efficiency through the financial statement analysis provides a good knowledge about the behavior of financial variables for measuring the efficiency of different units in the industry and to indicate the trend of improvement or deterioration in the organization.

### 2.5. AREAS OF EFFICIENCY

There are areas where the efficiency can be improved by effective assessment of performed by a business enterprise in different areas of operations. The areas of operations may be termed as the area of efficiency.
2.5.1 Service Production and Productivity, Efficiency

Service Production is the most important area of the efficiency, and productivity is the systematic analysis for evaluating the service production function. The service production efficiency of public sector insurance company can be compared for different years with the one other competitive public sector insurance companies.

The analysis of capacity utilization and component part analysis of service production can significantly prove the service production efficiency of an insurance company as a whole.

2.5.2 Profitability Efficiency

Profitability is the ability to earn profit. The insurance company management is vitally interested in profit as it is often used as an efficiency measure.

Measurement of profitability is the overall measurement of efficiency. Profit is also important to financial institutions, bankers and creditors. Profitability efficiency can be made by computing and interpreting various profitability ratios.

2.5.3 Liquidity Efficiency

By checking the fluctuations most probably in current assets, the researcher can take the estimate of liquidity efficiency.

2.5.4 Working Capital Efficiency

Generally working capital is said to be excess of current assets over current liabilities. It is used for regular business costing of loans and advances, payment of wages, direct and indirect expenses, investments, credit granted to customers and cash on hand. It is the lifeblood of each insurance company.
As soon as the heart gets blood, it circulates the same in the body. In the same manner working capital funds are obtained and circulated in insurance operations. As and when this circulation stops, the insurance business becomes lossless. So the working capital has an important place in the area of efficiency.

2.5.5 Fixed Assets Efficiency

According to foutke, Roy A. Some part of the capital of every master artificer or manufacturer must be fixed on the instrument of his trade.” Usually a firm does not deal with fixed assets, so they are not trading assets. They are also not acquired for sale. The amount invested in these assets is released gradually from every unit of sales made during the serviceable life of the assets. Analysis of fixed asset structure average annual growth of fixed assets, impact of gross block on sales and operating profit margin, and efficiency in the use of fixed assets may depict the efficiency of fixed assets. Since the depreciation is directly related to fixed assets. The study of depreciation and the depreciation provision policy in using fixed assets can also be useful.

2.5.6 Fund Flow Efficiency and Cash Flow Efficiency

Here a fund-flow statement of insurance company is prepared to check the receipt usage of fund and cash flow statement of insurance company is prepared to check the receipt and usage of cash.

2.5.7 Social Efficiency

The value of all the resource concerned with the insurance industry is called social efficiency. They may be men, material, money and machines. All these resources which are to be used for the welfare of society and the insurance industry are included to evaluate social efficiency.
2.6 THE CONCEPT OF “APPRAISAL”

“Appraisal” is just an intelligent application of techniques to examine, to measure, to interpret, and then to draw some conclusions. The appraisal is mostly done by the researchers or experts, who evaluate the problem with their viewpoint. When we correlate appraisal with the efficiency we mean to say “Appraisal of Efficiency.”

The appraisal of the efficiency of any general insurance company is depended upon the final accounts prepared and published by the general insurance company.

Appraisal of efficiency of general insurance public sector companies is very similar to the concept of checking human body. As we need a medical check-up and routine examination for our bodies to maintain our fitness, likewise the appraisal of efficiency of the insurance company is needed periodically as well as regularly. Such critical assessment not only draw our attention to remedy a deteriorating condition, but also to show the way and means to raise the efficiency to the possible maximum limit. The appraisal of efficiency is useful in two ways. In the insurance industry, appraisal of efficiency involves a wide area of study. The perspective throughout is on the effective management of the general insurance industry.

A careful consideration and critical analysis of financial statements can be yardstick for the appraisal of efficiency of general insurance company. Generally, financial statements used in any general insurance company are the profit & loss account and balance sheet. Though the statement of change in financial position and value added statements are also prepared and appended to annual reports, they may be considered as additional financial statement.

The data embodied in financial statements are rearranged in order to facilitate the appraisal of efficiency and the monetary figures are approximated to the nearest rupee to simplify the process of appraisal. The comparative data obtained by applying the tools and techniques of efficiency appraisal are evaluated, interpreted and reported in an understandable form. On the basis of all the areas of performance, the final
conclusions are arrived at as a result of the appraisal of efficiency presented in the form of a report, which highlights the efficiency of the general insurance industry concerned.

Appraisal of efficiency as a developmental tool for general insurance company, it is not as much the final product or the final assessment that is important as the whole process of appraisal. The learning opportunity for the appraiser and the appraise starts with setting of tasks and targets and manifests in the whole appraisal procedure such as self-appraisal interviews, final appraisal and regarding, developmental planning, etc.

However, the appraisal of efficiency may not give a correct answer to every question of doubt it may bring to light, but it can and will point to the direction in which further inquiries should be made. Hence, no single attempt can give firm results of appraising general insurance company’s efficiency. General insurance company’s conditions may differ by way of location, type of facilities, product and services, capital structure, capacity, accounting policies, level of performance and caliber of general insurance company’s management.

Conditions General insurance public sector companies have become more complicated in the advert of multi-product and multi services. An analyst should keeping mind all these differences at the time of appraising the efficiency of various general insurance companies.

2.7 THE NEED AND IMPORTANCE OF APPRAISAL OF EFFICIENCY

The need and importance of appraisal of efficiency rise from the viewpoint of different parties, which are actively interested in the affairs of the general insurance public sector companies.

These parties are as below-
(1) **Management:** According to Erich A. Heifert, “Managers are responsible for the efficiency, current and long term operations and effective development of capital and other resources in the process.” Appraisal of efficiency may help management in evaluating the effectiveness of its own plans and policies. The managements can measure the effectiveness of its own plans and policies, determine the advisability of adopting new policies and procedures and documentation to owners as a result of their management efforts by doing an appraisal of efficiency.

(2) **Employees and Trade Unions:** Employees of the general insurance companies are interested in profits and the financial position of a company. The employees measure the efficiency of the general insurance company with the satisfactory profit margin and adequate cash flow. The employees can compare the best efficiency and the present efficiency of company by appraisal of efficiency. Even the trade union of companies uses appraisal of efficiency of company for demanding an increase in wages and facilities.

(3) **Investors:** Investors are the real investor of any enterprise. In case of the insurance industry, the investors can know profitability, productivity and overall efficiency of the company by studying appraisal of efficiency.

(4) **Policyholders:** The policy holders, wanted a business with a general insurance company, general appraise the efficiency of a company before taking insurance. The policy holders are interested in good services as well as monetary benefits offered by general insurance companies, cash flow and liquidity of insurance companies. They can know these each aspect by referring appraisal of efficiency.

(5) **Government:** By studying the appraisal of general insurance companies the government can assess the growth of industries and economies. Moreover the government can take decisions about tax structure and incentives for the general insurance industry.
(6) Society: In the society, there are various agencies like media, stock exchanges, Economists, tax who are interested in appraisal of efficiency of general insurance industry. The society expects security of their beloved property which is provided by general insurance company mainly. The society also wishes to survive against risk of natural and accidental disaster by getting help from general insurance company. The societies at large also expect to know about the social efficiency such as environmental obligations, employment avenues and social welfare etc.

2.8 THE ROLE OF FINANCIAL EFFICIENCY IN PLANNING, CONTROL AND DECISION MAKING:

Financial efficiency plays an important role in providing so many useful information to the insurance management as it is inevitably needed for planning, control and decision making. Decisions always relate to what has to do immediately, in the near future and in the long run. For this, the insurance management requires various types of information, both qualitative and quantitative. Financial efficiency has taken on increasingly the task of providing the quantitative information. This term also includes provision of such information as will enable the management to exercise control over the day to day operations with a view to ensuring maximum efficiency and adherence to the plans of the insurance management. This control is different from control over property and assets, as it looks at things from such angles.

(a) That the work which had to be done has to be done without loss of time.
(b) That the cost incurred in doing the work is not more and is within the estimated limits. Also for planning, control and decision making of capital projects, such as expansion and diversification, financial efficiency provides and examines a great deal of information.
2.9 APPLICATION OF APPROPRIATE TECHNIQUES

The Techniques of appraisal of Performance Evaluation

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Ratio Analysis as a tool of Performance Evaluation

A Ratio analysis means the process of computing, determining and presenting relationship of items and groups of items in the financial efficiency. Ratio expresses the numerical relationship between the two figures. Accounting ratios are used to describe significant relationships, which exist between figures shown on a balance sheet, in a profit and loss account, in a budgetary control system or in any other accounting organization. The technique of ratio analysis involves four steps viz, determining the accounting ration to be used, comparison of ratio with the standard set and interpretation. An analyst has to determine which ratio is to be used, then he/she computes it and compares it to standards, but no such standards have been set up by the Indian industries till today. The interpretation of ratio requires careful, detailed study and sound judgment on the part of the analysis.

Significance of Ratio Analysis

The significance of the ratio analysis depends on the purpose of which it is made by the analyst. The important points of significance are as under.
A useful tool in the hands of management.
- Inter-firm comparison is possible.
- Trend Analysis may be easier.

Limitations of Ratio Analysis

Ratio Analysis suffers from a number of drawbacks. Difficulty in comparison due to (a) Different procedures and practice followed by different firms. (b) Different accounting periods.

Classification of Ratios

The ratio can be classified into two different categories depending upon the basis of classification (A) The Traditional classification (B) Classification Based on Nature of Ratios.

A. The Traditional Classification

The traditional classification has been made on the basis of the financial Statements to which the determinants of a ratio belong on this basis the ratio could be classified as...

(i) Profit and Loss Account Ratio Ratios are calculated on the basis of the items of Profit and Loss Account only.

(ii) Balance Sheet Ratios are calculated on the basis of the figure of balance sheet only.

(iii) Compensative Ratios are calculated on the basis of Profit and loss account as well as a balance sheet.

B. Classification Based on Nature of Ratio

To get a correct view of the profitability and financial soundness of a firm and to make a systematic study. The ratio is classified as under
(i) **Liquidity Ratio** This ratio indicates the liquidity position of a company. These ratios show the ability of a company to meet its short-term obligation. Current ratio, liquidity ratio and quick or acid-test ratio are included in liquidity ratio.

(ii) **Leverage Ratio or Structural Ratio** These ratios are used to judge the long term financial position of the firm. These ratios indicate the funds provided by the long-term creditors and owners. Leverage ratios are calculated from Balance-sheet items. Leverage ratios are (i) Debt equity ratio (ii) Gearing Ratio (iii) Debt to total Capital Ratio.

(iii) **Coverage Ratio** the coverage ratios measure the relationship between what is normally available from the operations of the firms and claims of the out-siders. Coverage Ratio includes (a) Interest Coverage Ratio (b) Dividend Coverage Ratio (c) Total coverage Ratio

(IV) **Profitability Ratio** Profitability ratio is calculated to measure the management’s overall efficiency. Various other parties like creditors, shareholders, prospective investors, bankers, financial institutions and the Government are also inserted in analysis of the profitability of a company.

Therefore the following ratio can be computed to analyze the profitability.

(v) **From Management Point of View** The management is mainly interested in finding out the amount of profit in comparison with sales ratio are mostly computed (1) Gross Profit Ratio (2) Net Profit Ratio (3) Operating Ratio (4) Operating Profit Ratio (5) Return on net capital Employed (6) Return on shareholders’ Funds (7) Return on Total Assets (8) Return on Gross Capital Employed (9) Return on Paid-up Share-Capital

(vi) **From Shareholder’s Point of View** Shareholders of the company are interested in the profitability a company as the earning are distributed amount them in the form of dividend. If the amount of earning is higher the rate of dividend will naturally be higher. For this purpose the following ratio is computed. (1) Earning Per Share (2) Dividend per Share (3) Dividend Payout Ratio (4) Price Earnings Ratio

(vii) **From Creditor’s Point of View** Bankers, financial institutions and trade creditors look at the profitability ratio as an indicator whether or not the company earns substantially more for the payment of their interest and principal amount.


Comparative and common size Income Statement Analysis

Profitability analysis is very useful to comparative basis, so, it is paramount importance that a series of statements over a period of years should be used. Comparative and common size income statement is the simplest technique, the figure of net sales is taken equal items are computed likewise. The statement so prepared provides a common basis for comparison as such the statement is termed as the common-size statement. The tent revealed by common-size is more authentic as it shows. “Qualitative Assessment” as opposed to “Quantitative Assessment”

This statement shows two important problems, which are as under

(1) It follows the concern of widely differing size to be directly compared.
(2) It allows an accurate comparison of financial activities of a company which have greatly changed in size over a few years.

Trend Analysis

Trend analysis is immensely helpful in making a comparative study of the changes in an item of groups of items over a period of time and to make conclusions regarding the change in date. For this purpose, a base year is selected and the amount of the item relating to the base year is taken equal to a hundred. The technique of trend analysis over a period of time, Relating to this, Anthony rightly noted that “If the values for other periods, this comparison is called a horizontal or trend analysis.” This technique shows the direction in which a concern is going on and on this basis a forecast for the future can be made in this technique.

Comparative Financial Statement

Comparative financial statements are statements of financial position of a business designed to provide time perspective to the consideration of various elements of financial position embodied in such statements comparative statements reveal following

(i) Absolute data (Money value rupee amounts)
(ii) Increase or reduction in absolute data (in terms of money values)
(iii) Increase or reduction in absolute data (in terms of percentage)
(iv) Comparison (in terms of ratios)
(v) Percentage of totals.

**Comparative Profit & Loss Account**

A comparative income statement / profit and loss account shows the absolute change from one period to another. Since the figures are shown side by side, the user can quickly understand the operational performance of the firm in different periods and draw conclusions.

**Comparative Balance Sheet**

Balance sheets as on two or more different dates are used for comparing the assets, liabilities and the net worth of the company. The comparative balance sheet is useful for studying the trends of an undertaking.

**Standard Costing**

“Standard costing” is a technique which uses standards for costs and revenues for the purpose of control through variance analysis. Standard is a predetermined measurable quantity set in defined conditions against which actual performance can be compared, usually for an element of work operation or activity. Standard costing involves the setting of predetermined cost estimates in order to provide a basis for comparison with actual costs. A standard cost is a planned cost for a unit of product or service rendered. Standard costing is universally accepted as an effective instrument for cost control in industries. Although the terms budgeted and standard costs are sometimes used interchangeably, budgeted costs described the total planned costs for a number of products. Usually budgetary control is operated with a system of standard costing because both systems are inter-related but they are inter-dependent.
Budgetary Costing

Budgetary costing is defined by the terminology as “The establishment of budgets relating the responsibilities of executives to the requirements of a policy and continuous comparison of actual budgeted results, either to secure by individual action the objectives of that policy or to provide a basis for revision.”

This definition clearly lays down that budgetary cost requires the establishment of budgets relating the responsibilities of executives to the requirements of a policy. Budgetary cost, thus involves the preparation of budgets and their application for control purposes. Accordingly, there can not be cast without budgets, and mere budgets do not achieve the objective of cost unless the actual results are compared with targets laid down.

Preparation of budgets of budgeting is planning function, and their application or implementation is a control function. The actively involved in both the function accomplishes budgetary control.

2.10 CONCEPT OF PROFIT

Concept of Profit

The word “profit” has had French / Latin origin in “Proficere” (being useful or proficient), “Profecus” and profectum (to make progress). Thus, profit is an index of proficiency or progress, as typified by “the gain resulting from the employment of capital.” The excess or returns over expenditure pecuniary gain in any transaction / occupation.”

Profit can arise when the price paid by the customers for the product of the business firm exceeds the cost that has been incurred for it. Profit has been defined in a number of ways by accountants, economists and others as per its use and purpose.
They have been many theoretical discussions of the concept of profit, but there is no consents on the precise definition of this theoretical construct. There are two main concept one is accounting concept and other is economic concept. But the concept of profit as an excess of revenue over the total cost differ in these two concepts. As a result the accounting concept of profit differs from economic concept and the figure of accounting profit will differ from that of economic profit. However, the various concepts of profit have been shown below which will give a clear conception of profit.

**Accounting Profit:** “The excess of revenue over related costs applicable to a transaction, a group of transactions of an operating profit is profit.” The more commonly use accounting forms of profit are gross profit, operating net sales and the cost of goods sold during a given period is termed as ‘Gross Profit’. For service firm the cost of services sold includes the price paid for services and all the expenses directly related to such services, while for a manufacturing firm it includes the cost of raw materials and direct cost of labor and power. If the selling and administrative expenses and provisions for non-cash items like depreciation are deducted from gross profit, the resultant figure is known as operating profit, while net profit is the residual income left after meeting all the contractual and non-contractual expenses such as administrative, selling and distribution costs.

**Economic Profit:** Back in 1939 the famous economist J. R. Hicks defined a man’s income as “the maximum value which he can consume during a week, and still expect to be as well off at the end of week as he was at the beginning.”

Economic profit is the residual of income meeting all the ‘explicit’ and ‘implicit’ items of expenditure for a given period. The term explicit item of expenditure has the same meaning that has discussed “Accounting Profit”, but the implicit items of expenditure include the amount of those factors of production which are owned by the owner. For example, the rent of winning land and building, the interest of own capital and salary of owners are termed as “implicit costs” or opportunity costs”. However the term economic profit in the form of an equation can be represented as under:
Economic Profit = Accounting profit – Implicit Profit

In Economics the accounting profit is known as gross profit while the profit remaining after subtracting the implicit cost of the owner’s time and capital invested is known as “pure profit.”

**Business Profit OR Income:** Businessmen and accountants usually look upon the entire return to stakeholders as profit or income, and do not regard any part of return as a cost. Thus business profit is pure profit plus the normal return on investment, which is also the difference between end-of period wealth and initial investment.

**Social Profit:** The business units are using scarce resources of the society. So they should be accountable towards the society which provided the resources. Therefore the social responsibility of the enterprise has been stressed. An increasing awareness of the social responsibilities on the part of business unit has led to discussion of “Social Profit”.

Eichorn and Clerk Abt. Associates of the U.S. have suggested “Social Statement Approach for social accounting in which the term ‘social profit or social surplus has been defined under this approach, the excess of social benefits over social cost is termed as “Social Profit” or Social Surplus.

The social benefits made available to the society by the business unit includes the employment generation, payment for goods and author services, taxes paid, contributions, dividends and interest paid, additional direct employee benefits like creating good townships, offering good condition of work environmental improvements. Any cost sacrifice which proves a detriment to society, whether economic or non-economic, internal or external is termed as social cost. Social cost include goods and materials acquired, buildings and equipment purchase, labor and services used, work related to injuries and illness, public services and facilities used, environment damages like terrain damage, air pollution water pollution, nice
pollution, solid waste, visual and aesthetic pollution. However there is no clear concept for measuring social benefits and social costs.

2.11 CONCEPT OF PROFITABILITY

The word ‘profitability’ is composed of two words via, ‘profit and ability. As discussed earlier’ Profit’ contained in a number of ways, but the meaning of ‘Profit’ change as per the use and purpose of the figure. The term ability shown the power of business brim to earn profits. The term ability is also referred to as a earning power’ or’ operating performance’ of concerned investment. Thus the term profitability can be defended as the earning power capacity of profit of business firms’ The word ‘profitability may be defined as the ability of giving investment to earn a return from its use “ It can be remarked that “ profitability’ is helpful in a usual basis for measuring business performance and overall efficiency.

Profit and Profitability

Profit is a measure of surplus wealth generated by a business firm from its operations. Profit is the excess of net sales revenue over the cost of goods sold while Profitability is the profit making ability of the business firm showing either steady or increased or decreased state of such ability during a specified time Profit is an absolute connotation showing absolute figures which alone cannot give an exact idea of change in efficiency of business firm when as profitability is a relative concept which gives a clear idea of variation in efficiency. Thus, profit and profitability are two different concepts. However They are closely related and mutually interdependent, having a distinct role in business It may find having game amount of sales in two different business firms the profitability R.S. Kulshresth has rightly stated that “Profit in two separate business concern may be identical; yet, many a time has usually happened that their profitability varies when measured in terms of size of investment. Hence, it can be said that profitability is a broader concept compared to the concept of profit.
2.12 PROFITABILITY AND EFFICIENCY

Profitability is also not synonymous with “efficiency” though it is an index of efficiency, it is regarded as a measure of efficiency and management guide to greater efficiency. No doubt, profitability is an important yardstick of efficiency, but the extent of profit cannot be taken as a final proof of efficiency.

Sometime satisfactory to profits can mask inefficiency and conversely, a proper degree of efficiency can be accompanied by absence of profit. The net profit figure simply reveals a satisfactory balance between the value receive and value given. The change in operational efficiency is merely one of many factors on which profitability of an enterprise largely depends between cost and profitability. Moreover, there are many other factors besides efficiency which attest the profitability.

Factors affecting the Profitability

The following are the two main factors which affect the profitability of a business firm:

1. Operating profit margin
2. The Rapacity of turnover of capital employed profitability of is the product of these two factors and thereore maximum or optimum profits can be earned only by maximizing them. In technical terms, the combination of these two factors is known as the “triangular relationship.” Its significant exits not only in its use as an analytical tool but also because the profitability ration can be calculated directly from the specific earnings and investment data. It is also useful in explaining the two forces bearing upon ultimate results and therefore, establishes the area of business operations which must be properly controlled if expected results are to be achieved.

3. Profitability is the product of these two factors and therefore maximum or optimum profits can be earned only by maximizing them. In technical terms, the combination of these two factors in known as the” triangular relationship its significant exits not only in its use as an analytical tool but also because the profitability ratio can be calculator directly from the. specific earnings and
investment data. It is also useful in explaining the two forces bearing upon ultimate results and therefore, establishes the area of business operations which must be properly controlled if expected results are to be achieved. The Triangular relationship has been shown in the following figure. It can be shown in an equation from asunder:

\[
\text{Profitability} = \frac{\text{Sales} / \text{Income of premium}}{\text{Operating Income}} \times \frac{\text{Income of premium} / \text{sales}}{\text{Operating Income}} = \frac{\text{Operating Income}}{\text{Operating Assets}}.
\]

Where “operating Assets” are used for ‘capital employed ‘and income from the utilization of capital employed in the business firm. The interrelationship between the above ratios has to be understood with a view to analyzing profitability. The rate of return on investment is the result of the profit margin and turnover of assets in sales / income of premium. These two components are multiplied for arriving at the profit percentage on investment. Each of these two components is itself an end – product of interrelated factors. These components are helpful in the investigation the financial composition, analyzing current financial position and formulating the financial forecasting future of a business firm.

**Importance of Profitability**

Profit is a very good indicator of business performance. But the real standard of performance of a business firm cannot be judged by the absolute size of its periodic profit for that profitability is a good device which represents the earning of a business firm. Modern management is engaged in the task of maximizing the profits and wealth. The efficiency of management is measured by the profitability of the business the greater is the profitability of the business, the more will be the efficiency. “Analysis of the profitability reveals as to total transactions made during the year it need not be stressed that profitability is analyzed through the computation of profit ratios.
Profitability of a business firm is very much helpful to the management, creditors and shareholders of a business firm. The management of a business firm has to take some crucial managerial decision like future expansion, raising of additional finance and problem of bonus and divided payments etc. and for this purpose the management greatly rely upon the profitability of the business firm. Moreover, management can evaluate the operational efficiency of the business firm. The creditors of a business firm are also interested in the profitability of business. Firms are also interested in the profitability of business firm. On the basis of profitability they decide their policy regarding the business firm. The shareholders are equally interested in the profitability of the company. The shareholders cannot be judged by the absolute size of its periodic profit. For that profitability is a good device which represents the earning capacity of a business firm. Modern management is engaged in a task of maximizing the profit and wealth – The efficiency of management is measured by the profitability of the business.

2.13 CONCLUSION

The chapter reveals the concept of financial efficiency by an easy explanation of framework related to the research topic. For that the chapter deals with the points like objectives of financial efficiency, measurement of efficiency, area of efficiency, the role concept of an appraisal, the needs and importance of appraisal of efficiency, the role of financial efficiency in planning, control and decision making. The chapter deals with the analysis of some important points like application of appropriate techniques, concepts of measurement and profitability, and importance of profitability. The operational efficiency of the business firm.
2.14 REFERENCES:

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