UNIT III

LESSON 11 **PROFIT POLICY**

STRUCTURE

11.1 INTRODUCTION

Profit may imply monopoly profit. It is earned by a firm through extortion, because of its monopoly power in the market. It is not related to any useful specific function. Thus monopoly profit is not a functional reward. Profit may sometimes be in the nature of a windfall. It is an unexpected reward earned by a firm just by mere chance, an inflationary boom.

11.2 OBJECTIVES

The objective of this lesson is to provide information about:

- The concept of profit
- Meaning of profit policy
- Objectives of profit policy

11.3 CONCEPT OF PROFIT IN BUSINESS

The concept of profit entails several different meanings. Profit may mean the compensation received bya firm for its managerial function. It is called normal profit which is a minimum sum essential to induce the firm to remain in business. Profit may be looked upon as a reward for true entrepreneurial function. It is the reward earned by the entrepreneur for bearing the risk. It is termed as supernormal profit analysis.

Profit is the earning of entrepreneur. To the economist, the most significant point about profit is that it is a residual income. However, the term profit has different connotations.

In short, the following are the distinctive features of profit as a factor reward:

(i) It is not a predetermined contractual payment.

(ii) It is not a fixed remuneration.

(iii) It is a residual surplus.

(iv) It is uncertain.

(v) It may even be negative. Other factor rewards are always positive.

Gross Profit and Net Profit:

In ordinary parlance, profit actually means gross profit.

Gross profit is a term in which the following items are included in addition to the net profit due to the entrepreneur:

(i) Remuneration for factors of production contributed by entrepreneur himself.

(ii) Depreciation and maintenance charges.

(iii) Extra personal profits.

(iv) Net profit.

Net profit is the exclusive reward for the entrepreneur for the following functions performed by him:

(i) Reward for co-ordination

(ii) Reward for risk taking

(iii) Reward for uncertainty bearing, and

(iv) Reward for innovation.

In short,

Gross Profit = Net profit + implicit rent + implicit wages + implicit interest + normal profit + depreciation and maintenance charges + non-entrepreneurial profit.

Net Profit = Gross profit – (implicit rent + implicit wages + implicit interest + normal profit + depreciation and maintenance charges + non-entrepreneurial profit)

In fact, Net Profit = economic profit or pure business profit. It is the net profit which may be positive or negative. A negative profit means a loss.

Accounting Profit and Economic Profit:

An accountant looks at profit as a surplus of revenues over costs, as recorded in the books of accounts. An accountant is interested in accounting, auditing, planning and budgeting profit. The accountant does not take care of implicit or opportunity cost. Accounting profit is also called residual profit.

For the business firm, accounting profit is very important. Accounting profit is defined as the revenue realised in a given period after providing for expenses incurred during the production of a commodity. A firm while making accounting profits may be incurring economic losses. Such a firm would have to withdraw from business in the long run. In the balance sheet of a firm, accounting profit occupies an important place.

The economist, however, does not agree with the accountant's approach to profit. The account-ant would only deduct the explicit or actual costs from the revenues to determine profit. The economist points out that in addition to the deduction of explicit cost, imputed cost, i.e., the cost that would have been incurred in the absence of the employment of self owned factors, should also be deducted.

Their examples are:

(i) Entrepreneur's wages that he could earn by working for someone else,

(ii) Rental income on self-owned land and building employed in the business, and

(iii) Interest on self owned capital that could have been earned by investing it elsewhere.

Thus the profit arrived at after deducting both explicit and imputed costs may be called economic profit. From the managerial point of view, economic profit is very important because this alone shows the viability of a firm.

Normal Profits and Supernormal Profits:

Normal profits refer to the imputed returns to capital and risk-taking just necessary to prevent the owners from withdrawing from the industry. The normal profits are usually defined as the supply price or opportunity cost of entrepreneurship. Such cost must be covered if the firm is to stay in business in the long run.

When competition among entrepreneurs is perfect, the market price of the product is equal to average cost which itself includes 'normal profit'. Normal profit is the minimum to induce the entrepreneur to remain in the business in the long run.

It is possible that the entrepreneur may not get normal profit in the short run and may have to sell his product at a loss, but in the long run every entrepreneur must get at least the normal profits. It is assumed to be part of the price. In the words of Mrs. Joan Robinson, "Normal profit is that profit which neither attracts a new firm to enter into the industry nor obligates the existing firm to go out of the industry."

Supernormal profit is defined as the surplus over the normal profit. It is obtained by the super-marginal firms. The marginal firm gets only the normal profit, but determines the supernormal profit of the intra marginal firm.

Profit as Functional Reward:

Some economists consider profit as a functional reward. According to them, profit is a reward for the entrepreneur for his entrepreneurial functions. Some have said that organising and coordinating other factors of production are the main functions of the entrepreneur. Some others have said that risk-taking and decision making are the important functions of the entrepreneur.

They say that since the entrepreneur takes risks in business, he earns profit. Schumpeter said that the entrepreneur is performing the role of an innovator and therefore profit is a reward for his innovation. Prof. Knight opined that profit is due to his risk taking and uncertainty bearing.

Monopoly Profit:

When a firm possesses monopoly power, it can restrict output and obtain a higher profit than it could under competitive conditions. Profit is the result of continued scarcity. It can exist only in an imperfect market where output is for various reasons restricted and the consumers are deprived of the opportunity of alternative sources of supply.

Sources of such powers are usually found in legal restric-tions, sole ownership of raw materials or access of sale to particular markets. Even some degree of uniqueness in a firm's product confers some monopoly power. Summarising, it can be said that profits may come to exist as a result of monopoly.

Windfall Profit:

Some consider profit as a windfall gain. According to them, profit is not a reward for any entrepreneurial function or monopoly power. It is merely a windfall gain. It arises due to changes in the general price level in the market. If the producer or trader buys his inputs and raw materials when the prices are low and sells the output when the prices have abruptly gone up due to some unforeseen external factors, we call the profit as windfall profit. This is also included under net profit.

Earning of Management:

The entrepreneur having good bargaining power, purchases raw materials at reasonable prices. He makes suitable arrangements to store the raw materials properly. By proper inventory building, he maintains the supply of raw materials regularly.

He hires labour at normal wages and borrows working capital at reasonable rates of interest. Thus he manages and controls explicit costs. Ensuring of supply of capital is the most important function of profit. A certain percentage of net profit is set apart for better management of business.

11.4 PROFIT POLICY

It is generally held that the main motive of a firm is to make profits. The volume of profit made by it is regarded as a primary measure of its success. Economic theory advocates profit maximisation as the chief policy of a firm. Modem business enterprises do not accept this view and relegate the profit maximisation theory to the back ground. This does not mean that modem firms do not aim at profits. They do aim at maximum profits but aim at other goals as well. All these constitute the profit policy.

(i) Industry Leadership

Industry leadership may involve either the achievement of the maxi-mum sales volume or the manufacture of the maximum product lines. For the attainment of leadership in the industry, there has to be a satisfactory level of profit consistent with capital invested, labour force employed and volume of output produced.

(ii) Restricting the Entry

If a firm follows a policy of restricting its profit, no competitors are likely to enter the market. Reasonable profits which guarantee its survival and growth are essential. According to Joel Dean, “Competitors can invade the market as soon as they discover its profitability and find ways to shift the patents and make necessary changes in design, technique, and production plant and market penetration.”

(iii) Political Impact

High profits are considered to be suicidal for a firm. If the government comes to know that the firms are earning huge returns, it may resort to high taxation or to nationalisation. High profits are often considered as an index of monopoly power and to prevent the govern-ment may introduce price control and profit regulation policies.

(iv) Consumer Goodwill

Consumer is the foundation of any business. For maintaining consumer goodwill, firms have to restrict the profit. By maintaining low profit, the firms may seek the goodwill of the consumers. Consumer goodwill is valued so much these days that firms often make organised efforts through advertisements.

(v) Wage Consideration

Higher profits may be taken as an evidence of the ability to pay higher wages. If the labour associations come to know that the firms are declaring higher dividends to the shareholders, naturally they demand higher wages, bonus, etc. Under these circumstances in the interest of harmonious relations with employees, firms keep the profit margin at a reasonable level.

(vi) Liquidity Preference

Many concerns give greater importance to capital soundness of a firm and hence prefer liquidity to profit maximisation. Liquidity preference means the preference to hold cash to meet the day to day transactions. The first item that attracts one's attention in the balance sheet is the ratio of current assets to current liabilities. In order to give capital soundness, the business concerns keep less profit and maintain high cash.

(vii) Avoid Risk

Avoiding risk is another objective of the modem business for which the firms have to restrict the profit. Risk element is high under profit maximisation. Managerial decision involving the setting up of a new venture has to face a number of uncertainties. Very often experienced managements avoid the possibility of such risks. When there is oligopolistic uncertainty, firms may focus attention at minimising losses. The guiding principle of business economics is not maximisation of profit but the avoidance of loss.

Alternative Profit Policies

Economists have suggested different profit policies which business firms may adopt as an alternative to profit maximisation.

These alternative profit policies are listed below

Prof. K. Rothschild observes, "Profit maximisation has until now served as the wonderful market key that opened all doors leading to an understanding of the behaviour of the entrepreneur. It was always realised that family pride, moral and ethical considerations, poor intelligences and similar factors may modify the results built on the maximum profit assumption, but it was right by assuming that these disturbing phenomena are sufficiently exceptional to justify their exclusion from the main body of price theory. But there is another motive which cannot be so lightly dismissed and which is probably a similar order of magnitude as the desire for maximum profits, namely the desire for secure profits". He has suggested that the primary motive of an enterprise is long run survival.

According to him, the assumption of profit maximisation is no doubt valid to the situation of perfect competition or monopolistic competition. Under monopolistic condition, the aim of the firm is to secure monopoly profits. In the case of oligopoly, he says that the assumption of profit maximisation is not sufficient.

W.J. Baumol puts forth the maximisation of sales as the ultimate aim of the firm. He says while maximising sales the producer will not regard costs incurred as output and profits to be made. If the sales of the company increase, it means that the producer is not only covering costs but also making a usual rate of return on investment. Baumol's theory of sales maximisation as a rational behaviour of the producer is considered as an alternative to the theory of profit maximisation.

Benjamin Higgins, Mekin Reder and Tibor Scitovsky have developed another alternative to the theory of profit maximisation, that of utility maximisation, if the producer is supposed to maximise his satisfaction. In this approach, they have introduced leisure as a variable. Leisure is an essential ingredient of an individual welfare. If more work is put in by the producer, the less leisure he will be able to enjoy. It is said that the producer would get maximum satisfaction where his net profit is optimum.

Donaldson and Lorsch are of the opinion that career managers prefer policies that favour long term stability and growth of their firms which are possible only when they get maximum current profits. For the survival, self sufficiency and success, the top managers strive hard and augment corporate wealth. The more the wealth, the greater the assurance of the means of survival.

11.4.1 Objectives of Profit Policy

The firm seeks to achieve many objectives and profit making is the main objective but it is not the only objective. Profit making is no doubt necessary. In addition to adequate profit, the firm often pursues multiple and even contradictory objectives. If a firm makes sufficient profits, it can give good dividends and attractive salaries, etc. The firm can fix a target rate for profits as its investment. There is a problem in determining the target rate of profits.

They are:

(i) Competitive rate of profit

(ii) Historical profit rate

(iii) Rate of profit sufficient enough to protect the equity, and

(iv) Plough back of profit rate.

Competitive rate of profit is the rate earned by other companies in the same industry or of selected companies in other industries working under similar conditions. It may be slightly different from the rate of profit of other companies.

Historical rate of profit is the rate of profit determined as the basis of past earnings in the normal times. The rates should be sufficient enough to attract equity capital, have provided adequate dividend to share holders and have not encouraged much competition.

Rate of profit sufficient enough to protect the equity is the rate sufficient enough to attract equity capital and the rate of return on investment should protect the interest of present shareholders. Plough back of profit late is that late of profit which should be such that there is a surplus after paying the dividends to finance further growth of the industry. Cyert and March have focused on five objectives which represent main operative organisational goals.

They are:

(i) Production goal

(ii) Inventory goal

(iii) Sales goal

(iv) Marketing share goal and

(v) Profit goal

Production Goal

The firms want to maintain the production of the product at a stable level to ensure stable employment and growth. The basic requirement is that the production does not fluctuate.

Inventory Goal

To ensure a complete and convenient stock of inventory throughout the production, a minimum level of inventory has to be maintained so that the firm can prevent fluctuations in prices.

Sales Goal

It is considered as very important from the point of view of stability and survival of the firm. Increasing sales mean progress of the firm. Sales strengthen the organisation. The more are the sales, the more is the profit.

Market Share Goal

Companysales do not reveal how well the company is performing. If the company's market share goes up, the companyis gaining as a competitor, if it goes down the company is losing relative to competitors.

Profit Goal

Profits are a function of the chosen price, advertising and sales promotion budgets. Normal profit is essential not only to pay dividends but also to ensure additional resources for reinvestment.

11.4.2 The Measurement of Profit

The problem of profit measurement has always been a difficult affair. In the present business world, the tendency is to discard the word 'profit' and use a neutral expression as "business income". In the accounting sense, profit is an ex-post concept. Accountants follow conventions and define their terms by enumeration.

Conventional accounting is largely concerned with historical profits rather than anticipated profits. Economists disagree with conventional techniques and theydefine their terms functionally. For an economist, profit is an ex-ante concept.

It is a surplus in excess of all opportunity costs or the difference between the cash value of an enterprise at the beginning and end of a period. From the management point of view, economic profits are a better reflection of profitability of business. The economist is basically interested in the theoretical analysis of profit.

The most important points of difference between the economist's and accountant's approaches centre around:

(i) Inclusiveness of Costs

To determine profits, economists include in costs, wages, rent and interest for all the services employed in the business, including both those actually paid for in the market and virtual wage or interest or rent for services rendered by the owner himself.

To determine profits, accountants only deduct explicit or paid out costs from the income. The non-cost items as the entrepreneurial wages, rental income on land and the interest that the capital could earn elsewhere do not appear in the books of accounts.

The economist s costs of production are a payment which is necessary to keep resources out of the next best alternative employment. The economist does not agree with the accountant's approach. The accountant would only deduct actual costs from the revenues, the economist points out that in addition to the deduction of actual cost imputed cost should also be deducted.

(ii) Depreciation

The treatment of depreciation has an important bearing on the measurement of profit. To the economist, depreciation is capital consumption cost. The cost of capital consumption is the replacement cost of the equipment. It has various meanings. In the accounting sense, it refers to the writing off the unamortised cost over the useful life of an asset. In the value sense, it may be defined as the lessening in the value of a physical asset caused by deterioration.

Economists recognise only two kinds of depreciation charges and they are:

(a) The opportunity cost of the equipment, and

(b) The exhaustion of a year's worth of limited valuable life.

The former includes the most profitable alternative use of it that is forgone by putting it into its present use, while the latter aims at preserving enough capital so that the equipment may be replaced without causing any loss. Both these concepts are useful to the management.

Causes of Depreciation

The major causes of depreciation may be classified as follows:

(i) Physical depreciation,

(ii) Functional depreciation, and

(iii) Accidental depreciation.

Physical depreciation resulting in the decline of the physical usefulness of an asset due to normal use is frequently known as physical depreciation. The deterioration may be due to abrasion, shock, vibration, impact and so on.

Functional depreciation arises due to economic factors such as suppression, obsolescence and inadequacy. Here nothing happens to the ability of the asset but the demand for an asset may be sup-pressed or it becomes so obsolete or it is not adequate enough to accommodate the demand placed upon it.

Accidental depreciation may be the physical damages caused by fire, explosion, collision and wind storm are generally insured and there are some normal risks or business such as minor damages due to natural calamities. All these are, therefore, accounted and treated as depreciation.

Methods of Depreciation

In the economics of an enterprise, the methods of depreciation occupy a very important role. Depreciation is an important internal source of funds and the method of depreciation becomes important as a tool of capital accumulation. Different methods are used to offset depreciation. The main aim of depreciation policy is to reduce the gap between the present depreciated value of the asset and its present book value.

There are many accepted methods of depreciation and they are:

(i) The straight line method

(ii) The unit of production method

(iii) The sinking fund method

(iv) The declining balance method

(v) The double declining balance method

(vi) The sum of the years digits method

(vii)The revaluation method

(viii) The repair provision method

(ix) The retirement accounting method

(x) The insurance policy method, and

(xi) The mileage method

(i) The Straight Line Method

It is the simplest and the most commonly used method of deprecia-tion. It is otherwise known as proportional or equal instalments method. This method is based on the assumption that the value of an asset declines at a constant rate. The amount of annual depreciation is calculated by dividing the initial costs of the assets by the estimated life in years, assuming that there is no scrap value. If the asset has scrap value then the amount should be deducted from the initial cost.

(ii) The Unit of Production Method

This method is also known as machine hour rate method. This method of depreciation is more or less a depletion method. Under this method, instead of counting the life of the assets in years, it is estimated in terms of working hours. The speciality of this method is that it utilises production instead of time as the unit of measurement. According to this method, capital expenses of the equipment are recovered on the basis of the expected production. This method is best suited for providing depreciation on costly machine.

(iii) The Sinking Fund Method

Under this method of depreciation, the amount written off as depreciation is calculated by means of fixed periodic charges and is deposited in readily saleable securi-ties at compound interest which accumulates to provide a sum equal to the original cost of the asset. The securities are then sold and the new asset is purchased with the sale proceeds. This method is useful if the asset has to be replaced when it becomes a scrap. It is best suited for the replacement of machinery and plant.

(iv) The Declining Balance Method

It is differently known as "fixed percentage method or Mathesan method of depreciation." Under this method, a constant percentage of depreciation is charged each year as the value of the asset as it stands in the books at the beginning of the year. The basic idea behind the use of this method is to provide for a more or less uniform total cost of production of the asset over different years of its life. Under this method, depreciation is high in the early part of the asset's life but it declines in the later years.

(v) The Double Declining Balance Method

Under this method, depreciation is provided at a uni-form rate on the book value of the asset as it stands at the beginning of the year. The book value is the balance of the unamortised cost of the asset as well as depreciation expenses and both go on declining at a constant rate. Any method of calculating depreciation that allows huge amounts in the initial years is preferred by management, as it helps in the quick recovery of the major part of the original investment.

(vi) The Sum of the Years Digit Method

Previously, this method was known as Cole method. Under this method, annual depreciation charge also declines each year. The economic advantage of this method is that it allows one to write off investment very rapidly. The very idea of this method is similar to that of the declining balance method.

The amount of depreciation in the beginning of the life of the asset is higher and it declines with the span of time. This method is realistic. It takes into account the immediate drop in the value of the asset and makes the decision to sell and replace the asset earlier before die expiry of its estimated life.

(vii) The Revaluation Method

This method is frequently used in the case of small items such as loose tools, laboratory glassware, livestock, jigs, packages, patterns, etc. where it is not possible to provide for depreciation on mathematical basis. The method of providing depreciation by means of periodic deductions each of which is equal to the difference between the value of such assets and their revalued value at the close of the financial year is considered as the amount of depreciation.

(viii) The Repair Provision Method

According to this method, the cost of repairs is added to the cost of the equipment.

This method provides for the aggregate of depreciation and maintenance cost by means of periodic charges each of which is a constant proportion of the aggregate of the cost of the asset depreciated and the expected maintenance cost during its life. This method is commonly used by the public works contractors while hiring their own plants to other contractors. This method not only deals with depreciation but with repairs and maintenance too.

(ix) The Retirement Accounting Method

This method stresses that we shall charge the cost of capital less salvage value as depreciation only when the asset is worn out. This method is considered one of the most objective methods. The validity of the method is that the total cost of the capital is charged as depreciation once and for all.

(x) Insurance Policy Method

This method is similar to sinking fund method. According to this method, an endowment policy is taken as the life of the asset so that at the end of a definite period the insurance company will pay the assured money and with the help of that money a new asset can be purchased. This method is suitable for leases where the life of the asset is definitely known.

(xi) The Mileage Method

This method is otherwise known as 'use method'. This method appears to be fair as the depreciation charged will be according to the use to which the asset is put. This technique is followed in the case of those assets the use of which can be measured in terms of miles, e.g. automobiles.

So far we have discussed the different methods of depreciation but not about the methods used in actual practice. The suitability of methods of depreciation depends on the nature of assets concerned and their owner's discretion. But a liberal depreciation policy is helpful to stimulate capital formation and encourages risky investments.

(iii) Treatment of Capital Gains and Losses

All the assets of a firm are subject to windfalls due to inflation or natural calamities or legal judgements. It plays an important role in the economics of a firm. These changes generally result in larger losses than gains. Conservative concerns never record such changes.

The gains accruing from revaluation of assets are usually transferred to capital reserves.

Certain concerns add capital gains to the profit of the year in which such gainsoccur. Capital losses are charged either to current profits or to retained earnings. Economistsare least interested in recording these windfalls. They are concerned about the future.Economists are of the view that most of these gains or losses can be foreseen before they