What is profit?

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I've spent 50 years studying profit as an accountant, economist, and political economist. And here's the truth: almost no one understands what profit really is, least of all mainstream economists. In this video, I explain why profit is not just income minus expenses, why external events matter more than you think, and why our government has no concept of capital worth preserving. This isn't just about accounting. It's about building a new system where people and planet come first.

https://www.youtube.com/watch?v=cqfsHR6z3go?si=kFgHKD-1ivY4A-sL

This is the audio version:

https://www.podbean.com/player-v2/?i=w4c7v-19236a4-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

I've been talking about profit now for 50 years.

I was 17 when I first prepared a profit and loss account for a business, and now, at 67, I've talked about it as an accountant, as an economist, as a political economist, and just as a member of society. And the one thing that I've learned over that quite long career is that most people have not a clue what profit is or how it is measured, or what the concept represents, and as a result, they, and most especially economists, talk complete nonsense about it.

So in this video, what I want to talk about is:

What is profit?

What does it represent?

How do we measure it?

And what happens if we can't agree on what those measures are?

And perhaps most importantly of all, why has the government got no equivalent measure to use in its own accounts, which means it's totally out of control when it comes to economic management? 📍

These are big issues, and we really do need to understand them. So buckle down. This is quite a long and potentially quite a complicated video, and I'm not going to pretend otherwise, but I think you'll find this interesting.

So let's start at the very beginning. What is profit? Most people think it's quite simply the income of any business activity during the course of a period, less its expenses, and that's it. And they could not be more wrong.

So let's say what profit really is. Profit is a measure of the change in the capital employed by a business over time, having taken into consideration any of that capital that has been withdrawn by the business owners or other people with a claim upon it during the course of a period.

I told you it was going to be complicated, and it certainly is, but critically profit does not equate to income minus expenses, because profit is also heavily influenced by not just the internal actions which those things represent, but also the external events that influence any type of organisation from an individual to a government during the course of a period.

So let's define some of those concepts a little more precisely because we need to if we're going to understand where this video is going.

Profit is the increase in capital value of a business or other undertaking over a period of time.

It follows, therefore, that a loss is the decrease in the capital value of a business or other undertaking, which could include a government, over a period of time.

And both of these figures are stated having ignored any money that has been taken out of the business; so money taken by the owner in a very small undertaking, or dividends paid to the investors in a company, or of course, the national income that is consumed by people during the course of a year if we're talking about a government; it is the figure for the change before those are taken into account.

So, in other words, what profit includes are two things. There's the income earned; that is the income, less the expenses, plus the other consequences of changes that reflect the value of the capital of an organisation, however large or small it may be, and both of those measures are between two specific dates - very often a year, but it could be a day, it could be a week, it could be a month, and it could be decades; you can choose.

Now, what that means is there are always two key income statements that have to be considered when we come to understand what the true net income or profit of an enterprise is during the course of a period, and again, I use that term enterprise very loosely to cover any type of undertaking.

One of them is the income that is generated by activity undertaken during the period, that is, the revenue generated less, the expenses incurred, and then there are the gains and losses that have arisen with regard to capital values.

Now, not all of those capital changes result from trading.

Many of them arise because of external events that affect outcomes, and I'm going to explore those in a little more depth in a minute, but the point is, at this moment, that profit is not just the income, less the expenses, profit, if it truly reflects the changing capital value of the enterprise over the period is going to include both these measures, one of which is, broadly speaking, under the control of the reporting entity, the enterprise, whatever you wish to call it, that is the company, individual or state, and the others which aren't. And that point is particularly important, we have an internal measure here, which has an impact upon profit, and an external measure; how the world beyond our boundaries affects our worth.

Now, let's just have a think about those externalities that affect profit.

Some of them are just things we have no control over. Things like the failure of a supplier, or a customer, or perhaps more importantly, of our IT. We have seen this in some recent events. But those, to some extent, are considered to be internal by accounting.

Other events are harder to recognise in that way. In particular, we have the consequence of regulatory change on the future capacity of a company, individual or state to make a profit from an activity.

For example, if we banned all carbon fuel extraction in the future, then instantly and overnight, every single oil and gas company in the world would move from having an enormous value to no value at all. Now, I'm not saying that's necessarily going to happen, but that is an external change which can massively change capital value.

So too, for example, can interest rates.

If an organisation has liabilities which are dependent upon the rate of interest which is going to be payable in the future, then if the interest rate expectations change, so will its capital value. So too, will the cost of financing its pensions change as a result, and the cost of financing pensions in the future, which have arisen as a consequence of work undertaken now, is a cost of the current period. So there are all these externalities which can change the value of a business over which it has almost no control.

But you wouldn't believe that from the way in which economists and others talk about profit. They talk about profit as if it's the result of the genius activity of entrepreneurs, but it isn't. A lot of it comes down to luck, good fortune, and being able to fiddle the calculations on what the future consequences of current actions might be.

And even then, when you've considered that these things arise, you have to decide what is the capital that you're trying to maintain. I talked about the 'changes in capital value', but there isn't one form of capital.

We could, for example, consider the physical capital of an organisation, and a whole basis of accounting, the historic cost convention, is entirely based upon the idea of maintaining the physical capacity of an organisation to carry on producing.

There are some concepts of accounting which look at replacement costs. They're relatively few now, but they do exist.

And more importantly, we now have a whole concept of capital in accounting, established by International Accounting Standards, which seeks to preserve the financial investment in a business. What it focuses upon is the market valuation of an organisation and the maintenance of that value.

But those aren't the only things we could look at.

We could look at the investment in human capital that an organisation has, and we could also look at environmental or sustainable capital, which is something that I've spent quite a lot of time writing about in recent years in my work as a professor of accounting.

All of these things can also get mixed together in one set of accounts, but the important point here is none of them are the same.

So, depending upon what form of capital we choose to prioritise in any form of accounting that we undertake, we can get very different accounting results, and that's before we take into account the impact of all the externalities of which we have no control when we're looking at any of these systems.

As a consequence, what is profit? You tell me to a certain degree.

But then there's another issue, and I have to mention this one because, again, it's really important.

The accounting concept of profit and the economists' concept a profit are virtually irreconcilable.

For accounting, we look backwards to see what has happened during the course of a period to understand the income generated. That is the first half of this equation in the movement of capital. So we look at income less expenses.

But economics doesn't do anything like that. Economics is a solely forward-looking measure of capital when it comes to determining value at the end of a period, which it then compares with the value of the enterprise at the end of the previous period to determine what profit might be.

So economics just looks at how much cash flow might be generated in the future as a consequence of actions that have already taken place and tries to determine what the current worth of those is, to do which it undertakes something called discounting. But discounting requires that the value of future transactions be literally reduced or discounted by a set interest rate over a period of time, so we can value them at present.

But what is that interest rate? Who knows?

The point is that, actually, both are fundamentally different measures. Accountants and economists might as well be talking different languages when it comes to profits. Accounting lacks consistency, but economics is based entirely upon assumptions about the future, and the result is two irreconcilable languages, which have enough common to confuse the world.

And then we move on to government accounting, and here things get even worse, because there is no capital maintenance concept of any sort whatsoever in any approved form of government accounting the world over at present. In other words. If we are saying income for a period is a change in the value of the capital of a country over a period of time, having taken into consideration what was consumed by the people in that country during the course of a period, there is no such measure of capital available to any country to work out whether that equation is a good result, or a bad result. And that's because there is quite literally no balance sheet required in any of the standard forms of accounting established for governments, the main one of which was established by the United Nations in 2008 and then adopted by the International Monetary Fund and the EU and is the one that we use in the UK still.

Therefore, no one knows what change in value is being reported by government accounting. In effect, the future is entirely ignored in that system of accounting. It's just all about cash. It doesn't even properly match income and expenses.

So the government isn't considering physical capital.

It isn't considering financial capital.

It isn't considering our environmental goals.

It doesn't have any priority with regard to human capital and its development or potential.

No. It's just talking about cash flow.

And as a consequence, it has almost useless information on which to manage our economy. You could not have come up with a worse system of government accounting if you tried, except they did, and that's what they came up with.

And so we are now talking about a system where, for businesses profits are inherently uncertain because of the methods of accounting that we use; future assumptions can shape profit expectations considerably and, therefore, allow for manipulation of the reporting of current results; discount rates or interest rates have a massive impact upon current values of many businesses, and there is no way to verify predictions made, and profit is, as a consequence, whatever you wish it to be unless we begin to think about something else.

Suppose we don't talk about profit maximisation, and suppose we adopt just one capital maintenance concept, and suppose that capital maintenance concept that we adopt is one that puts people and planet at the core of capital maintenance, because if you were a politician, isn't that what you would do? Wouldn't you put the maintenance and protection of the people within your country, and even the protection of that country itself, at the core of your political thinking?

Suppose we just talked about maintenance and not growth, and we tried to work out whether we were actually achieving that goal or not, and we were, to use an accounting phrase, 'prudent' with regard to our assumptions; in other words, we didn't overstate our expectations for the future, but were entirely reasonable, only making assumptions that we can prove to be fair.

If we did that, first of all, we'd stop talking about profit maximisation in a world where that is not understood and where it may not even be possible.

But we'd also be talking about how we consider the consequence of externalities and the impact they have on well-being in a totally different way from what we do now, and government would be forced to look at that.

We would embrace the uncertainty of the externalities and of our future as a consequence, and try to come up with sensible ways in which we can manage them, whereas at the present point of time, we actually quite literally try to discount them by pretending the future consequences of current actions reduce significantly over time, to the point where we can ignore them, which is why we've ended up with the climate crisis, for example.

And so if we were to put the protection of people and planet at the epicentre of our thinking and used it as the capital maintenance concept when measuring profit, then, and only then, would we have a goal which had a social purpose for both micro and macroeconomic accounting.

But as it stands, that isn't the case. As it stands at present, we have this supposed claim that we must maximise profit, which actually equates to wealth accumulation by proxy, and we've seen all the consequences of that with regard to inequality and everything else.

This concept, which is talked about by economists, is in fact so vague that it is socially useless and at the same time totally socially powerful.

And of course, it is that mythology which has served the interests of an elite. This idea supports unjustified enrichment, and yet simultaneously, it of course supports exploitation of people and planet, and there is no theory or measure that we have inside the current systems of operation of capital maintenance that lets us challenge that satisfactorily.

So this is not real economics as it stands.

We aren't defining issues properly.

We're talking about profit maximisation as if it is a concept when it is, at best, an ideology, and it is certainly not one that has ever been agreed upon by all the people who engage in the activity of measuring profit.

It ignores externalities.

It pretends value can be owned where much of it is beyond control, and it reduces life to a largely meaningless number as theory stands at present.

So profit as a human construct is a very poor one. It depends upon a chosen capital concept, and almost nobody seems to understand that fact, and many of those who do will choose one that represents their own goal and not the greater good.

The system's true aim, then, at present, would appear to be the justification for avarice, but we actually could create a capital maintenance concept with real meaning, putting people and planet at its centre, and then we could have a system of proper economic management, and that is my goal.

This has been a complicated video. I'm aware of that.

I said it at the outset, I'll say it again now because I'm not pretending otherwise. It took quite a lot of thinking to put it together.

So we've created a poll. There are multiple questions in this poll, and you are allowed to provide multiple answers because it's a complex issue and we're fundamentally asking four things.

Was this useful? Do you want me to explore the issues in more depth? Do you agree people and planet should be the priority of our capital maintenance concept? And if it was, could accounting save us?

Those are big questions. I'm really interested in your opinions.

Poll

[poll id="170"]