



# Profitability Indicators

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# Profitability Indicators



- Profit = Total revenue – Total Costs
- Profit = (Price\*Quantity) – (Fixed Costs + Variable Costs)
- Profit = (Price\*Quantity) – {Fixed Costs + Variable Cost per unit\*Quantity}
- In a market based economy, profitability is the measure to look at for sustainability.
- An enterprise that is not profitable cannot survive in market-oriented production.
- Higher profits result in increasing income.
- Profitability influences value chain actors' decision to participate in seed value chain and strengthen their role.



# Profitability Indicators



- There are various Profitability analysis tools that include:
- Gross Margin (GM) =  $\text{Gross income} - \text{Variable Cost}$
- Net Income (NI) =  $\text{TR} - (\text{TVC} + \text{TFC})$
- Return on Investment (ROI) =  $\text{Return} / \text{Investment}$
- Return on Capital (ROC) =  $\text{Return} / \text{Capital Invested}$
- Return on Cost of Capital (ROCC) =  $\text{Return} / \text{Total Cost of Capital}$
- Return on Net worth (RONW) =  $\text{Net income} / \text{Net worth}$
- Return on Assets (ROA) =  $\text{Net income} / \text{Total Assets}$
- Return on Sales (ROS) =  $\text{Net income} / \text{Net Sales}$



# Profitability Indicators



- \* **Return on Net worth:** This ratio measures return relative to investment in the Company. It indicates how well a company leverages the investment in it. The ratio may appear higher for start ups and sole proprietorships.
- \* **Return on Assets:** Companies which use their assets efficiently will tend to show a ratio higher than the industry norm. The ratio may appear higher for start ups and sole proprietorships.
- \* **Return on Sales:** The ratio indicates the level of profit for each unit of currency of sales. The ratio can be used as a predictor of the company's ability to withstand changes in prices or market conditions. The ratio may appear higher for start ups and sole proprietorships.



# Profitability vs Cash flows



- \* “profit” does not always give a useful or meaningful picture of a company’s operations. User’s of a company's financial statements could even be misled by a reported profit figure.
- \* For example, shareholders may believe that if a company makes a profit after tax of £300,000 then this is the amount it could afford to pay in dividends.
- \* Unless the company has sufficient cash available to stay in business and also to pay a dividend, the shareholders’ expectations would be wrong.
- \* Survival of a business depends not just on its profit-generating ability but on the ability to pay debts when they fall due.



# Profitability vs Cash flows



- \* The distinction between profit and cash is fundamental to understanding any set of financial statements.
- \* Financial statements are based on the accruals concept and as such the operating profit disclosed in the financial statements will often be significantly different from the cash flow generated from operations.
- \* To exploit opportunities and to meet its bills as they fall due, the business has to generate the necessary cash and ensure that the amounts and timing match the needs.

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# Profitability vs Cash flows



- \* On the face of it, it would appear that a company making profit would necessarily have correspondingly more cash. Such an expectation would be met if the increased profit was not tied up in additional inventory, receivables and non-current assets.
- \* The income statement sets out the revenue and expenses, rather than the cash receipts and cash payments, for an accounting period.
- \* For Example, a business making revenue by selling goods on credit. Assuming the goods are sold at above cost then the business will generate a profit and wealth will increase. However, as the sale is on credit, no cash changes hands at the time of the sale. In addition, any inventory sold will result in a loss of wealth to the business as an asset is reduced. The income statement will record an expense but there is no change in cash.





# Profitability vs Cash flows



Examples on effect of various transactions on profit and cash.

	Effect on Profit	Effect on Cash
Repayment of Bank Loan	None	Decrease
Depreciating a non current asset	Decrease	None
Making a share issue	None	Increase
Payment of Interest	Decrease	Decrease

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# Cash as a Cycle



- \* Cash is the life blood of all growing businesses. Cash management is as much an integral part of the business cycle as any other part of the process. Not managed correctly, cash problems can lead to the bankruptcy of a business.
- \* Cash flow can be thought of in terms of a cycle in which goods or services are produced, then sold and money is collected.
- \* Since profits are not same as cash flows, It is possible to declare a healthy profit for the year, and yet face a significant pressure on your cash flows.
- \* Part of managing the cash flow involves budgeting when you believe the cash outflows will exceed the inflows.

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# Cash as a Cycle



- \* A useful technique when looking at financial statements is to calculate the cash operating cycle (sometimes called the cash conversion period or working capital cycle). This provides an estimate of the amount of time it takes to convert the product or service into cash.
- \* It is calculated as follows:

Inventory (days) + Trade receivables (days) – Accounts payable (days)

It is important to note that different business sectors will have very different conversion cycles.