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Are Profit and Profitability the Same Thing?[1]

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Introduction

The terms "profit" and "profitability" are used quite frequently in everyday talk to mean the same thing. We often hear someone say "my business made a profit last year" or "my business was profitable." But are the two statements equivalent? Does making a profit automatically mean that the business is profitable? The simple answer is no; the two statements are not necessarily equivalent. True, the definition of "profitable" means yielding a "profit," but the two words are quite different. For example, let us consider my conversation with an avocado grower who wanted to know how many trees per acre he could remove from his orchard and still make a profit if his orchard were affected by laurel wilt disease. My answer was, "You can remove several trees and still make a profit, but you can remove only a few if your operation is to remain profitable." He looked puzzled, so I explained what I meant. In this article, I'll explain again in greater depth, taking a closer look at the two terms, outlining the difference between them, and discussing a few things that growers can do to improve the profitability of a farm business.

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Definitions of "Profit" and "Profitability"

Profit is the excess of revenue/income above the costs/expenses incurred in the process of producing the revenue/income. Profit is an **absolute measure** of the positive gain from an investment or business operation after subtracting all expenses. Put another way, it is the **absolute** amount of money a business makes after accounting for all expenses, and is calculated using the formula "Profit = Total Revenue – Total Expenses" as part of an Income Statement. Making a profit is what all businesses strive to do because without profit, the business will not survive in the long run.

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Profitability, on the other hand, is the size of the profit relative to the size of the business. Profitability measures how efficient the business is in using its resources to produce profit (rate of return on investment). Unlike profit, profitability is a **relative measure** of the success or failure of a business. It has more to do with the rate of return expected on an investment (capital), or the size of the return, compared to what could have been obtained from an alternative investment (such as putting your money in a risk-free certified deposit or buying government treasury bonds). **The point to note is that it is possible for a business to generate a profit but not be profitable. In other words, profit is a necessary but insufficient criterion for a business to be profitable.**

A simple example will help to clarify the point being made. Consider two growers: Bruce and Pam. Each of the growers invested $1,000. For simplicity, we will assume that the total amount invested was used to cover expenses. Bruce's total receipt (revenue) was $1,002, while Pam's total receipt was $1,500. Are both of these operations making a profit? The obvious answer is yes: Bruce made a profit of $2 and Pam made a profit of $500. But are both operations profitable? Before you answer, let's do some quick calculations. In Pam's case, she is making an annual return on her investment of 50%. What about Bruce? His business is making a profit, but he is getting a paltry return of only 0.1% on his investment. Had Bruce invested in a risk-free government bond yielding only a 2% return, he'd have made appreciably more money than he made with his business. Therefore, though Bruce's business did return $2 on his $1,000 investment, by most reasonable estimates, Bruce's business was not profitable. A second example will help to shed further light on the difference between profit and profitability. Suppose Jill and Jack, after fetching and selling pails of water for a year, tot up their returns and discover that they have made profits of $1,000 and $2,000, respectively. Are both businesses profitable? Is Jack's business more profitable than Jill's? It may seem on the face of it that the answer to both these questions is "yes," but in fact before we can answer these questions, we need to do some simple calculations. Suppose Jill invested $2,000 to fund her year's worth of trips up the hill to fetch pails of water, while Jack invested $200,000. Now we see that even though Jill's profit was less than Jack's, she had a return on investment of 50%, compared to Jack's meager return of 1%. Because Jack could have secured a guaranteed 2% return on his $200,000 had he invested it in a risk-free government Treasury bond instead of his wildcat hilltop water-fetching venture, his business cannot be considered to have been profitable despite his $2,000 profit.

Let us now reconsider the real-life question from the concerned Florida farmer about maintaining the profitability of an avocado orchard at risk from laurel wilt disease. The answer to the avocado grower's question will depend on his fixed costs (in particular the amount of money he has invested per acre) and the price he expects to get for his avocados. It is possible to remove 40 or even 50 trees per acre from an orchard that initially had 100 trees per acre and still end up with a profit of say about $5 per acre. A $5 per-acre profit, however, represents a return on investment of far less than 1%, given that the average investment for an avocado orchard is in excess of $5,000 per acre without even considering the value of land. This would certainly not be considered to be a profitable business. If he hopes for his business to generate a respectable rate of return in the short term, the grower cannot remove more than about 15 trees per acre. If the grower is keeping an eye on the longer term investment, however, it may make sense to make the sacrifice and forego short-term profit. It is acceptable to make a low profit (even a negative profit) in the short term if proposed changes will lead to increased profits in subsequent years and result in an overall increase in the profitability of the business.

Improving Profitability

Why does it pay to consider these questions and to learn the difference between profit and profitability? The simple answer is that unless you are a hobbyist who is farming for the pure pleasure of the exercise, you are most likely in the business to make money and obtain a respectable return on your investment. You must therefore consider not only how much profit you are making with your farm, but also how much profit you *could* have made had you invested your money in the next best alternative. Farming has always been a challenging enterprise, and it continues to be challenging today. Global competition, changing government regulations, and fluctuating consumer demands make the risk in agriculture greater than ever. The crucial question is not whether your operation is making a profit, but whether your operation is profitable—and how profitable. Are you earning a sufficient rate of return to compensate you for the risk you are taking? If not, what steps can you take to improve your rate of return? I will discuss in a subsequent article several indicators you can use to calculate the profitability of an operation (Kay et al. 2004). For now, I'll describe five ways you can improve your bottom line and the profitability of your farming operation. There are five essential steps to success.

Step 1: Improve Your Financial Record

Keeping

Good financial record keeping is essential for success in any business, and now, with the availability of computers and software programs, the tasks of financial record keeping have been greatly simplified, and much of the drudgery and boredom of record keeping have been eliminated. Commercial software programs such as Quicken and QuickBooks can easily be modified to accommodate any farm situation.

Most accounting software programs are user-friendly and do not require the user to be familiar with accounting terms. They can be used for activities ranging from simple checkbook balancing, to keeping track of employee finances and payroll reports, to complex financial analyses such as generating whole-farm budgets using historical or current data. Transaction reports, as well as other reports such as cash flow, account balances, balance sheets, and tax summaries, can easily be generated. The programs are also quite useful in helping farm businesses with their tax reports. If you are interested in learning more about using these programs, please feel free to contact my office via telephone at 305-246-7001, extension 272 (Homestead, Florida).

Step 2: Conduct a Basic Financial Analysis

Keeping good financial records is certainly necessary to improve the profitability of your farm business, but the records will not be useful until you learn to analyze them and gain the insight that comes from understanding the recorded information. Many farm businesses have failed because growers lacked the skills to adequately measure business status and performance. At the very least, a farm business needs to generate regular balance sheets, income statements, and cash flow statements. Analyzing these three financial statements provides a clear picture of the financial position and performance of the business. For example, analyzing the cash flow statement identifies periods where cash funds or revenue surplus may be insufficient to meet requirements and provides information to lenders for borrowing and repayment schedules. Analyzing the balance sheet shows how much the business is worth and whether it has grown, provides information for estate planning, and indicates risk.

Step 3: Control Your Costs

One reason why a farm business might not be profitable is because of the high cost of production. In general, if the farm is generating high revenues compared to other similar farms but the net income from operating the farm is relatively low, it is a sure sign that input costs are too high. Farm records can be studied to ensure that the inputs are being purchased as cheaply as possible and used to the fullest extent possible. Here it is advisable to focus first on the higher-cost items. Depending on the source of the cost problem, one or more of the following options might be applicable:

- Reduce machinery costs by custom hiring or leasing
- Consider leasing rather than owning
- Sell un-needed or little used machinery and equipment
- Replace old machinery and equipment
- Renegotiate rental rates
- Join with other farmers to purchase inputs in bulk (e.g., cooperatives)
- Eliminate unnecessary labor
- Substitute a less expensive input for a costlier one (e.g., machinery for labor)
- Monitor energy use
- Renegotiate interest on loans

In addition, consider ways to reduce harvesting and marketing costs, which usually account for a considerable portion of the cost of producing and marketing the commodity. For additional information, contact your local extension agent.

Step 4: Increase Your Returns

Increasing the volume of output by enlarging the operation and/or shifting to improved technologies such as higher-yielding varieties is the typical recommendation given in cases where the profitability of the enterprise is relatively low. These approaches can certainly improve gross revenue and net income, but take care to ensure that the cost of adapting a new technology or increasing the scale of production does not outweigh the benefits. A less costly alternative might be to look into improving marketing through any of the following options:

- Direct marketing of produce
- Adding value to the produce (i.e., process the raw commodity)
- Producing for niche or selected markets
- Improving the quality of produce

Direct marketing of produce is becoming more popular these days among small-scale farmers. With the advances made in information technologies, as well as consumer concerns about personal health, the environment, and

food safety, there are increasing opportunities for direct selling of produce. Common means of direct marketing include selling to friends and neighbors; selling at u-pick farms, farmers' markets, roadside stands, or through a community-supported agriculture enterprise (CSA); selling through catalogs or over the Internet; and selling at trade shows and fairs.

Step 5: Change the Mix of Your Enterprises

In today's economy, where the only thing that appears not to be changing is change, farm managers must constantly assess the contribution of their various enterprises so as to eliminate unprofitable ones , and, if resources permit, expand profitable ones and introduce new potentially profitable ones. While economic principles suggest specializing to maximize profit, depending on a single enterprise is not advisable in an increasingly global market. In choosing an enterprise mix, take care to determine whether the new enterprise will compete with or supplement existing enterprises. Competing enterprises take away resources from existing ones and may lower the overall profit of the farm. Two enterprises are considered to be supplementary when an increase in the level of one does not adversely affect the production of the other but adds to the total income. The information bank at Agriinfo.in has a list of types of agricultural enterprises that may help: http://www.agriinfo.in/?page=topic&superid=1&topicid=707. Whenever deciding to add another enterprise to the existing mix, first:

- Determine whether a market exists for the new product
- Define goals for the enterprise, and determine how the enterprise will contribute to your overall business goals
- Consider whether you already have or can easily acquire the necessary skills for making the enterprise profitable
- Determine whether necessary facilities, equipment, and other physical resources are available or can be made available
- Prepare investment guidelines showing how much you can invest initially, how much annually, and how long you can maintain a negative cash flow
- Conduct enterprise budgets, including sensitivity of profit to yield and price variability (Doyle 2004)

Shifting from one enterprise to another is recommended with reservations and only after proper planning because a shift can of itself increase the risks (production, financial, and marketing) faced by the farmer.

Conclusions

Improving your bottom line (profit) is important to the long-term survival of your farming operation. Understanding profit and profitability is the first step toward managing your investment in your farm business. Successful producers also keep good business records, perform regular, careful financial analyses to help control costs and increase returns, and, if financial analyses indicate it would be beneficial, consider changing the mix of enterprises to improve the profitability of the operation and increase the likelihood that it will thrive and endure over the long term.

References

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