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# Analysis on Profit Quality of Small and Medium-sized Agricultural Enterprises: A Case Study of YM Industrial Co., Ltd in Guang'an City of Sichuan Province

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**Abstract** For a long time, under the influence of system and environment and other factors, some small and medium-sized agricultural enterprises in China only seek growth of profit in quantity, but neglect the growth of profit in quality, leading to low profit quality. This study reasonably defines the concept of profit quality of small and medium-sized agricultural enterprises, and expounds general characteristics of high quality profit. On the basis of general factors influencing profit quality of enterprises, it builds indicator system for evaluating the profit quality of small and medium-sized agricultural enterprises. Also, it conducts an empirical analysis on profit quality of Chinese small and medium-sized enterprises with YM Industrial Co., Ltd in Guang'an City of Sichuan Province as an example.

**Key words** Small and medium-sized agricultural enterprises, Analysis of financial statement, Profit quality

The profit is the operating return received on a business undertaking after all operating expenses have been met in a certain accounting period. It is not only an important basis for enterprise shareholders, creditors, government administrative departments and other interested parties making decisions, but also an important indicator for evaluating performance of business managers. In this sense, the study on evaluation of profit quality of small and medium-sized agricultural enterprises is of great significance. Externally speaking, the evaluation of profit quality can provide clear basis for investors making proper decisions. Internally speaking, the evaluation of profit quality can provide definite reference for operators making prudent decisions in their daily operating activities and investment, so as to raise the management level and provide support for enterprise development.

## 1 Theoretical analysis of the profit quality

**1.1 Literature review** As early as the 1970s, foreign scholars have started the research on profit quality of enterprises. Fabozzi<sup>[1]</sup>, Bernstein & Siegel<sup>[2]</sup> took whether the growth of product sales of an enterprise is accompanied with growth of accounts receivable and stock out of proportion as the criterion for judging the profit quality. Klein & Todd evaluated the profit quality through testing the relationship between current year accrued profit and the cash flow in the period of profit disclosure<sup>[3]</sup>.

Chinese scholar Wang Anwu *et al.* believed that the profit accompanied with cash inflow is high quality profit<sup>[4]</sup>. Zhang Ximin *et al.* contended that the profit quality includes the quality of profit forming process, structure and results of small and medium-sized enterprises<sup>[5]</sup>. Ji Ze measured the earnings quality on the basis of abnormal accrued profit, and studied earnings quality and

stock price relevance of agricultural listed companies using the cash flow data in five consecutive years (2003 – 2007) of Chinese agricultural listed companies<sup>[6]</sup>.

The existing indicators for evaluating the profit quality of small and medium-sized agricultural enterprises mainly focus on net profit, which leads to one-sided and simple evaluation. In view of problems of current evaluation indicators for the profit quality, we propose evaluating the profit quality of small and medium-sized agricultural enterprises from the comprehensive profitability, profit structure, and cash supportability of profit.

**1.2 Definition and characteristics of the profit quality of small and medium-sized agricultural enterprises** The profit quality of small and medium-sized agricultural enterprises refers to "gold content" of the profit, namely, the interior quality of the profit. Whether enterprises can keep sustainable profit and stable development in every period depends on whether the profit structure is reasonable and whether the cash supportability is high. In other words, the profit quality is a comprehensive evaluation of profit situation of small and medium-sized agricultural enterprises from various angles.

High quality profit of small and medium-sized agricultural enterprises features excellent operation of enterprise assets, bright market development prospect of major businesses, reasonable profit structure, and high paying capacity (such as paying taxes and duties and dividends, etc.). In general, high quality profit of small and medium-sized agricultural enterprises are characterized by high profitability, high cash supportability and reasonable profit structure.

**1.3 Factors influencing the profit quality of small and medium-sized agricultural enterprises**

**1.3.1 Selection of accounting policy.** Different accounting policies and methods will generally bring different financial achievements. Selection of depreciation methods, pricing of stock, amort-

ization of intangible assets, accounting of bad debt reserve, and confirmation of revenues will influence the profit of small and medium-sized agricultural enterprises.

**1.3.2** Influence of price fluctuation. The influence of price fluctuation on accounting profit is of common occurrence. When there is inflation, on the surface, the profit amount possessed by enterprises may be very huge, but in fact, the usable cash flow is very little, thus the profit quality is extremely low.

**1.4 Indicator system for analysis of the profit quality of small and medium-sized agricultural enterprises** Through summarizing characteristics of the profit quality of small and medium-sized agricultural enterprises, we evaluated earnings quality of enterprises on the basis of accounting statement data, and made objective and accurate evaluation of the profit quality of small and medium-sized agricultural enterprises from the profitability, profit structure, and cash supportability for profit<sup>[7]</sup>. Financial indicator system for evaluation of the profit quality of small and medium-sized agricultural enterprises is listed in Table 1.

**Table 1 Financial indicator system for evaluation of the profit quality of small and medium-sized agricultural enterprises**

Target level	Level I indicators	Level II indicators	Calculation formula
Evaluation of profit quality	Profitability	Net profit	Net profit = Operating profit + Net amount of non operating revenue and expenditure – Income tax expenses
		Profit ratio of sales	Profit ratio of sales = Net profit/Income from sales
	Profit structure	Return on net assets	Return on net assets = Net profit/Average net assets
		Ratio of profit of main operations	Ratio of profit of main operations = Profit of main operations/Total profit
		Ratio of non-recurring profit and loss	Ratio of non-recurring profit and loss = Non-recurring profit and loss/Net profit
	Cash supportability for profit	Net operating cash inflow to sales ratio	Net operating cash inflow to sales ratio = Net operating cash inflow/Sales (including value-added sales amount)
		Operating cash flow to operating profit ratio	Operating cash flow to operating profit ratio = Operating cash flow/cash generated from operations (where the cash generated from operations = net profit – Non profit on return + Non out-of-pocket expenses)
		Cash dividend coverage	Cash dividend coverage = Net cash flow from operating activities/Cash dividends

## 2.2 Analysis on the profit quality of YM Company

### 2.2.1 Analysis of profitability.

(1) Net profit. The net profit is an indicator for measuring the absolute amount of profitability of small and medium-sized agricultural enterprises. Generally, if the size of small and medium-sized agricultural enterprises is not changed and accounting policy and system are stable, the higher absolute amount indicates the higher profitability of small and medium-sized agricultural enterprises. In the period of 2009 to 2011, YM Company realized the net profit of 110 million, 150 million and 230 million yuan, showing a gradual rise in profitability of small and medium-sized agricultural enterprises.

(2) Profit ratio of sales and return on net assets. The profit ratio of sales, return on assets and return on net assets are three directors measuring the profitability of small and medium-sized agricultural enterprises, analyzing operating capability, asset profit-

## 2 Empirical analysis: a case study of YM Industrial Co., Ltd in Guang'an City of Sichuan Province

**2.1 Brief introduction to YM Industrial Co., Ltd** YM Industrial Co., Ltd (hereafter referred to as YM Company) is a typical small and medium-sized agricultural enterprise introduced from other places by Guang'an municipal Party committee and municipal government in accordance with the strategic decision of the State Council for east-west cooperation project. With development in recent years, YM Company has purchased state-owned, collective and individual forest farm and land for seedling growing, tree planting, prevention and control of plant diseases and insect pests, fire prevention and control, wood processing, vegetative propagation and improved breeding, etc. It is mainly engaged in production and sales of various solid wood floor and furniture, including blank wood floor (shaving board, wet plate, etc), furniture board and standard scraping material, and customized wood-works.

ability and capital profitability, so as to analyze overall profitability of small and medium-sized agricultural enterprises. Generally speaking, the higher and more stable these indicators, the higher profit quality of small and medium-sized agricultural enterprises.

The analysis of profit quality of YM Company in 2009 – 2011 is summarized in Table 2. From the table, it can be known that the net profit on sales is 18%, 17.5% and 17.29% respectively in 2009, 2010 and 2011, showing a declining trend, mainly because the growth rate of income from sales is lower than that of costs or expenses. The return on net assets is an important indicator for evaluating the profitability of small and medium-sized agricultural enterprises, and is an indicator with the highest comprehensiveness and representativeness. In 2009, 2010 and 2011, this indicator is 15.41%, 22.27% and 26.25% separately, showing an obvious rise trend of the profitability of net assets.

### 2.2.2 Analysis of profit structure.

(1) Ratio of profit of main operations. The ratio of profit of main operations is the ratio of profit of main operations to total pre-tax profit. It is an important indicator for evaluating stability and sustainability of operation benefits. The profit of main operations refers to profit realized from major businesses of production and sales and fully manifests comprehensive quality and competitive-

ness of enterprises. In 2009, 2010, and 2011, the ratio of profit of main operations of YM Company reaches 99.82%, 99.95% and 100.11% respectively, indicating that the profit of main operations takes up a great portion in enterprise profit, and it is a major approach to realizing profit, and showing high profit quality.

**Table 2 Analysis summary of profit quality of YM Company in 2009–2011**

Year	Return on net assets // %	Return on assets // %	Net profit margin on sales // %	Assets turnover // %	Equity multiplier
2009	15.41	14.22	18.00	79.00	1.08
2010	22.27	16.63	17.50	95.00	1.34
2011	26.25	16.08	17.29	93.00	1.63

(2) Ratio of non-recurring profit and loss. The components of non-recurring profit and loss are complex and generally include net balance of current investment, net non-operating income and expenditure, and subsidy revenue, etc. The non-recurring profit and loss is included into the profit of small and medium-sized agricultural enterprises and is not continuous. Through observing the influence of non-recurring profit and loss on the net profit, it is able to evaluate stability of the profit quality of small and medium-sized agricultural enterprises. If this ratio is lower, enterprises will have higher profit quality and smaller influence from contingent income and expenses. In 2009, 2010, and 2011, the ratio of non-recurring profit and loss of YM Company is -6.23%, -0.70% and 0.10%, indicating that its profit quality is stable.

### 2.2.3 Analysis of cash supportability for profit.

(1) Net operating cash inflow to sales ratio. Reflected in operating activities, it is the proportion of net operating cash inflow into sales amount. In generally, if this ratio is higher, enterprises will have higher cash collection ability and higher sales quality. In 2009, 2010, and 2011, the net operating cash inflow to sales ratio of YM Company is 14.84%, 14.06% and 27.85% respectively, showing an obvious rise trend of the profitability of net assets.

(2) Operating cash flow to operating profit ratio. This ratio is mainly used to evaluate the capability of generating cash from operating activities. In 2009, 2010 and 2011, the operating cash flow to operating profit ratio of YM Company is 12.69%, 12.13% and 23.00% separately, indicating low cash generating capability of operating activities. This is because some operational profit does not receive cash, credit-sale transaction takes up a large portion, and sales income fails to collect cash in time. YM Company should strengthen management of accounts receivable, to raise the operating cash flow to operating profit ratio.

(3) Cash dividend coverage. This indicator is the ratio of net cash flow from operating activities to amount of cash dividend. The higher cash dividend payout ratio means smaller proportion of cash dividends of small and medium-sized agricultural enterprises into the balance of cash flow, and higher capability of paying cash dividends. In 2009, 2010 and 2011, the cash dividend coverage of YM Company is 1.33, 1.41 and 1.51 separately, indicating its higher profit quality basically can satisfy the requirement of investors for sharing dividends.

**2.3 Evaluation of profit quality** Through analysis on financial statements of YM Company of 2009 to 2011, we reached following conclusions for its profit quality.

(1) Its profitability constantly grows, but the net profit margin on sales takes on slightly declining trend, indicating that the growth rate of sales income is less than that of selling costs.

(2) Its profit structure is reasonable, and the profit of main operations takes up a large portion. From the perspective of cash structure of profit realized by YM Company, the profit structure features that the income from main operations takes up more than 99% of the total income, and the income from other businesses, non-operating income and investment income only take up an extremely small portion.

(3) Its cash supportability for profit is high. Its operating activities have stable cash flow support, net operating cash inflow to sales ratio, operating cash flow to operating profit ratio, cash dividend coverage gradually rise year by year, showing YM Company has excellent cash payout ability and high profit quality.

## 3 Policies and recommendations for improving the profit quality of small and medium-sized agricultural enterprises

**3.1 Establishing and perfecting scientific investment decision and risk prevention mechanism** The establishment of scientific investment decision and risk prevention mechanism is an important part of improving the profit quality of enterprises. Generally speaking, constant decline of business performance is positively correlated to wrong operating decisions. At present, the constantly low profitability of enterprises is mainly resulted from lack of risk prevention and control awareness in decision making process, as well as blindly pursuit of diversified investment. Enterprise managers should transform ideas, focus on investors, improve the company administration structure, regulate corporate information disclosure action, and set up a supervision and restriction mechanism with cooperation of both inside and outside.

**3.2 Strengthening the management of accounts receivable and increasing the cash supportability for profit** The proportion of accounts receivable into income from main operations and circulating fund remains high, leading to low cash supportability

for enterprise profit. Therefore, enterprises should make practical and feasible credit policies, strengthen daily control of accounts receivable, reinforce internal control of accounts receivable, and increase the cash supportability for the profit.

### 3.3 Continuing to attach importance to development of main operations

The profit quality of enterprises depends largely on the proportion of main operations. Income from main operations plays a decisive role in sustainable development of enterprises. It is not only a major factor for stable and high quality profit of enterprises, but also a factor that can control core profitability and market competitiveness of enterprises. In YM Company, the main operations always take up a high proportion, indicating that its managers pay close attention to development of main operations and its development enters a stable period.

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