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# AGRIBUSINESS MANAGEMENT

## MANAGING FOR SUCCESS AND FAILURE IN A SMALL AGRIBUSINESS FIRM

I am fearful that I may be evolving into the world's greatest skeptic. Sixteen years of work with small agribusiness firms has contributed much towards this gradually deteriorating mental state. At the young age of 25, I was a confirmed optimist and a staunch believer that the viability of our agricultural economy was dependent upon the entrepreneurial skills and practices of small agribusiness firms. At that time the basic infrastructure of businesses serving Northwest agriculture was comprised mostly of smaller enterprises. Each rural-based service community contained its locally owned and operated supply and/or marketing cooperative. Competition was evident in the form of numerous small independent companies offering such products/services as fertilizer, seed, feed, storage, hardware, and repairs. The only hint of a large corporate presence in the rural communities appeared in the form of petroleum and farm equipment sales, but even here, some local managerial control was afforded. How could one have predicted that the situation was to change? After sixteen years, I find that many local cooperatives have either ceased to exist or have been assimilated into the operations of a much larger regional organization. Similarly, the privately owned independent businesses are now either abandoned or operated as branches of large national corporate entities. One cannot and would not wish to turn back the clocks to a previous era. But as so many small agribusiness firms have disappeared, one does grow increasingly skeptical about the future of small agribusiness firms. As an observer of this phenomenon, I have seen basic patterns of managerial conduct which

reoccur again and again, ultimately contributing to the small firm's demise. It is often too convenient to blame the trend on general economic conditions, competitive forces, or just bad luck or poor timing. But this convenience is based upon simplifications and a failure to identify root causes. When a small agribusiness firm survives for many years (or even decades) and then finally falls on hard times, the following observations can usually be made. First, a valuable core of managerial talent and expertise likely remains buried somewhere within the bowels of the struggling company. Second, small but persistent management inadequacies have gradually eroded the strength of the business, leaving it vulnerable to the demands of contemporary times.

To the extent that such strengths have eroded, observations would suggest that there are three principal areas of weakness in small agribusiness firms where problems are likely to arise and contribute towards business failure. *First, managers are too prone to blame the lack of growth of sales for almost all problems encountered. In their urge to spur additional sales volume, too little attention is paid to the impact such growth will have on the overhead cost burden. Second, small business managers fail to adequately analyze the product cost impact of adding to their existing product line, particularly when some products already handled may be in a loss mode. Third, those who manage small agribusiness firms devote their attention to income statement parameters while ignoring the balance sheet side of the business.* In this way cash flow problems emerge and management goes in search of added capital rather than searching for a better way to employ those monies already available.

In the following material, I shall attempt to discuss each of these weaknesses in greater detail. Hopefully the discussion will provide managers of small agribusiness firms with a means for retaining the viability and role of their enterprise in the rural communities they serve.

### **Growth and the Capitalistic Ideal**

Many business managers see growth of sales as the solution to all problems. Seldom is this true. These capitalistic ideals, when placed on the American free enterprise system, would often seem to support the contention that bigger is better. Perhaps for this reason, small business managers are very reluctant to reduce product-line offerings even when it can be shown that such reductions will provide for a higher return on investment. Agribusiness firms, in particular, argue that because theirs is a service-oriented industry, a full line of offerings is expected by their customers. Profitability does not seem to be a concern as firms elect to handle supplies in bulk and by the sack. The broadest range of sizes, shapes, brands, and configurations of products are carried despite wide variations in turnover. Credit and other complementary services are added when the firm is ill-prepared to support them. Even standard accounting procedures tend to suggest to managers that higher profits follow automatically from higher sales.

***Marginal Income Management:*** As economists, we are fond of preaching the principles of marginal income management. In theory at least, we argue that in the short run additional sales can be profitably added to normal volume even at prices lower than those required to cover a proportionate share of fixed overhead expenses. If, indeed, all overhead costs are borne by the regular business volume, new products may be priced below a full-cost base. Unfortunately, this practice is particularly dangerous for small businesses. Except for rare cases, marginal sales added to a business during periods of stress often incur the same overhead costs as the regular sales volume

and may, by adding to the complexity of an otherwise small operation, generate more than proportionate costs.

I recently visited with an agribusiness retailer whose accountant had just advised him to price all new products at a level just to exceed the cost of goods and direct labor costs. While this advice might have had some theoretical basis, it failed to recognize that the physical plant was already operating at full capacity and any product additions would require major changes in materials handling procedures. We must remember that only if overhead expenses cannot be cut during short periods of excess capacity does it make sense to price new products on the basis of less than full costs incurred. However, the danger is that an emergency measure taken under these unique circumstances later becomes a standard pricing practice. When this occurs, the small business manager has found a theoretically appealing way to go broke.

***Break-even Management:*** Another common management tool that inadvertently encourages growth for the growth's sake alone is known as break-even management. Under this theory, the sale price is set to provide for material and labor cost, plus any variable overhead costs, plus an increment to cover fixed overhead costs and allows for a profit. When the sales volume reaches a level high enough to absorb all variable costs as well as the lump of fixed overhead costs, the break-even point has been reached. The margin on additional sales, above variable costs, goes entirely to profit as all the fixed overhead costs have already been covered by prior product sales. Because of this short run phenomenon, managers are particularly delighted with a sudden unexpected surge in sales. If this surge occurs beyond the break-even point, profits are disproportionately large.

The unfortunate fallacy of break-even management is that it is based on the proposition that all expenses are easily divisible into fixed and variable categories. As

my recent experience with a fertilizer retailer would suggest, except for very short periods of time, overhead expenses are rarely as fixed as some accountants and economists are inclined to think. This particular business had leased a 10,000-square-foot facility for a ten-year period. Accountants had classified the annual rental as a fixed expense and argued that since the firm was stuck with the lease agreement, increased volume was the only way to squeeze a profit from the operation. But only in the very short run was this a valid recommendation. If the space were found to be inadequate, more would have to be rented. If surplus space were available, you could sublet a portion of the facility. Hence the rental expense was really not as fixed as traditional break-even procedures might suggest. Had pricing and future budgeting been based on this overhead treatment, management would have made a major mistake.

### **Inadequate Cost Analysis**

At best, cost accounting is an inexact process and is designed to attain only limited goals. It provides management with a means for evaluating those direct costs attributable to a particular product, function, or service. As more agribusiness firms have access to computerized accounting systems, their access to cost analysis programs is much improved. However, even with the advent of automated accounting procedures, the cost analysis process is still plagued with difficulties in the allocation of indirect costs. As products are added or dropped from the product line, the proportionate allocation of costs is too often not adjusted to reflect this change. As a new product is added to the line, rarely is it assigned the full cost of its net addition, while the previously existing product line is expected to carry the cost load.

A classic example of this misallocation lies in the areas of research and development. Too often the massive costs of new product development are largely borne by current operations and accepted by management as a normal cost of doing business. In many

cases, it is probably necessary to have old products subsidize the introduction of new ones. Were this not allowed, R. and D. efforts would suffer and many innovative products would never reach the marketplace. The problem, of course, is that many agribusiness managers are simply not aware that such subsidization occurs. As a result, they undervalue the profitability of an existing product line and understate the costs of bringing a new product into the market.

*Costs Simplification:* With the aid of computerized cost accounting systems, most managers are better able to interpret their cost structure. Many, however, are still reluctant to shrink their operations even when the simple facts are available. In one recent example, a farm supply operation included a subsidiary function for the sale and delivery of home heating oil. Because of intense competition and the rising expense of maintaining its bulk delivery vehicles, the subsidiary had been viewed as a break-even operation for years. Indeed, the cost analysis suggested that few if any profits had been generated for some time. Management was most reluctant to drop the subsidiary. What the cost analysis did not show, however, was that heating oil sales were contributing greatly to the firm's growing accounts receivable. When the subsidiary was finally sold there was a sharp reduction in unpaid accounts and profits of the parent company reflected favorably this change. The lesson to be learned, of course, is that some cost accounting procedures are oversimplified and therefore cover up valuable management information.

The farm supply sector of the agribusiness industry is especially impacted by product line decisions. Advancing technology and changing agricultural practices force management of farm supply firms to regularly consider adding or dropping products and/or services. Cost analysis alone will not provide all the answers. When confronting such decisions, management should ask the following questions:

1. Is sales volume of the product rising or falling? Experience has shown that all products have something called a natural "life cycle." If sales are declining and reflect a long-term trend, managers should spend little to keep the product from a premature death. Conversely, management should focus attention on those products which are maturing in the market and promise a healthy margin.
2. Is the product earning a profit? Loss leaders and other products carried only because they support overhead costs should be heavily scrutinized. Too often products are retained only because they were once the mainstay of the business, but have recently contributed little to profit.
3. What are the relative gross margins? If gross margin is low, unless you can raise the selling price, one faces a difficult struggle to improve operating efficiency. Remember that while you may look for some cost reductions, your competition is doing likewise and the advantage may be quickly lost in the market.
4. How do your customers perceive the product? Your customer is always the final judge of your product's quality and value. Products that managers view as promising may fail miserably in the market. The true value of a product, therefore, is only what the customer judges it to be.
5. Are you full-service oriented? Competition will likely be the best determinant of whether a small agribusiness must sacrifice some profit for a full-service image. One-stop shopping has proven itself in a number of retail settings, but it has some limits in the agribusiness industry. For "big ticket" items particularly, the farmer continues to shop around and location convenience with other products seems less important.
6. Does your product line carry a wide variety of options, extras, and special support equipment? Custom products and

specialized equipment or services always cost more, and unless some economies of scale can be achieved, small businesses are likely to lose money. Some businesses gradually add more and more variations to their product line to suit the specifications or whims of selected (favorite) customers. These specialized products are carried as a matter of habit for years even when the standard product can be shown to be as satisfactory.

### **Show Some Balance Sheet Concerns**

Many agribusiness firms are branch operations of large corporate entities. Managers of these branches rarely even see the corporate balance sheet and cash flow concerns are rarely evident. Independently owned small agribusiness firms, however, are quite a different matter. Here, a lack of concern for cash flow and productivity of capital can be chronic and often fatal. A small business manager's best source of capital often lies hidden in the balance sheet. Here's where it can often be found.

*Accounts Receivable:* Liquidity, of course, measures your firm's ability to transfer assets into cash. Often the quickest and best source of cash is the accounts receivable. Collecting amounts owed by customers is a generally unpleasant job and in a poorly managed firm it is often neglected. Further, if your company has not earned a profit, there exists no income tax incentive to write off uncollectibles. As a result of this combination of forces, the accounts receivable begin to clutter a balance sheet and starve a company of the working capital it so badly needs.

In the agribusiness industry, salesmen are rarely penalized when their customers generate poor payment records. Understandably, salesmen are reluctant to irritate the very people on whom they rely for business. Experience has shown that salesmen often perform poorly as bill collectors and this function should be assigned to a specialist in the accounting

department with the skill and ability to remain "firm but fair" with slow paying customers.

*Inventory:* If your company is operating in the black, there exists every incentive to mark down or write off inventory that is no longer worth full value. Managerial judgment is essential here if you are to remain in a good position with your accountant and the tax collector. Most of us hate to throw things away, but a good housecleaning is often appropriate. It is good for the business to occasionally rid itself of inventory which has become valueless.

*Fixed Assets:* Where, you might ask, can hidden capital be found in the form of fixed assets? To the agribusiness firm, such things as machinery, buildings, and equipment almost seem sacred. Assuming the small business has been operating for several years, such assets have long accumulated. Just visit the "back yard" of any small agribusiness firm and the physical evidence of rarely used machinery and equipment is much apparent. While such assets are carried on the books at their much depreciated value, their true worth may be greater than that shown on the books. As manager, the capital you employ is not measured by the net book value, but by its current market value. Once you recognize this, you should seriously evaluate whether you really need those assets or whether you are using them effectively. When such assets have a highly specialized or intermittent use, you might consider selling the equipment for cash and contracting out the required function or service.

A related decision centers around whether to continue to operate the business in its present location(s). If you occupy high value real estate and alternative locations exist, consider the cash generating process of trading a current location for one that is less capital intensive. If several locations are used, consider whether each satellite location is critical to your business's future. Closing plants and abandoning locations may actually reduce costs while leaving sales almost

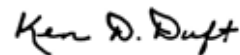
unaffected. Moreover, such decisions may release a large chunk of capital which can be better employed elsewhere in the business.

## Summary

All things considered, success or failure in the agribusiness industry is linked less to volume of sales than it is to return on investment. On this basis alone, there is no fundamental reason why small agribusiness firms cannot continue to operate and prosper. Too often management concentrates on sales growth while ignoring return on investment. Cost analysis is an effective tool for management, particularly as computer-linked accounting systems are more available to the small business, but management must still take great care with product line decisions if the firm is to survive. Finally, management must not become preoccupied with Income Statement analysis. Small business managers must place equal importance on Balance Sheet parameters as they search for hidden sources of capital and a better means of employing it.

While fewer small businesses can be found in the agricultural economy, their continued disappearance is not preordained by competition, the economy, or bad luck. Good management can sustain a small agribusiness firm as it continues to serve well its agricultural clientele.

Sincerely,



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