



## **AGRIBUSINESS PROFITS AND THE EXTENSION OF CREDIT**

There exists no single sector of our economy that has not been impacted by the rapidly rising costs of extending trade and customer credit. As interest rates reached unprecedented levels, many firms adjusted upwards their monthly charges for unpaid accounts or otherwise changed their credit terms. The agribusiness sector has been similarly affected by rising interest rates, but competition, market conditions, and the normal seasonality of agricultural operations have prevented many agribusiness firms (particularly those in the supply and services industries) from passing on to their customers the full costs of credit extended. Often these agribusiness customers had grown accustomed to penalty-free terms for credit extended during the growing season. Other firms, fearful of a decline in sales during a period of economic recession, initiated innovative credit terms designed specifically to lessen the so-called "sticker-shock" for their customers of agricultural equipment and machinery. Regardless, customers and/or trade credit has become a commonly accepted method of handling a large majority of agribusiness sales. While some firms claim to adhere to a cash basis, they represent an ever-declining minority of total industry sales volume.

There is little doubt that credit sales, when based on sound judgment and basic business principles, enhance profitable operations by expanding sales opportunities and broadening the market. Yet it must not be forgotten that if credit is being extended, then credit costs are being incurred and the firm's profits are being impacted. Historically, the extension of customer credit

has fulfilled a major role in the development of numerous agricultural supply markets. The fertilizer industry, for instance, provides a classic example of how credit, extended by both wholesale suppliers and retail dealers, can be both used and abused. When dealing with homogeneous products of comparable use and value, the industry concluded that credit and services remained as an important factor in competitive differentiation. Particularly as new firms entered a market, the liberal extension of credit provided a means for carving out a competitive position. In numerous cases the extension of credit reached liberal dimensions. As other firms scrambled to match these provisions, the industry soon found itself awash in aged accounts receivable. For some firms, the period of recovery was both long and painful. For others, a total restructuring of their total debt position was required.

How do such situations develop and why do they deteriorate so rapidly? How are the participating firms impacted and why is remedial action not taken? The answer to all these questions probably relates to the fact that while trade and customer credit have become common business practices, many firms have only a peripheral understanding of the true costs of credit and others fail to relate such costs directly to firm profitability. In an attempt to address this problem, this discussion shall review the pros and cons of extending credit. Second, I shall review those areas where the true costs of credit often lie hidden. Finally, I shall illustrate graphically the impact such costs have on firm profitability.

## **The Advantages of Extending Credit**

It should first be recognized that all customers, farmers especially, are becoming more credit conscious. While the product, price, and service remain important factors to the farmer, the nature and extent of credit terms have taken on a greater importance. As the farmer confronts a rising cost of production (short-term) loans, he views supplier credit terms more seriously. It is a fact, therefore, that the extension of customer credit has a positive influence on a firm's ability to expand the ranks of its clientele.

Some research work has shown that credit customers tend to buy a higher quality of merchandise and perhaps more of it. Unfortunately, such research has been conducted only in consumer product areas and it is only conjecture as to its applicability to the agribusiness industry. We can surmise, however, that liberal credit terms might induce a farmer to purchase a more expensive, high-quality, fertilizer and/or increase his rates of application.

The extension of credit encompasses a convenience factor of some value to the customer. While the ability to pay all of your monthly bills at once may be less of a convenience to farmers than to homeowners and families, it does provide the farmer an opportunity to better manage his monthly cash flows. Included within this convenience factor are the added dimensions that goods can be purchased and delivered on an approval basis and that adjustments on merchandise returned to the retailer can be more easily handled.

A less measurable, but still important factor associated with the extension of customer credit is the establishment of a more direct or personal relationship between the customer and the retailer. The extension of credit, of course, implies a substantial degree of trust and respectability. This mutual sense of commitment and obligation tends to solidify retailer-customer relations

and strengthen a feeling of loyalty, one towards the other.

As noted earlier, credit sales increase the range of customers to which your product or service might appeal. Farmers confronting a short-term cash deficiency might be discouraged from purchasing products sold on a cash basis only. By removing this barrier, the potential market has been expanded.

Finally, as a purely competitive factor, the retailer may use credit as one of the many means available for improving his market position. As such, credit becomes an important management tool or vehicle through which the entire array of competitive factors can be more effectively utilized.

## **The Disadvantages of Extending Credit**

An early impact experienced by agribusiness firms extending credit is that normally described as a shortage of working capital. Those funds normally used to restore inventories, meet payrolls, and cover daily operating expenses are tied up in the form of a growing accounts receivable. When a firm is caught in such a squeeze, management's flexibility is severely restricted and the short-term liquidity of the business is directly threatened.

As working capital shrinks to that point where daily operations are impacted, the firm is forced to adjust its debt position by borrowing short-term funds. The interest expense accruing to this debt is directly assigned against the credit policy.

Of course, a natural corollary of any customer credit provision is an allowance for bad debts. Regardless of the past record of collection efficiency, some losses due to bad debts are bound to be realized. Again such losses are directly assigned to the credit policy.

Insofar as customer credit attracts added sales volume, this same attraction may prove so strong that some customers are enticed to purchase more product than is actually needed. Stated a little differently, this practice may encourage some customers to purchase beyond their ability to pay. Their own financial position is, thereby, threatened. In severe cases where this leads to their operational failure, a customer is permanently lost and the total market suffers.

It can be argued that credit customers are more likely to return merchandise. While this is less prevalent in the agribusiness industry, any merchandise returned does impose inefficiencies on the retailer's operations.

As credit is extended, it must be supported by an accounting system. Records must be maintained, statements must be prepared, and additional postal expenses must be incurred. The direct costs of an accounts receivable record keeping system are commonly underestimated. Even where the program is computerized, the processing and mailing of customer statements can easily take two working days out of each month.

### **Some Hidden Costs**

Those items noted above represent costs normally recognized as attributable to customer credit. Yet it must be remembered that not all costs are so easily recognized. For example, it should be noted that a business invests in its accounts receivable in much the same way that it invests in other assets such as buildings, inventory, and equipment. To a larger degree, this investment in accounts receivable is just as permanent as is an investment in any fixed asset. While the names of customers listed under this account may change from month to month, the average monthly unpaid balance may change very little during the course of a year. Aside from some seasonal variation, most agribusiness firms can

closely predict this balance, given some reference to past performance and current sales trends. As noted earlier, a retailer may be forced to borrow funds to cover those monies tied up in unpaid customer accounts. If this is not needed, and internal funds are used to support accounts receivable, then this restricts investment opportunities and deprives the business of additional profits that might have been generated had such funds been used in another manner. The academic terminology used to describe such "profits sacrificed" is generally referred to as "opportunity costs." Hence even if external funds are not used and an interest expense is not incurred, one must treat the internal investment of funds no differently than if such monies were invested in other assets, i.e., some opportunity cost is assigned to it.

Also overlooked are those administrative costs associated with an accounts receivable policy. In large agribusiness firms, the salaries of credit personnel are more readily identifiable since the people responsible for this function are easily isolated from the other phases of the business. Yet most agribusiness firms are relatively small and do not separately employ a credit manager and support staff. In such cases, the general manager or another person spends only a portion of their working day on credit matters. In the absence of a detailed study there is little basis for correctly measuring the salary expense attributable to the credit function. Moreover, a portion of that management expense is rarely assigned to the credit function. However, the credit expense is very much incurred and should be recognized. Also associated with the credit function are those costs associated with membership in local credit bureaus and direct credit investigations. Again, smaller companies may simply incur such expenses and account for them only as a normal operational cost of doing business. Here we must also recognize certain legal costs associated with a firm's compliance with such recent legislation as Truth in Lending,

the Fair Credit Billing Act, and the Fair Credit Act. Compliance, of course, is mandatory for businesses of all types and sizes and the process of disclosing various facts to your customers may be costly in both labor and machine (computer) time. In many cases a firm is required to mail notices regularly and make other appropriate disclosures. Penalties for failure to comply may take the form of forfeiture of interest on past-due accounts, forfeiture of the entire account, and/or the imposition of a fine.

When dealing on the input side of farm production supplies, the agribusiness retailers must also remember that they are selling a product which often cannot be repossessed. For example, when fertilizer or fuel is sold and remains unpaid, the retailer has no vehicle for physically recovering that product which has already been applied or consumed. When dealing in credit with their supplier, the retailer must also remember that the use of credit may cause them to sacrifice cash or early payment discounts offered by that supplier. In a similar sense, your relationship with your supplier may be jeopardized when your uncollected receivables get out of control. Finally, it should be noted that time spent attempting to collect slow receivables represents time that might better be spent on matters relating to management planning, personnel, or marketing. Such a sacrifice may, in the long run, prove to be the most costly of all factors associated with the extension of credit.

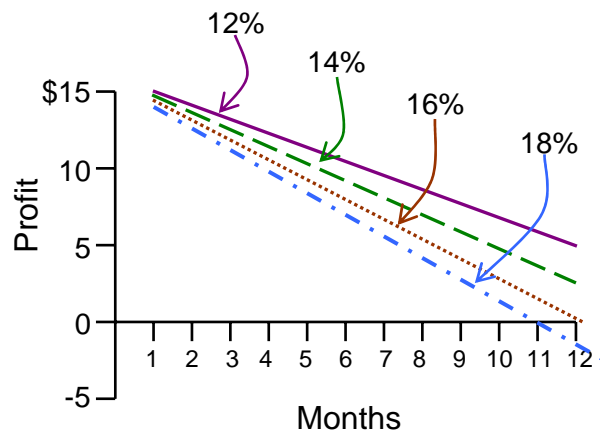
### The Profit Impact

Most agribusiness managers have a good understanding of both the advantages and disadvantages associated with credit provisions. As the cost of debt capital has risen, many managers have been forced to reevaluate their credit practices. As the agricultural economy weakens, firms will likely find it necessary to reassess those costs associated with a growing accounts receivable operation. As provided below,

Figure 1 is designed to emphasize just how rapidly unpaid accounts can erode firm profits. For example, if a firm is operating at a 15 percent profit margin and allows its average aged accounts receivable to reach six months, profit levels have been reduced to half those anticipated. Should some of these accounts go uncollected for one year, a net loss has been incurred. Many in the trade have argued that the value of past due accounts should be even more aggressively deflated to reflect the increased likelihood of bad debt loss as an account remains unpaid beyond three to six months<sup>1</sup>. Should such an allowance be made, the present value lines in Figure 1 would decrease at an ever-increasing rate.

**Figure 1: Unpaid Accounts and Agribusiness Profits**

If your firm expects to generate \$15 in profit for each \$100 in sales and the interest rate on debt capital used to support accounts receivable is 12, 14, 16, or 18 percent, profits are diminished by the relationship shown below:



<sup>1</sup> W. R. Ruzek, "The Costs of Extending Credit," *Fertilizer Progress*, p. 23, September-October 1976.

**Table 1**  
**Assuming \$15 Profit on \$100 Sales**

<i>Profits After</i>	With Interest Costs of:	12%	14%	16%	18%
One Month		\$14.00	\$13.85	\$13.69	\$13.52
Two Months		13.02	12.71	12.39	12.06
Three Months		12.05	11.58	11.11	10.63
Six Months		9.20	8.28	7.38	6.45
Nine Months		6.43	5.08	3.73	2.45
Twelve Months		3.74	2.00	.34	-1.37

### Summary

The extension of customer and trade credit has become a permanent operational feature of the agribusiness industry. The objective of management is to use credit to their sales advantage while minimizing its adverse impact on firm profits. If this objective is to be reached, management must seek to manage its accounts receivable. Some suggestions for maintaining a reasonable credit practice include the following:

1. Regularly review your firm's credit policy and practice prudent account management. This requires that credit customers be billed regularly, systematically, and in compliance with existing credit legislation.
2. Meet with your credit customers for purposes of relating to them the terms of sale or any change therein.
3. Make sure that firm agreements are made between you and your customers at the time of sale or delivery as to when and in what manner payments are to be made.
4. Seek to improve, where possible, the general caliber of your credit customers. Keep up-to-date as to their financial abilities and the

degree to which your credit provisions meet their needs.

5. Encourage cash or 30-day sales through the establishment of early payment discounts. Make sure such discounts reflect accurately your costs and margins.
6. Pay attention to your receivable records. Analyze each monthly report in an attempt to detect early any general trends or specific customer problems.
7. Don't hesitate to demand payment from customers who have violated the terms of sale. This should be done tactfully and in a manner such that the customer understands fully the reasons and logic.
8. Do not delay shutting off credit when an account is judged to be delinquent and of doubtful liquidity. Commensurate with this decision you should provide the debtor with provisions by which reinstatement might be granted.

*Ken D. Duft*

Ken D. Duft  
Extension Marketing Economist