Financial Management for a Small Agribusiness

A training manual

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About this Manual

This training manual is designed for female agribusinesses running their own small home-based agribusiness. The manual provides essential concepts relating to financial and accounting affairs of a small agribusiness enterprise. Its contents are made simpler so as to facilitate understanding of the audience in question.

About the Author

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1. Introduction

Starting and running a new agribusiness requires, among others, adequate financial resources. If an agribusiness is to be profitable, it should have sufficient financial resources. Remember the old saying, "it takes money to make money." Money is required in every area of an agribusiness, including payments for land, buildings, equipment, livestock, crops, and operating expenses. Personal savings and credit are the two main sources of financing an agribusiness enterprise. Small farmers can hardly save, therefore, they need credit to finance their agribusiness. Majority of afghan farmers are small, conventional and subsistence characterized by small holding size, low productivity, lack of access to improved agricultural technologies, lack of access to credit on reasonable terms, limited information, no or negligible marketable surplus, severe problems in marketing of their products, and so on. Hence, small farmers are in dire need of support and help from government, private sector, and international community.

Entrepreneurs accepts risks in starting a new business venture with a purpose to make a profit. Running a business involve various transactions (buying, selling, etc.) and operations to meet the business objectives. Keeping accurate records of business transactions is vital to the success of an agribusiness venture. These records allow tracking of the financial position and profitability of an agribusiness.

2. Need for Credit

In the agricultural industry, financing is needed in three areas: fixed expenses, operating expenses, and startup expenses. **Fixed expenses** are items that can be used over and over for a long period of time, incurring the same price (expense) each year. Examples of fixed expenses include land, buildings, machinery and equipment, tools, and fixtures. Usually a large amount of money is borrowed for fixed expenses. **Operating expenses** cover everything needed to run a farm, ranch, or agribusiness. The amount of money needed depends on the size of the operation. For farmers, operating expenses are figured on yearly or seasonal basis. A wheat growing farmer would need money to purchase seed, fertilizer, and chemicals and to pay workers. **Startup expenses** are payable before the business begins operations. Examples of such expenses include registration fees, incorporation expenses, and costs for the development of a site. Startup expenses do not include the initial cost of land and other fixed items.

Afghan famers do not have access to credit on reasonable terms, and often lack information regarding sources of credit. Farmers, therefore, obtain necessary amount of money from local moneylenders on high interest rates. This could be one of the major hindrance in front of agricultural development. Credit allows farmers to: increase production; improve the quality of what is produced; access improved agricultural technologies; and revise operations to make them more profitable.

3. Three Fundamentals of Credit

There are three credit fundamentals each starts with the letter **R**. Hence, in credit there are three R's: returns, repayment, and risk.

3.1. **Returns:** the main reason for borrowing money is to increase net returns and make a profit. An agribusiness manager must carefully choose among the best alternatives when considering credit. Money should not be borrowed based on quick, thoughtless decisions.

3.2. **Repayment:** agricultural lenders expect their money to be repaid in full plus interest. It is crucial for an agribusiness venture to determine its ability of repaying loans. Priority should always be given to loans that have earning capacity. For example, borrowing for a dairy cows would take priority over borrowing for automatic feeders to replace hand feeding.

3.3. **Risk:** borrowers with strong assets can take on more risk than those with few assts. It is only reasonable that lenders tend to favor individuals in the agricultural industry who have enough stability to absorb a potential loss.

4. Rational Credit Principles

Applying the following principles, wisely, can lead to success and profitability for an agribusiness and farmers:

1) Use credit for productive purposes – purposes that increase income.
2) Limit borrowing on unfamiliar enterprises.

3) Use credit where it will generate the highest return within reasonable risk limits.
4) Know your own business situation.
5) Keep debt in line with income and repayment capacity.
6) Shop for loans and select a dependable lender.
7) Be businesslike, honest, and fair in credit dealing.

5. Types of Loans

A loan is basically a contract between borrower and lender. Loans usually fall into three borrowing timeframes: short-term, intermediate term, and long term.

5.1. **Short-term loans** are distinctive in that their terms are normally one year or less. The main use of the short-term loan is to finance operating inputs. Banks, individuals, merchants, and farm credit services are among the suppliers of short-term loans. In business applications, short-term or operating credit assists in purchasing items such as fuel, fertilizer, chemicals, and seed, and in meeting maintenance expenses. Short-term credit may be the most important type for the survival of an agribusiness, because it finances the everyday operations of the firm, which generate the cash flow in the business.

5.2. **Intermediate term loans** vary in length from 1 to 10 years. They finance assets that may be depreciable over their expected lives. Farm machinery and equipment, breeding livestock, irrigation systems, and any modernization of farm facilities are examples of these assts. Commercial banks and farm credit institutions are suppliers of intermediate term loans. A lender may require collateral when considering whether to grant a loan.

5.3. **Long term loans** are loans that extend over 10 years. Purchases of land, buildings, and housing create the need for this type of credit. Typically, the credit instrument used in long-term financing is a mortgage. Businesses and individuals both use mortgages for long-term financing needs. Long term credit is especially important when starting an agribusiness.

6. Sources of Credit

Generally, formal or informal sources supply loans to individuals and firms. Formal sources include commercial banks, agricultural and rural development banks, and microfinance institutions. Informal sources of credit include local moneylenders, traders, relatives, and friends. Although banking sector is rapidly growing in Afghanistan, yet majority of farmers do not have access to credit on reasonable terms. Hence, framers mostly relies on informal sources of credit. Establishment of agricultural bank will, to a greater extent, solve credit problems of farmers and agribusinesses. At present, some organizations and agencies including ministry of Agriculture, Irrigation, and Livestock (MAIL) provide credit to Afghan farmers and agribusinesses, but their services are limited to a small number of farmers, leaving majority of small and marginal farmers uncovered.

7. Preparing a Household Budget

A budget is simply a plan for spending and saving money. That is, an accurate written outline of income and expenses. A good budget is an essential tool in every household. Some of the benefits of a budgets are as follows:

1) A budget puts you in control of your financial future.
2) A budget ensures that you do not spend more than you earn.
3) A budget helps you prepare for major periodic expenses such electricity bill, insurance, and vacations.
4) A budget helps you save money to prepare for unpredictable expenses, such as medical bills, major car repairs, pest control, etc.

A household or family budget can easily be prepared by outlining all income, and expenses & savings. The total income must equate total expenditures and savings. Table 1 presents a hypothetical example of a household budget.

8. Preparing an Enterprise Budget

An enterprise budget generally has three components: gross income, costs (fixed and variable), and net income. To estimate gross income, a manager should estimate total production or output as well as expected per unit price of output. When making these estimates, assume normal conditions, and be as realistic as possible. For estimation of costs, a manager must determine and list all expected fixed[1] and variable[2] costs. The last step in preparing an enterprise budget is to calculate net income by deducting total costs from gross income. Table 2 provides a hypothetical example of an enterprise budget.

Table 1. A hypothetical Example of Household Budget.

Household Budget	
Name: Ms. Shilla	
Time Period: June - July, 2013	
Income (after taxes)	
1. Sales	Afs 15,000
2. Part time Job	Afs 8,000
3. Others	Afs 2,000
Total	**Afs 25,000**
Expenditures & Savings	
1. Savings (emergency/ opportunity)	Afs 8,000
2. Food	Afs 5,000
3. Transportation	Afs 3,000
4. Furniture	Afs 4,000
5. Children's School Fees	Afs 3,000
6. Miscellaneous	Afs 5000
Total	**Afs 25,000**

Table 2. A hypothetical Example of Enterprise Budget.

Enterprise Budget for Strawberries Production (1 hectare)	
Income	
Sale of 2500 kg (strawberries) @ Afs 100 per kg	Afs 250,000
Costs (fixed and variable)	
Seedlings	Afs 2,000
Fertilizer	Afs 2,500
Labor	Afs 6,000
Packages and packaging expense	Afs 25,000
Transportation cost	Afs 10,000
Tractor expense	Afs 1,500
Insurance	Afs 15,000
Miscellaneous	Afs 12,000
Total costs	**Afs 74,000**
Net Income/Estimated Profit	**Afs 176,000**

[1] Fixed costs are those that do not change with the level of output such as taxes, insurance, etc.
[2] Variable costs are those that varies with the level of output such as fertilizers, seed, fuel, etc.