## An Evaluation of the Credit Management System of an Enterprise

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#### Abstract

The company under this case study is facing the problem of cash operating cycle and higher debt level which eventually increases the days' sales outstanding. Due to a high level of account receivables, the company incurs administrative expenditures and opportunity costs. Therefore, it is required to reduce the debt level of the company to decrease the loss of opportunity cost and administrative expenditure. We find that the implementation of a robust credit management policy will improve the quality of sales of the company and will eventually reduce the bad debts and days' sales outstanding (DSO). The appointment of a credit manager improves the relations of the company with the regional office, subsidiary companies, and customers of the company. A robust credit policy helps credit managers involve employees of the organisation in credit management. The receivable-based commission policy encourages salespeople to focus on viable projects, leading to a low level of DSO.

**Key Words:** Working capital, Day's sales outstanding, Credit management, Risk Assessment. **JEL:** M41, M49

#### Introduction

This study provides a detailed discussion on organization's working capital management (WCM) and its importance in enhancing performance. It also provides a holistic account of working capital management practices as well as days' sales outstanding as distinctive concepts to generate ideas about how firms should manage these to enhance their operational activities. While optimal financing in an organization is often an incorrect proposition, successful firms tend to find a match between their assets' average life and their operational activity level. Commonly defined as the difference between short-term liabilities and short-term assets, working capital is more specifically related to cash required to run an organization's operations (Altaf & Ahmad, 2019). It is considered the balance of accounts that is directly connected with a firm's operating cycle (such as accounts payables, inventories, and customer receivables).

#### Net Working Capital (NWC) = Current Assets (CA) – Current Liabilities (CL)

This is based on a simple concept that the growth of a business depends on its revenues, which should be convertible into cash to help run business operations. Generation of cash specifies the operational activities that a firm can undertake at a given point in time, which is a measure of its productivity as well (Dechow, 1994).

Across the world, scholars, and business analysts are endeavouring to evaluate the measurement of a firm's operational efficiencies through its working capital management practices (Haron & Nomran, 2016). The main rationale behind the new regulatory environment and innovative financial systems is to achieve reductions in working capital as a favourable source of cash other than external funding sources. Two main reasons behind this peripheral interest to WCM include their frequency which means they are much reversible than long-term financing decisions and secondly, due to their insignificant individual value which means they are routine decisions by nature. However, in the post-crisis period from 2008 onwards, declining organizational productivity has attracted researchers towards this field. The rationale behind this was to ensure enough cash flows to be able to mitigate or minimize the risks associated with the inability to fulfil payment commitments in the short term. This also supported the idea that only limited investments in working capital

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should be done so as to avoid shortages in the daily running of the business. While greater investments indeed foster organisational liquidity, excessive investments in this area can be troublesome for the organisation. This is a classic case of risk-return nature that means more working capital will reduce the risks and ensure greater returns and vice versa. Since it is mainly found in dynamic working environments, the identification and estimation of working capital is a challenging task. It varies from one industry to another and from one time period to another for a single firm.

A few note-worthy studies on WCM literature were published in 1979 and 2012 respectively (Gentry et al., 1979; Lind et al., 2012) after which research on WCM became limited. There is a dearth of scholarly content dealing with WCM practices, which is why it is important to identify the underlying literature gaps and study the existing body of research in a precise manner. The importance of working capital can also be noticed during the global pandemic times of COVID-19. The high-level availability of cash allows firms to avoid technical insolvency (Zimon & Tarighi, 2021). Therefore, working capital should continue to grow during recessionary periods. This study focuses on developing credit management policies to reduce the debt burden of the studied company. It presents an analysis of the factors causing increments in the days' sales outstanding of the service company despite operating in various countries.

#### Literature Review

## Effects of Conservative and Aggressive WC Policies on Profitability

Working capital policies (WCPs) are meant to inform decisions on finding sources for current assets and liabilities and seek ways for firm profitability. Several researchers evaluated the relationship between WCM and the profitability of the organisation depending on the types of operations the organisation undertakes and its external market volatilities. Based on these factors and internal organisational governance, an aggressive or conservative WCP is selected. In an aggressive scenario, higher risk entails involves steady flows of cash in and out of the business (Bhattacharjee & Han, 2014). On the other hand, a conservative WCP entails a lower risk-lower return policy, where firms acknowledge market volatilities and other externalities in their decision-making (García-Teruel & Martínez-Solano, 2007; Blinder & Maccini, 1991). To avoid loss of sales, a conservative policy adopts extensive investments in the current assets of the firm. Based on its alignment with the internal and external conditions of the industry, both aggressive and conservative WCPs have their strengths and weaknesses.

Industries such as construction and tourism generally adopt a conservative approach to ensure their banks are full of cash, and a reasonable working capital ratio is maintained. However, these firms usually neglect the prospects of long-term profitability (Bhattacharjee & Han, 2014; Baños-Caballero et al., 2010). In aggressive working capital financing, short-term finances yield a low cost of interest which means a higher profitability rate. Also, lower levels of inventories in this scenario affect profitability. The whole idea behind the aggressive policy is to ensure the working capital is effectively managed in running the operating cycle of the organisation. In a conservative strategy, there is a risk of insolvency for the organisation because of its utilization of short-term financing sources (García-Teruel & Martínez-Solano, 2007). In a conservative policy option, there is a lower risk of bankruptcy for the organisation because it maintains higher liquidity that can help in its survival.

The scope of this paper, in addition to the reviewed literature, is tied to the agency theory parameters that provide a clearer foundation of strategic decision-making for corporate officers and board members. Solomon et al. (2021) highlights the differentiation between shareholders (as principals) and company management (as agents) to understand the intricate agency involved in the principal-agent relationships that stipulates what an agent does must be in the interest of the principal parties.

#### **Relationship between WCM and Profitability**

According to the researchers, WCM is a sustainable strategy that can boost organisational profitability. The cash Conversion Cycle (CCC) is the main independent variable that operationalizes WCM and results in the conversion of firm resources into cash flows (Baños-Caballero et al., 2010). Most research also provides evidence on the adoption of WCM policies that result in low receivables and inventories, and the highest number of accounts payables that can lead an organisation towards higher profitability. Other studies propagate that efficient adoption of working capital policies can maximize profits for an organisation which will, in turn, increase shareholder wealth. This can be done by reducing average collection periods for a firm's receivables and reducing the average days in inventories to a minimum. Samiloglu & Akgün (2016) also professed the benefits of performing a formal investigation of creditors before granting credit to its customers.

Investments in working capital can possibly lead an organisation towards a negative firm value at certain levels. With the increase in inventory, costs associated with keeping the stock such as rent of warehouse and other security expenses tend to multiply (García-Teruel & Martínez-Solano, 2007). Moreover, investments in working capital mean the firm should explore new sources of finance that incur opportunity costs. Interest expenses also increases with higher working capitals and resultantly, there is a higher chance of credit risks. With the increase in working capital, an organisation's probability of bankruptcy also increases, and it might face acute financial turmoil (Aktas et al., 2015; Kieschnick et al., 2013). This is why firms with higher working capital levels tend to reduce it, to lower their chances of bankruptcy and distress. The optimal level will provide a balance between costs and benefits, and negative relations between WCM and firm performance will be avoidable (Kieschnick et al., 2013).

The relationship between WCM and corporate profitability was studied by Deloof (2003) who suggested that reduction of inventory days and debtor days can be an effective way of increasing profitability. Other researchers also identified a negative relationship between CCC and operating performance which means that reducing the collection period of receivables and payables can effectively reduce CCC (Aktas et al., 2015; Kieschnick et al., 2013). Previous literature touched upon the effects of WCM and organizational performance to question whether a shorter CCC would be beneficial to the organization in the longer run. Shin & Soenen (1998) argued that when firms have a generous credit policy, they can increase their revenues with extended CCC. In this case, a positive relationship between CCC and firm profitability (Abuzayed, 2012). The recommended best practice suggested is that organizations must realize that the lengths of CCC depend upon the nature of products and services and their customers. The sooner an organization can collect payment from customers, the more revenues it will have achieved (Kieschnick et al., 2013). Without an effective payment policy and collection strategy in effect, an organization cannot achieve adequate resources to support the requirements of WCM. An adequacy of cash and current assets are, therefore, necessary for effective WCM and to support the growth or survival of the organization. Trade credit collection policies should be ascertained in great detail so that the organization is able to understand its requisites and manage them satisfactorily (Cheng & Pike, 2003).

#### **Research Approach and Methodology**

The analysis of the studied issue begins with the collection of invoices between 1<sup>st</sup> January 2010 and 30<sup>th</sup> April 2012, followed by desk research and interviews with the organisational employees. To protect data confidentiality, the company details have been kept anonymised throughout the research. Collecting first-hand data from an organisation is one of the major contributions of this paper. Primary data, as opposed to secondary sources, is generally objective and collected from the original source. Maintaining the privacy of the data source is this case is a crucial aspect of data ethics and integrity however, primary data gives researchers more control over how the data is managed and analysed, and generally is more specific within the studied context. Specific existence and objectivity of the data collected from an organisation adds to the authenticity and reliability of the reported findings.

Invoices collected between the aforementioned periods included additional details such number of days paid/pending, client names, invoice numbers, client codes, credit statuses and invoice descriptions. These invoices were further sorted according to the number of days with an exclusion of inter-company transfers. 269 invoices were identified to be paid or pending for more than 90 days.

Six meetings were arranged with Senior Accountants of the company to identify the reasons behind the delayed invoice payments. These meetings were designed to involve a combination of semi-structured and unstructured questions. Semi-structured interviews helped in focusing the conversation on delayed invoice payments whereas unstructured interviews helped to understand the underlying trends and processes of the Accounts and Finance department. During these interviews, 22 types of reasons were identified out of which some of the reasons were less significant and some of the reasons were merged into the main ones, so finally eight main reasons were identified for delayed payment. Out of eight main reasons, two reasons were related with the operating system of the PPD segment. In order to find out about the loopholes of the PPD segment and how it can be improved, a meeting was organised with the Operations Manager, PPD-EAM. Another reason related to the operating system of ILI segment. A meeting was conducted with the Data Analyst, Eastern Hemisphere and the Operations Manager, and the In- Line Inspector to identify the issues and scope of improvement within this segment. In these interviews, it was observed that few problems related to the terms and conditions of the contract itself. Subsequently, discussion was needed to be organised with the ILI Commercial Manager to understand the process of entering into an agreement and promoting sales. A meeting was also arranged with the Finance Manager to find out the problems in the process of account and finance department. The identified

reasons and their descriptions are given in Appendix 1. We have also created a significance index using the following formula.

Significance index = 
$$\frac{\text{Product of delayed days and delayed amount for each reason}}{\text{Sum of product of delayed days and delayed amount for all reasons}} * 100$$

Significance index shows the significance level of each reason on total identified reasons. It considers the average days delayed due to each reason and the amount retained by the client due to that reason. The high level of significance index shows a high impact of the reasons in DSO of the company whereas the low level of significance index shows low impacts on DSO.

Proportion (%) shows the amount retained by the clients of total selected invoice for specific reason.

## **Descriptive Statistics**

Table 1: Reason Wise Retained Amount and Significance Index for Combined Segment					
Reasons	Total Amount (£) (1)	Average Amount (£) (2)	Average Days (3)	Proportion (%) (4)	Significance Index (%) (5)
Retention Money	230,200	16,443	543	6.4	18.0
Reconciliation of account	130,747	4,842	405	3.6	9.1
Letter of credit/ Cash against documents/ Performance bond	769,202	33,443	186	21.3	19.6
Below the acceptance level of ILI Report	399,262	36,297	211	11.1	10.8
Pro forma Invoice	415,804	23,100	164	11.5	8.8
Hard Payer/ Complicated Countries	659,243	10,300	190	18.3	16.4
Issues related with Invoicing	303,513	23,347	188	8.4	9.3
Other Specific Requirement	379,195	8,068	159	10.5	8.0
Total	3,287,167			91.1	100.0

The table describes reason wise the total retained amount by the clients in column one, average retained amount by clients in column two, average days of retention by clients in column three, proportion of amount retained by clients out of total invoice in the fourth column, and reason wise significance index depicting the most impactful reason contributing to high DSO in the fifth column.

## Days' Sales Outstanding of the Company:

According to the data collected from the company, the DSO of the ILI and PPD segment for the period of December 2011 to April 2012 is as follows:

Table 2: DSO of ILI and PPD Segment			
Month	PPD	ILI	Combined
December 2011	123	85	118
January 2012	123	86	117
February 2012	161	90	141

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March 2012	131	113	125
April 2012	117	128	111
Average	131	100	122

The table depicts the days' sales outstanding of the two segments PPD and ILI of the company along with combined DSO of both the segments.

From Table 1, we have observed that the DSO of the PPD segment is quite volatile. In December 2011 and January 2012, it was 123 days which increased significantly from 123 days to 161 days in February 2012 and then dropped to 131 days in March 2012. The average DSO for this period for the PPD segment was 131 days. Whereas, the DSO for the ILI segment has followed an increasing trend, in December 2011 it was 85 days, which increased slightly in January and February 2012 to 86 and 90 days respectively. However, it increased significantly in March and April 2012 to 113 and 128 days respectively. It can be seen that the DSO for PPD segment is higher than the ILI segment.

To identify the main cause for the high level of DSO, we collected invoices for the period of 1<sup>st</sup> January 2010 to 30<sup>th</sup> April 2012. Moreover, we organised meetings the Account Manager to find out the reasons for late payment of those invoices which were due for more than 90 days.

We have also conducted pooled OLS regression to identify the significant reasons for the high level of days' sales outstanding. We have used three dependent variables i.e., natural log of number of days, natural log of amount due, and proportion of amount due. The independent variables are dummy variables for each reason. The following is the regression equation:

$$DEP = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \mu_c \dots (1)$$

Where;

DEP = Natural log of number of days (ND)/ Natural log of amount Due (AD)/ Proportion of Amount Due (PD)

 $X_1$  = Retention money

 $X_2$  = Reconciliation of account

 $X_3$  = Letter of credit/ cash against documents/ performance bond

 $X_4$  = Below is the acceptance level of ILI report

 $X_5$  = Pro forma invoice

- $X_6$  = Hard Payers/ Complicated countries
- $X_7$  = Issues related with invoices

 $X_8$  = Other specific requirements

## **Findings and Analysis**

This section discusses analysis of regression and descriptive statistics. The column 1 presents the results for number of days (DSO), column 2 shows the results for amount due, and the column 3 exhibits the relationship between proportion of amount due and independent variables.

No of Days	Amount Due	Proportion of Amount Due
(1)	(2)	(3)
1.345***	1.497***	0.232
(0.158)	(0.586)	(0.259)
0.857***	-0.093	-0.003
(0.129)	(0.477)	(0.210)
0.155	1.052***	0.704***
(0.136)	(0.503)	(0.222)
0.178	2.306***	0.783***
(0.172)	(0.638)	(0.281)
	No of Days   (1)   1.345***   (0.158)   0.857***   (0.129)   0.155   (0.136)   0.178   (0.172)	No of Days Amount Due   (1) (2)   1.345*** 1.497***   (0.158) (0.586)   0.857*** -0.093   (0.129) (0.477)   0.155 1.052***   (0.136) (0.503)   0.178 2.306***   (0.172) (0.638)

## Table 3: Regression Analysis

Pro forma invoice	0.052	0.277	0.417*
	(0.146)	(0.541)	(0.238)
Hard Payers/	0.151	0.286	0.062
Complicated countries	(0.109)	(0.403)	(0.178)
Issues related with invoice	0.190	-0.091	0.197
	(0.139)	(0.516)	(0.228)
Other specific requirements	-0.001	-0.140	0.035
	(0.119)	(0.442)	(0.195)
F	17.34	3.64	2.95
r2	0.3682	0.1091	0.0903
Ν	247	247	247

The table presents findings from regression analysis using three dependent variables. Column 1 shows the number of days, column 2 presents the results for log of amount due, and third column shows the results for proportion of amount due. We have used the dummy variables for all the independent variables.

\*, \*\*, \*\*\* Indicate that the estimate is significant at the 10%, 5%, and 1% levels respectively.

The columns 1 and 2 of Table 3 present a positive coefficient for retention money at 1.34 and 1.5, statistically significant at 1% level. This suggests that an increase the number of invoices held due to retention money increases the number of days outstanding by 1.34 days.



#### Figure 1:

The figure plots the proportion of delayed amount and significance index due to retention in combined and ILI segments. The proportion (%) is the share of retention money to the selected invoice. The significance index value shows the importance of retention of money in contributing high level of DSO and accounts receivables among all the identified reasons.

Retention money was identified one of the major concern for high level of days' sales outstanding. For example, in the following meeting with the Senior Accountant, we find that an amount of £230,200 was retained by the customer as retention money for more than 500 days. This amount constitutes 6% in proportion of total selected invoice value and 18% in significance index of combined segments. The amount constitutes 24% of total selected invoice value and 55% in the significance index of the ILI segment. These situations can be managed with the regular follow up with the customer.

We also find a positive association between reconciliation of accounts and number of days outstanding. The coefficient for the reconciliation of account is 0.86 at 1% significance level, suggesting an increase in the number of invoices held due to pending reconciliation increases the number of days outstanding by 0.86.





The figure plots the proportion of delayed amount and significance index due to reconciliation of accounts. The proportion (%) is the share of reconciliation of the accounts to the selected invoice. The significance index value shows the importance of reconciliation of accounts in contributing high level of DSO and accounts receivables among all the identified reasons.

According to the selected invoices, it has been observed that an amount of £130,747 were showing unsettled for more than 90 days, which accounts 4% of the total selected invoice value and 9% in the significance index in combined segments. The same amount accounts 14% at the significance index of the ILI segment and 5% in the proportion to the total selected invoice of the ILI segment. Hence, it is required for the company to reconcile the accounts with agents at a regular interval.

Letter of credit (LC) and Cash against documents (CAD) are basically a promise from the buyers to pay the bill amount in future date after succession of contracts, whereas the performance bond is basically a promise from the seller side to the customer to deliver the quality products / services. If buyers and sellers both agree to more than the normal credit terms in all three cases, it increases the DSO level of the organisation. Sometimes, organisations issue invoices before completing the contracts and getting the satisfactory approval from the customer. In such circumstances, customers' banks usually don't pay.

The column 2 and 3 of Table 3 show a positive relationship among LC/PB, amount due, and proportion of amount due. The coefficients for LC/PB are 1.52 and 0.70 at 1% significance level for amount due and proportion of amount due respectively.



Figure 3:

The figure plots the proportion of delayed amount and significance index due to LC and CAD. The proportion (%) is the share of invoice pending due to letter of credit/ cash against document to the selected invoice. The significance index value shows the importance Letter of credit/ Cash against documents/ Performance bond in contributing high level of DSO and accounts receivables among all the identified reasons.

We also find that an amount of £769,202 was paid or pending for more than 90 days. The amount constitutes 21% in proportion of the amount of total selected invoice value and 20% and 29% at significance index in combined and PPD segment.

Moving to next key independent variable, we find a strong positive association between amount due, proportion of amount due, and quality of ILI report. The columns 2 and 3 show positive coefficients at 2.31 and 0.78 and statistically significant at 1% level. The results suggest that an increase in the number of ILI invoices increases the change in amount due by 2.31 and the proportion of amount due by 0.78.

It has been found that the below acceptance level of the quality of the report generation is one of the major reasons, due to which an amount of £399,262 was delayed by the customers for more than 90 days. This amount constitutes 11% to the total selected invoice value and 11% at the significance index in combined segments. The same figure accounts 42% of total selected invoice value in the ILI segment and 33% of significance index in the ILI segment.



The figure plots the proportion of delayed amount and significance index due to ILI report (Below the Acceptance Level of Clients). The proportion (%) is the share of invoice pending due the below the acceptance level of ILI report to the selected invoice. The significance index value shows the importance quality of ILI report in contributing high level of DSO and accounts receivables among all the identified reasons.

According to the data of the ILI segment received by the company for the year 2011, out of 179 projects, 27 projects reports were below the standard level and not accepted by the customers. In the following meetings with the Operation Manager of the ILI segment, ILI Commercial Manager and Data Analysis Manager, few reasons for being below the standard of quality reports were identified.

1. Information provided by the customers and sales representative to the project management, operation, and data analyst teams was not adequate to work on the project and prepare the report.

2. Due to regulatory pressure, most of the work related to the checking of the pipeline is completed during the last quarter, which creates work pressure and burnout.

3. The inefficiency of technicians of the kind of field worker may create a problem in collecting the data from running an appropriate tool to check the status of the pipeline.

We also find that a positive association between proforma invoice and proportion of amount due (see column 3 of Table 3). No other dependent variables show a significant relationship with proforma invoice. The coefficient of proforma invoice is 0.42 at 10% significance level, suggesting an increase in the number of proforma invoice, increases the proportion of amount due by 0.42%.

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We find that out of 269 selected invoices, 18 were pro forma invoices were due for more than 90 days. The total amount of those invoices was £415,804 and according to the significance index level, it constitutes 9% and 13% of the combined segment and PPD segment respectively. The proportion of combined and PPD segments were 12% and 16% respectively.



#### Figure 5:

The figure plots the proportion of delayed amount and significance index due to proform invoice. The proportion (%) is the share of invoice pending due the proform invoice to the selected invoice. The significance index value shows the importance proform invoice in contributing high level of DSO and accounts receivables among all the identified reasons.

The company sends pro forma invoices to its clients asking for an advance partial payment to arrange the ordered instruments. However, most cases clients do not pay the amount in advance, just to avoid the risk of non-delivery of goods. Additionally, sometime due to delay in delivery of products and documents causes delay in payment. We do not find a significant relationship between other reasons and dependent variables. Therefore, we are cautious in

making any inference from them.

#### Policy recommendations and conclusion

The problem of DSO of the company is not only related to the account and finance department of the company. In fact, it is mainly related to the business process of the company. The major amounts which were retained by the clients were due to inefficiency of the operating system of PPD and ILI segment of the company.

The paper has various academic contributions. It contributes to the working capital management and credit management literature by exploring the reasons for high level of days sales outstanding (Baños-Caballero et al., 2014; Deloof, 2003). It also contributes to the sales and motivation literature by studying the impact of sales commission policy on the DSO (Cadwallader et al., 2010; Pullins, 2001). This paper, through its review and analysis of corporate governance aspects, reinforces the importance of agency theory. Compensation and other perks are effective mechanisms by virtue of the relationship of the agent with the principal can be optimised (Al Amosh & Khatib, 2021).

It has been observed that the account department generally is overburdened with duties and responsibilities. They lack a focused approach to address credit management issues. Therefore, to manage the account receivables, it is advisable to appoint a Credit Manager, whose job would be a) to prepare the terms and conditions for sale, b) to reconcile accounts at regular intervals, c) to follow up with customers on retention money, d) to introduce and execute collection policies, e) to prepare the sales deed for ILI segment carefully, and f) to change the commission policy from selling the ILI services to receipt of amount.

Changing the policy of commission and providing correct and full information about the contract and pipeline status have the potential to improve the efficiency of the ILI segment and eventually reduce debt levels.

The appointment of credit manager may involve employees of the organisation to improve the cash flow of the company by providing a better service to customers. A Credit Manager may also be able to build good relations with

customers which may eventually help to improve the business of the company. This way, an agent-principal relationship can be built and sustained over the life of the organisation, and employees and employees would enjoy a conducive cooperative work environment.

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