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TRADE CREDIT MANAGEMENT AND FIRM PROFITABILITY OF SAUDI MANUFACTURING FIRMS

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Abstract: In a dynamic and hyper-competitive business environment, trade credit management is critical to the growth and survival of any organization. Trade credit management is an effective method to reinforce the organization's sound financial situation. This research paper aims to explore the relationship between trade credit management and firm profitability. A sample of 41 manufacturing firms from three indexes namely energy, materials and capital goods, listed at the Tadawul Stock Exchange in Saudi Arabia from 2009 to 2017 is used. Fixed effect regression method is employed to analyze the panel data with the operating profit margin as the dependent variable, daily sales outstanding and accounts receivable turnover as independent variables. The empirical results of the study identified a strong, positive and significant influence of trade credit on firm profitability. The outcomes of the study imply that effective trade credit management can substantially improve the cash flows and profitability of the manufacturing firms in Saudi Arabia.

Key words: trade credit management, receivables management, firm profitability, accounts receivable turnover, daily sales outstanding

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Introduction

The practice of selling goods without demanding cash payment, essentially lending funds to customers has become a trivial and indispensable application in the business world. Commonly flagged as trade credit refers to credit extended by manufacturers and wholesalers to their customers. With trade credit, a customer's receipt of goods or services occurs before payment is rendered. Consequently, the firm's overall sales increase with such trade credit extension because of the convenience of trade credit may trigger large purchases; it also builds goodwill and aids supplier-customer relationship. In other terms, trade credit is widely considered as a strategic tool to increase revenues and gain market share relative to rival firms.

The main motive behind firms to extend trade credit is to increase the shareholder value with accelerating sales figures. But the downside of trade credit extension is the creation of accounts receivable. Investments in accounts receivable represent a significant part of working capital management and occupy a substantial portion

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of current assets in manufacturing and service firms. Accounts receivables are created when goods and services are sold to customers on credit with an agreement that the customers are permitted to pay at a later date (Ventkataramana et al., 2013). It measures the unpaid claims a firm has over its customers at a given time, usually comes in the form of operating line of credit and is mainly due within a relatively short time period (up to one year). The volume of accounts receivable indicates the firm's supply of trade credit while accounts payable shows its demand for trade credit. This common industrial practice engenders one of the sizeable short term assets as receivables in the enterprise's balance sheet. In most of the manufacturing firms, a substantial amount of receivables depict large financial sources invested in asset and involve a significant volume of business and decisions. As predominantly the cash flows from a sale can be invested only if it is collected, monitoring and controlling of receivables becomes imperative in stabilizing firm profitability and liquidity (Rangarajan and Misra, 2006).

Impact of Receivables on firm profitability: It is very often argued that though revenue generation is most critical in any business, generating cash flows out of the revenues is all the more significant. Variations in the values and turnover of receivables are directly associated with the level and timing of a firm's cash inflows and outflows. Shortened day's sales outstanding results in increased cash flow to firms without affecting the sales figures. This, in turn, creates a positive net present value of cash flows, reduced risk and increased shareholder value. On the other hand, extended days of sales outstanding results in firm's failure to generate adequate cash flows, either burn their cash or rely on external financing which in turn increases operating cost, alter the capital structure, reduces profit and increases risk. In addition, a lax collection policy will cause the average collection period to lengthen compared to credit terms adversely impact firm's liquidity. Therefore with effective accounts receivable management the firms can maximize their value by successfully bringing out a balance between liquidity and profitability.

Monitoring of Receivables: The 2009 financial crisis impelled the firms in emerging markets to revamp their major focus from long term financing decisions to append the systematic management of short term working capital. This resulted in growing realization about the importance of short term working capital components including receivables which impacts the firm liquidity and profitability at large. Three traditional approaches to monitoring the receivables balance include Days Sales Outstanding (DSO) Accounts Receivable Turnover (ART) and the aging schedule.

Days Sales Outstanding (DSO): the value is interpreted as the number of days of credit sales remaining uncollected, or how many days, on average it takes for the company to collect credit sales. A firm can compare the DSO with the number of days specified in the credit policy to estimate the effectiveness of the firm's credit policy. As DSO signals slowed collections, the credit manager initiates a series of contacts with customers involved to speed up the collections. In planning

framework, DSO can also be used to determine the average receivables needed to support a forecasted sales level.

Accounts Receivable Turnover (ART): ART provides insight into a firm's credit policies and collection procedures. Accounts receivable turnover is elucidated as how many times a company's investment in accounts receivable turned over into sales during a period. A high receivable turnover ratio indicates the firm is successfully collecting receivables on a regular basis. This ratio indicates that the number of times the firm got paid and depicts how effectively the firm is extending credit to their customers and collecting the same. Tracking ART enables firm's to improve their cash flows, evaluate and redesign their credit policies and procedures to minimize bad debts.

Review of Literature

Many research studies have stressed the importance and the impact of receivable management on firm performance. Dencic-Mihajlov (2013) investigated accounts receivable management practices in organizations of the Republic of Serbia. Account receivable policies of 108 organizations during the financial crisis years of 2008 to 2011 were studied. The investigation revealed that though there is a positive relationship between account receivable and profitability, there is no evidence of a significant relationship between these two variables. It indicates that the effect of accounts receivables on organization's profitability varies during the period of financial crisis. A similar study by Ndebugri and Senzu (2017) in their study of account receivables and strategies employed by organizations throughout the industries of Ghana demonstrates that the majority of the organizations do not have a consistent credit policy, credit monitoring system and credit control function.

Michalski (2008) used the portfolio approach to determine the extent of trade receivable in an organization. The study revealed that a rise in the extent of account receivables in an organization leads to a direct rise in the actual working capital, cost of holding and also the cost of trade receivable management. The study conducted by Michalski (2012) in the Republic of Kalmykia found that any alteration in the level of account receivables leads to an increase in the working capital level and impacts the costs of managing receivables in the context of non-profit organizations.

Whilst the above research studies examined the trade credit management practices, there were few studies empirically investigated the effect of receivable management on firm profitability. Venkataramana et al. (2013) investigated the impact of receivable management on working capital and profitability of selected large cement companies in India for the period between 2001 and 2010. The study demonstrated a strong impact of receivable management on working capital and profitability of the organizations. Consistent with this study Jindal et al. (2017) found a strong positive relationship between debtor's turnover ratio and profitability in the commercial vehicle industry in India from the year 2009 to

2016. This signifies that effective receivable management is critical to the growth in profitability of the industry. On the contrary, organizational growth and liquidity does not strongly impact profitability. A study conducted by Yao and Deng (2018) used sorting, and various regression methods to find out how US manufacturing organizations use managerial incentives to influence working capital components. The study highlighted that the organizations with very good financial position, accounts receivable can lead to higher market share and obtaining good demand and supply relation which may thereby lead to favourable share prices.

From GCC context, few prior research studies have examined the effect of various working capital components on firm profitability. Nobanee and Ellili (2015) employed net trade cycle to measure the working capital management efficiency of Kuwait construction companies. The study concluded that large construction companies in Kuwait are more efficient in managing their working capital than the small companies. Almazari (2013) in his study found a significant positive relationship between DSO and gross profit margin of Saudi Cement manufacturing firms during 2012. Consistently, Kumaraswamy (2016) in her paper while exploring the effect of working cpaital on firm profitability identified a negative realtionship between DSO and firm earnings in GCC firms. As highlighted in the above literatures, studies have used either DSO or ART as a part of working capital component in a specific industries provided mixed results. However, no previous studies have empirically analysed the effect of receivable management in Saudi Arabia including the three sectors of energy, materials and capital goods. So this research paper is an attempt to examine the impact of receivable management on firm profitability of Saudi manufacturing firms by employing the two significant receivable measures DSO and ART.

Methodology

Hypotheses: The follwing two hypotheses were framed to examine the relationship between receivable monitoring measures and firm profitability of Saudi manufacturing firms.

H1: There is no statistically significant relationship between ART and operating profit margin.
H2: There is no statistically significant relationship between DSO and operating profit margin.

Data sources: A balanced panel data was constructed by including the data of all the manufacturing indexes listed in Tadawul stock exchange namely energy, materials and capital goods. The branch structure of the sample selection is shown in Table 1.

The financial data of Saudi manufacturing firms listed on Saudi stock exchange was collected through Thomson Reuter's database and analyzed using the statistical software, STATA. As this research paper aims to explore the relationship between trade credit management and firm profitability, important accounts

receivables measures DSO and ART were included as independent variables and operating margin as the dependent variable.

Table 1: Branch Structure of Sample Selection

Index	Total No of firms included	Continuous Data availability firms from the years 2009 to 2017
Energy	4	2
Capital goods	12	10
Materials	42	30
Total	58	42

Total debt to total assets, current ratio and firm size are included in the analysis as control variables. Definitions of variables employed in the analysis are presented in Table 2.

Table 2: Definitions of Variables

Variable	Abbreviation	Measurement	Expected Sign/s
Operating Profit margin	OPM	(Operating profit/Revenue)*100	%
Accounts Receivable Turnover	ART	Sales / Accounts receivable	+
Daily Sales Outstanding	DSO	Accounts receivables/ Average Daily Sales	-
Current Ratio	CR	Current assets/Current liabilities	+/-
Total debt to total assets	TATD	Total debt/Total assets	+/-
Firm Size	SIZE	Market capitalization value	+/-

Research Model: Based on the existing literature, the research model was developed to test the above stated hypotheses. Receivable management measures ART and DSO are modeled against the profitability measure along with other control variables. Subscripts i in the research model indicates firms (cross-section dimensions) ranging from 1 to 41, t denotes years (time-series dimensions) ranging from 1 to 9, ε is the error term of the model and β0, β1, β2, β3, β4, β5=Regression model coefficients.

$$OPM_{it}=\beta_0+\beta_1 DSO_{it}+\beta_2 ART_{it}+\beta_3 TATD_{it}+\beta_4 CR_{it}+\beta_5 SIZE \quad (1)$$

Regression: As the nature of data collected is cross-sectional for nine years, pooled panel regression was adopted. As the panel data model comprises of two divergences, fixed effects, and random effects, the Hausman test was conducted to identify the model fit. The results are shown in Table 3.

Table 3: Hausman Test *(STATA output)*

Ho: Random effect panel data is preferable	
Ha: Fixed effect panel data is preferable	
Prob>chi2	0.0357

The p values are less than 0.05 indicating that the null hypothesis of 'random effect is preferable' is rejected. Therefore the study adopts fixed effect regression, a preferred model to control unobserved variables.

Results

Descriptive Statistics

Table 4: Descriptive Statistics of the Variables *(STATA output)*

Variable	Obs	Mean	Std.Dev.	Min	Max
OPM	369	0.190325	0.19945	-0.412	0.727
ART	369	8.057995	10.59078	0.3	99.1
DSO	369	93.63902	100.2854	3.7	1311.4
CR	369	2.675176	2.396522	0.24	19.64
TATD	369	22.44164	195.0442	0	3565.778
SIZE	369	3.424918	0.614709	1.896108	5.524396

The average OPM of Saudi manufacturing firms shows at 19% with a standard deviation of 19%. On an average the sample firms' collects its accounts receivable 8 times per year to a maximum of 99 times. ART indicates that on average the firms' turnover its investment in account receivable as 8 times into sales during the sample period. In other terms, each Saudi Arabian Riyal (SAR) invested in sample firms' support almost 8 SAR of the firms' actual sales. It takes 93 days for the Saudi manufacturing firms to collect its credit sales.

Pearson Correlation: Bivariate Pearson Correlation is exerted to identify the robust association between the dependent variable (OPM) and independent variables (ART, DSO) and control variables (TATD, CR, SIZE) using STATA.

Table 5: Pearson Correlation Coefficients *(STATA output)*

VAR	OPM	ART	DSO	CR	TATD	SIZE
OPM	1					
ART	0.1901* 0.0002	1				
DSO	-0.2692* 0	-0.3666* 0	1			
CR	0.2872* 0	-0.0107 0.8383	-0.1252* 0.0161	1		
TATD	0.1244* 0.0168	-0.0321 0.5383	-0.0089 0.8653	0.0384 0.4621	1	
SIZE	0.4825* 0	0.1480* 0.0054	-0.2640* 0	0.0716 0.1799	0.1424* 0.0075	1

The results showed a strong positive relationship between ART and OPM in Saudi manufacturing firms. This outcome indicates that the firm profitability increases with the increasing number of times the firm collects its average accounts receivable. It is also observed that a strong significant negative relationship exists between firm profitability and the number of day's sales outstanding. Similar findings were reported by Paul et al. (2012), Tran et al. (2017), Killingsworth and Mehany (2018) but contradicts with Enqvist et al. (2014) who reported a positive relationship between DSO and gross operating margin in Finland firms. In terms of control variables, current ratio, total assets to total debt and the firm size are positively correlated to operating profit margin. The independent variables and control variables are statistically significant at the 0.05 level.

Multicollinearity: Presence of multicollinearity between variables will reduce the power of the estimated regression model to identify the independent variables that are statistically significant. So, Variance Inflation Factor (VIF) test was administered and the results are shown in Table 6.

Table 6: Variance Inflation Factor *(STATA output)*

Variable	**VIF**	**1/VIF**
DSO	1.23	0.813805
ART	1.16	0.864452
SIZE	1.1	0.905357
TATD	1.02	0.976087
CR	1.02	0.978798
Mean VIF	1.11	

VIF greater than 10 indicates the presence of multicollinearity (Chaterjee and Price, 1977). The VIF all the variables included in the regression are less than 10 indicate the variables are free from multicollinearity issues. As a next step, accounts receivable measures were regressed against the firm profitability measure, operating profit margin using fixed effect. The results are shown in Table 7.

Table 7: Regression Results *(STATA output)*

Fixed-effects (within) regression				Number of obs = 369		
Group variable: COMPANYCODE				Number of groups = 41		
				Obs per group:		
R-sq:				min = 5		
within = 0.2737				avg = 8.6		
between = 0.3398				max = 9		
overall = 0.3173				F(5,306) = 23.06		
corr(u_i, Xb) = 0.4355				Prob > F = 0.0000		
OPM	Coef.	Std.Err.	t	P>t	[95% Conf. Interval]	
ART	0.002112	0.00101	2.08	0.038	0.000116	0.004108
DSO	-0.00016	8.6E-05	-1.87	0.063	-0.00033	8.43E-06
CR	0.0071	0.00285	2.49	0.013	0.001492	0.012709

TATD	-2.2E-05	2.4E-05	-0.91	0.362	-6.8E-05	2.51E-05
SIZE	0.279127	0.03229	8.64	0	0.215589	0.342665
_cons	-0.79135	0.1133	-6.98	0	-1.01431	-0.5684

Discussion

The Relationship between Trade Credit Management and Firm Profitability: The fixed regression F value at 23.06 with probability value less than 0.05 indicates the overall model is statistically significant with an overall adjusted R squared of 32%. The variables included in the regression equation explain to 32% of the changes in the operating profit margin of Saudi manufacturing firms. The estimates of the model show that the prominent receivable management measure ART depicts a strong positive association with OPM. The probability values of the ART coefficient at 0.038 indicate that the results are statistically significant at 5% level. So, the structured null hypothesis that there is no significant relationship between ART and OPM is rejected and the alternate hypothesis is accepted. The outcomes depict that increased receivable turnover creates a positive net present values of cash flows, reduced risk, and increased firm profitability or shareholder value of Saudi firms. High receivable turnover of a firm indicates a conservative credit policy in place accompanied with effective credit management including the collection of debt and efficient management of receivables. On the other hand, firms with low turnover indicates the firm's lax or lenient credit policy, delayed cash collections procedures which entail increased chances of default or bad debts. These factors collectively hurt the firm's timely cash flows which eventually impact the firm liquidity and profitability. These results are consistent with the findings of the similar study by Sharma and Kumar (2011), Jindal et al. (2017) and contradict with Deloof (2003) on Belgian firms, Gill et al (2010) on NYSE, Baveld (2012) on Netherland firms.

Daily sales outstanding, another relative measure of receivable management of Saudi manufacturing firms' associates negatively with firm profitability as shown in Table 7. The negative coefficient indicates that firm profitability decreases with increasing DSO. This result could be attributed to the fact that lengthened DSO indicates the firm's cash flow is tied with the customers for longer periods. Stiff competitions force firms to adopt liberalized credit terms and collections procedures eventually results in increased DSO. Lengthened average collection period reduces cash flow to the operating cycle forces to raise additional external financing with increased interest expenses eventually reduces firm profitability. Similar results were reported by Garcia-Teruel and Martinez-Solano (2007), Paul et al., (2012), Ukaegbu (2014), Kumaraswamy (2016), Tran et al., (2017) and contradicts with Sharma and Kumar (2011) reported a positive association with firms earnings.

When it comes to controlling variables, total debt to total assets proved a negative association with firm profitability as shown in Table 7 and the results are not statistically significant. As an indicator of the firm's financial leverage, the results

show that higher the proportion of total assets financed by creditors, the firms prove less profitable. The sample firm's liquidity position proxied by current ratio indicates a positive and statistically significant relationship with the operating profit margin in Saudi manufacturing firms. As indictated earlier, firm's liquidity position is greatly influenced by the timely cash flows which in turn depend on effective credit collections and receivables management. The regression results in Table 7 also show that firm size tend positively with firm profitability and the p values are statistically significant at the 0.05 level. The outcomes prove the renowned Baumol (1959) hypothesis that the increased money capital will increase the total profit of the firms.

Conclusion

Our results show a strong positive association between firm profitability and receivable turnover. Another relative measure of receivable management, DSO demonstrated a weak, negative relationship with the firm's earnings. The results imply that accounts receivable turnover significantly influence the cash flows and profitability of Saudi manufacturing firms. The outcomes of this study indicate the need for these firms to meticulously design its credit policy components for its best interest to reduce customer default. A carefully devised credit policy may not prove efficient if the firm does not diligently collect the receivables. So, the firms need to frequently monitor and evaluate the collections procedures to revamp their strategies in continuously improving credit management and firm profitability. Greater use of automated credit scoring and expert system methods will improve the information processing efficiency and accuracy for the credit managers. In addition, a holistic approach in integrating marketing and finance considerations will be a value-addition to the credit department to improve, meet or exceed benchmark standards. One of the limitations of this study is that only two receivable management measures were included due to the factor of non-availability of relevant data. Further research could be conducted by employing similar other techniques like balance fraction approach and aging schedules to be tested in matured and developing markets.

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ZARZĄDZANIE KREDYTAMI HANDLOWYMI I JEDNOSTKĄ ZYSKU FIRM SAUDYJSKICH

Streszczenie: W dynamicznym i hiperkonkurencyjnym otoczeniu biznesowym zarządzanie kredytami handlowymi ma kluczowe znaczenie dla rozwoju i przetrwania każdej organizacji. Zarządzanie kredytami handlowymi jest skuteczną metodą wzmocnienia dobrej sytuacji finansowej organizacji. Niniejszy artykuł badawczy ma na celu zbadanie związku między zarządzaniem kredytem handlowym a rentownością firmy. Wykorzystano próbkę 41 firm produkcyjnych z trzech indeksów, a mianowicie energii, materiałów i dóbr inwestycyjnych, notowanych na giełdzie Tadawul w Arabii Saudyjskiej w latach 2009–2017. Metodę regresji o ustalonym skutku stosuje się do analizy danych panelu z marżą zysku operacyjnego jako zmienną zależną, dzienną sprzedażą zaległą i obrotem należności jako zmiennymi niezależnymi. Wyniki badań empirycznych wykazały silny, pozytywny i znaczący wpływ kredytu kupieckiego na rentowność firmy. Wyniki badania wskazują, że skuteczne zarządzanie kredytami handlowymi może znacznie poprawić przepływy pieniężne i rentowność firm produkcyjnych w Arabii Saudyjskiej
Słowa kluczowe: zarządzanie kredytem handlowym, zarządzanie wierzytelnościami, rentowność firmy, obrót wierzytelnościami, codzienna sprzedaż zaległa

沙特制造业公司的贸易信用管理和公司盈利能力

摘要:在动态，竞争激烈的商业环境中，贸易信用管理对于任何组织的成长和生存至关重要。贸易信贷管理是增强组织健全财务状况的有效方法。本研究旨在探讨贸易信用管理与企业盈利能力之间的关系。我们使用了2009年至2017年在沙特阿拉伯的Tadawul证券交易所上市的，来自能源，材料和资本货物三个指数的41家制造公司的样本。采用固定效应回归方法，以营业利润率为因变量，日销售余额和应收账款周转率为自变量来分析面板数据。该研究的实证结果确定了贸易信贷对公司盈利能力的强大，积极和重大影响。研究结果表明，有效的贸易信贷管理可以大大改善沙特阿拉伯制造企业的现金流量和盈利能力
关键词:贸易信贷管理，应收账款管理，公司盈利能力，应收账款周转率，日销售额