Business performances: between profitability, return and growth

Lect. Monica Violeta Achim Phd.
Babes-Bolyai University,
Faculty of Sciences Economics and Business Administration,
Cluj-Napoca, Romania
Lect. Sorin Niculae Borlea Phd.
Vasile Goldis University,
Faculty of Sciences Economics,
Arad, Romania

Abstract: To survive in a competitive business environment every company must operate in conditions of performance. Over time approaches of business performance have seen various valences differentiated both according to the importance given at the moment to the information needs of different partners in business and according to the modern method which are meant to demonstrate and validate by using their practical relevance exercised over time, referring to the performances demonstrated in real terms of competitiveness and sustainable development.

The aim of this paper is to synthesize the main approaches regarding the business performances, underlining the modern approaches referring to the perceptions of business performances for owners/shareholders but also for the other stakeholders. Based on a lot of researches and studies, we also tried to highlight some correlations between performance-profitability-return-growth useful for managerial strategic decisions which lead the company to global business performances, in the actual context of sustainable development.

JEL classification: M10, M14, M21

Keywords: performance, profitability, return, growth, value added.

1. INTRODUCTION

The term "performance" is currently experiencing a high degree of complexity and to specify its contents it must consider several sides of activities. Assessing the global performance of an entity is useful primarily for shareholders, because they are the ones who invest and assume the greatest risk and as a consequence, the company must first meet their expectations.

At the same time, an entity's global performance increase can not be achieved if needs are not satisfied upon all participants in economic life (stakeholders). Each category of participants in economic life (both shareholders and managers, creditors, suppliers, customers, state, civil society) have their own expectations and as such the performances of an entity are assessed differently by each category.

A company is performing globally if it can satisfy the interests of all partners: shareholders, employees, suppliers, customers, creditors. Today the most privileged of these partners are the shareholders. They are the ones who invest and assume the greatest risk and as a consequence the company must first meet their expectations.
For each category of business partners there should exist the specific indicators for measuring enterprise performance, which have to show how the results meet the expectations of business partners concerned.

Also, we are considering that business performance must be assessed differently by an entity according to the following answers to general questions on the concepts of profitability-return-growth:

• Can any profitable activity also have a good return ratio?
• Are there any activities that have a good return ratio although they don’t register any growth values?
• Has a company which registered growth value also good return ratio?
• Is a company that has a good return ratio also profitable?
• Are there entities that are profitable but not have a good return ratio?
• What is the value increase? Who is interested in increasing the value? How to appreciate the value of an entity?

Considering the methodology for determining the global performance of the entity, we use two categories of assessment criteria: quantitative (measurable) and qualitative (nonmeasurable). Therefore, a system for assessing the performance of economic entities usually has two parts namely:

• Quantitative component, which has its content, given by economic and financial analysis;
• Qualitative component, which has its content given by extra financial analysis which includes non-quantifiable aspects but very representative for the global performances of a firm. Extra financial analysis is relatively recent, appeared in the new context of sustainable economic development, where ethical and moral values gather new valences. The extra financial analysis would include the quality aspects related to: social responsibility of the entity in relation to various partners, intangible capital value and / or the quality management team, quality of activity, other elements such as: company image quality of products / services, etc.,

In the context presented above we can highlight the financial and nonfinancial performances, each of them having a well defined role. Next we refer especially to the financial performance highlighted by financial analysis, especially with reference to issues of profitability / return / growth and to the correlations that are interposed between these categories. Extra financial analysis finally comes to complete supplement the main picture of the entity in terms of global performance by increasing the value for stakeholders.

2. LITERATURE REVIEW REGARDING THE BUSINESS PERFORMANCES

Generally specking, the performance is a great achievement in a particular area of activity. The term "performance" is used in different areas; there is talk of economic performance, financial, technical, sporting, social. Etymologically, the word „performance” comes from the Latin "performare" which means to complete a given activity proposed. But the meaning comes from the English word "to perform" which means to make something that requires a certain ability or skill.

The term "performance" is often used to assess the work done by an enterprise and to assess competitiveness. In literature there is a unified vision about the performance concept and especially the business performance concept. Definitions of this concept may be abstract, or general, less defined, or clearly defined.

The performances are defined abstractly by various authors such as:

○ Porter M. (1986) considers that "enterprise performance depends on its ability to create value for its clients. But de doesn’t specify what kind of value and are only the
clients interested in increasing business value? Wouldn’t also be interested in increasing the business value the owners and other business partners?

○ Marmuse C. (2000) considers that performance is "the one that can keep the distance on a long term, compared to the competitors, by using a strong motivation (based on systems of reward) of all the organization’s members.”

In a more punctual way the entity's performance are defined by another group of authors:

○ Cohen E. (1995) puts the sign of identity between performance and efficiency, following the results obtained by the entity in relation to resources used.

○ Refering to the business activity, the performance is defined by Niculescu M. & Lavalette G. (1999) as "a state of competitiveness of the economic entity, reached by a level of efficiency and productivity that assures a sustainable presence on the market".

○ Verboncu I. & Zalman M. (2005:64) appreciate that "performance is a particular result in the Management, Economics, marketing domain etc. which gives characteristics of competitiveness, efficiency and effectiveness to the organization and to the structural and procedural components.

○ N. Albu & Albu. C. (2005) define the performance of an entity by "reference to other concepts, as follows:

✓ Performance means to reach the strategic objectives;
✓ Performance is an unstable balance between efficiency (as an indicator of endogenous firm) and effectiveness (which shows the relationship with business partners).
✓ Performance implies, as an economic concept, the creation of wealth and the value in the organization.”

○ Duran V, Cozac Al, Duran D (2005:135) appreciate that the performance analysis of a company is realized by using the both indicators of profitability and return. The first category of indicators has the role of determining the operation process while the second category follows the way in which the capital invested is remunerated

○ Greunning HV (2005:27), making an interpretation of International Financial Reporting Standards, appreciates that financial analysis uses a variety of subclasifications in order to determine the risk and the business performance. However, he highlights five classifications of indicators which are: liquidity, solvency, operational efficiency, growth and profitability.

○ Philip M. Parker (2006), in the extended studies made, in order to highlight the performance of companies around the world, he took in account four broad types of rates, namely: the profitability ratios, the asset utilization ratios, the leverage ratios and the liquidity ratios.

○ Bătrâncea M., Bătrâncea LM (2006: 69) consider that most commonly indicators used in the performance assessment of a firm are the following ones: net result, operating results, operation cash flows and value-added.

○ Siminica M. (2008:108) appreciates that "an enterprise is performant when it is at the same time efficient and effective. Therefore the performance is a function of two variables, efficiency and efficacy. While efficacy reflects the achievement of external expectations, efficiency is measured by the achievement of internal environment of a firm”

○ Radu F, Țaicu M, (2009) considers as being performant the company,”which manages to create value for its shareholders and this is realized when the return on capital
invested is higher than the funding sources used’s cost. It is not enough for the company to have profit to also create value."

○ Colase B. (2009: 53) gives a very complete definition of the concept of performance. In his view the word "performance" is a " bag-word" because it "covers various and different notions such as growth, profitability, return, productivity, efficiency, competitiveness"

○ In the International Financial Reporting Standards (IFRS)’ view, the performance of a company isn’t exactly defined, but they note that "profit frequently used as a measure of performance or as a reference for other indicators such as profitability investment or profit per share. Revenues and expenses are directly related to measuring profit structures. (Framework for the Preparation and Presentation of Financial Statements, paragraph 69).

Based on the literature review mentioned above concerning the performance’s concept, we can conclude that the concepts of profitability, return, growth or value creation are often dashed as evidence, well defined both conceptually and especially easy to quantify, in order to be interposed in some models of global analysis performances of a companies.

3. LITERATURE REVIEW REGARDING THE PROFITABILITY, RETURN, GROWTH CONCEPTS AND THE WAYS OF ITS DETERMINING

As there are conceptual differences in how these elements are defined according to the economic and accounting world economies framework, we will also evidence the influence of Anglo-Saxon and Continental economical culture upon the defining and assessing the profitability-return-growth concepts.

3.1. PERFORMANCE IN TERMS OF PROFITABILITY

Referring to the tries of deifying the state of profitability in the literature, there are various approaches:

► Making an Anglo-Saxon literature review we can find the following:
  ○ Gibson Ch. H. (1998:385) defines the profitability of a firm as "the ability of firms to generate earnings”.
  ○ Brigham EF, Gapenski LC, Ehrhardt, (1999) consider that "profitability is the net result of various policies and managerial decisions, and the profitability rates represent the net operating result of the combined effects of liquidity, asset management and debt management.
  ○ Greuning H.V (2005: 27), making some interpretation about International Financial reporting Standards (IFRS), considers that the profitability indicators generally mean "an indication of how a company’s profit margins are associated with sales, average capital and own average capital. Profitability can be further analyzed by using analysis of Du Pont. "

► Making a Continental (especially French) literature review we can find the following:
  ○ Colasse B (2009:54) appreciates that " the enterprise’s profitability represents its aptitude to get a result in consequence of its business; it is often expressed with the help of the ratio between this result and sales (or production).
Making a Romanian literature review we can find the following:

- Stefea P. (2002) appreciates that the profitability is the "ability of a lucrative activity to generate revenues higher than expenses involved. The profitability indicators are well known as profitability ratio or accumulation margin".
- Buglea Al (2004;134), referring to an entity's profitability rates, estimates that they "are known as margin rates and they are built as a ratio between the results of the profit’s nature and revenues or expenses.
- Duran V, Cozac Al, Duran D (2005:135) consider that „firm-level profitability’s analysis aims two essential objectives: to determine the level of profitability and setting margins of profitability”.
- The Romanian accounting regulations now in operation (OMFP 3055/2009, Note 9) states that "indicators of profitability express the entity’s efficiency to obtain profit from the available funds.”

Based on the literature review presented above, we can extract some clear conclusions without any doubt about the definition of profitability concept: For being profitable, a company must work in conditions of profit, which means that the revenue has to exceed costs involved in achieving the activity.

### 3.2. PERFORMANCE IN TERMS OF RETURN

In that which it concerns the clear definition of „return” concept, it is more ore less found in specialty literature, but there where it appears, there are quite convergent views.

Making an Anglo-Saxon literature review, we can find that there is no distinction between the rates of return and rates of profitability, in general. Basically the term "return" is subordinated as meaning to that of "profitability". Thus, it is talked about profitability even in conditions in which it is referring to the indicators that measure efficiency investments. For this purpose, we can mention only a few of the studies done in this regard: Ch. H. Gibson (1998), Halpern P, Weston F & Brigham E. (1998), Brigham E.F., Gapenski L.C., Ehrhardt, (1999), Helfert E.A (2003), Philip M. Parker (2006).

Making a Continental (especially French) literature review we can find various authors highlighting the clear differences between the concepts of profitability and return. In this sense some French authors even express their negative attitude to confuse the two concepts of profitability and return and often use them as synonyms.

- Famous French authors, in which we mention Vernimmen P. (1988), appreciate that: “We can not talk about return unless reporting the results of the invested capitals to these capitals. It is an abuse of language to talk about business profitability reporting results in a turnover”.
- Another renowned author, representative of the French school of accounting, Colasse B (2009:54) defines return beginning with the enterprise’s capacity to get a result; it is measured with the aid of the report between this result and the investment which is represented by the enterprise”. Defining elements of the state of return are given by the economical and financial return.

In Romania, given the reminiscences of French inspired accounting adopted in the first phase of modernization of the Romanian accounting system after 1989, approaches of the rate of return exist. These approaches are reunited mainly to determine financial status of the entity, determined based on information taken from financial statements and especially
from Profit and Loss Account component. We can present several such approaches as follows:

- Ştefea P. (2002) appreciates that "it can be spoken about return only when comparing the surplus realized by an investor with the capital invested." In this regard, in calculating rates of return it must be started from the reasons that the investor has had at the time of placing capital, namely to recover after a certain period of time that capital along with a surplus that would justify the investment decision. Therefore, one can talk about return only when comparing the surplus obtained by the investor with the capital invested, in other words comparing "effect" with "effort".

- Buse L (2005:244) thinks that „return is a synthetic form of expression of economic efficiency, which reflects the firms’ ability to make a profit. Return requires obtaining some revenues, as a result of the sale and collection of manufactured production, higher than the costs involved in achieving it.

- Duran V, Cozac Al, Duran D (2005:138) appreciate that „profitability is determined by reporting the results’ indicators in the capital invested.”

- Petrescu S. (2008) say that "profitability is the ability of capital invested or placed to provide income expressed in monetary terms and it can be evaluated both by the margins of return and the rate of return."

- Crecana C. (2002) gives a comprehensive definition to the notion of return. Thus, in his opinion "the return of a company certifies its intrinsic ability to get profit, to use inputs efficiently, and in the strict conditions of market economy, to get return is a condition of survival of that enterprise and to avoid bankruptcy”.

Based on the literature review presented above, regarding the assessment of business performance in terms of return, we conclude that the Anglo-Saxon’s approaches and the Continental ones’ (the Romanian approaches subscribe to the mainland) may overlap to a certain extent. Thus, practically, the Anglo-Saxon’s approaches in terms of assessing the performances are more general, the concept of "profitability" having a wider range of coverage, so that indicators of "return" clearly defined in the Continental approach are practically absorbed in the Anglo – Saxon approach, which is more general. Moreover, we are already used to this „light” approach including the Anglo-Saxon accounting system, where framework and normalization accounting is less aggressive compared with the Continental system, more rigorous standardized (see for this purpose Accountant General Plan French).

In conclusion, we consider that rates of return can be used under this name with a well-defined role which is to highlight the effectiveness of its investments made in the use of the entity, as reflected in differences:

- On one hand, under the form of efficiency of investment by long-term shareholders and creditors, represented by equity and / or capital employed, in which case we talk about rate of financial return (eg. Return on Equity);
- On the other hand, under the form of efficiency of investment represented by the resources controlled by the entity, in which case we talk about rate of economical return (eg. Return on Assets).

3.3. PERFORMANCE IN TERMS OF GROWTH

Classical indicators that measure the performance have the disadvantage of providing information on historical performance of undertakings. These indicators do not take into account the cost of capital but only show the results of its use. Therefore, if we confine
ourselves only to use the classic indicators, we can find companies that gain performance but do not create value, instead they consume an existing one.

Measuring financial performance by using indicators of profitability and return is completed by modern approaches to measure performance with regard to the concept of value creation and hence increase the value concept.

Modern performance measurement indicators are considering the concept of value creation. The enterprise creates value when it provides compensation at a rate of return on capital that exceeds its cost. Using modern indicators to measure the performance of an enterprise, it is quite simple to express performance from the view of shareholders and difficult from the view of other business partners.

The preoccupations about the quantification of the entity’s value growth, as a synthetic indicator of financial global performances, are various:

► Making an international literature and practice review, we can find the following:
  ○ Halpern P, Weston F & Brigham E. (1998) refers to a company’s growth measured by growth rates that are designed to indicate the firm's ability to maintain its market share when the economy and industry are in a period of expansion. Most representative indicators that reflect a company's growth would be, in the authors’ view the following: turnover, net profit, earnings per share and dividend yield.
  ○ Greuning H.V (2005: 27), making some interpretation about International Financial reporting Standards (IFRS), considers that the increase of a firm would be given by "the rate at which an entity can achieve growth, as it is determined by the retain (undistributed) of the profit and by the profitability measure with the help of return on equity (ROE)."
  ○ Colasse B (2009:54) defines the state of "company’s growth" as "the company’s capability to increase its size; it can be measured by using several criteria such as: turnover, production, value added, fixed assets, total assets'.
  ○ Cabinet consultancy Stern Stewart (1991) proposed as indicators able to measure the performance of a company the economic value added (EVA) to which they added the market value added (MVA), the Future Growth Value (FGV) and the Current Operations Value (COV) (http://www.sternstewart.com).
  ○ Boston Consulting Group and HOLT Value Associates from Chicago have promoted Total Shareholder Return (TSR), Cash Flow Return on Investment (CFROI),
  ○ Applied Finance Group have promoted the Economic Margin (EM) as a representative indicator for measuring the value of an entity that comes to correct distortions created by the traditional financial analysis based on accounting documents. The Economic Margin Framework is more than just a performance metric, as it encompasses a valuation system that explicitly addresses the four main value drivers of enterprise value: profitability, competition, growth, and cost of capital. Unlike traditional valuation approaches that utilize highly sensitive perpetuity assumptions, AFG’s approach incorporates company specific competitive advantage periods which identify companies that may lose excess returns over time faster than their competitors (http://www.economicmargin.com).

► Making a Romanian literature review, we can find the following conclusions:
In particular, we intend to point out only two of them, referring to the concept of value creation and how to measure it to meet such information needs of shareholders in companies listed but also of the owner, for the unlisted, as follows:

- Niculescu M (2003) notes as indicators for value creation the next: cash flow return on investments \((CFROI)\), economic value added \((EVA)\), market value added \((MVA)\).
- Petrescu S. (2008) says that the indicator value added is "the main element in determining value creation indicators with significant increase in activity of any entities listed or unlisted on stock market." For the entities listed, the value creation is the major criteria of performance evaluation by shareholders and is appreciated by a "battery" of indicators such as: Economic Value Added –EVA, Market Value added –MVA, Cash Value Added- CVA, Total Shareholders Return- TSR, Cash Flow Return on Investment –CFROI.

Based on the national and international literature review presented above, we conclude that if we use only the classic indicators (of profitability and return), we can find companies which gain performances but do not create value, instead they consume an existing one. Therefore, to gain profit and, going further, to work efficiently (the increase of the efforts to overcome the increase of the efforts involved), is not sufficient to lead the Company to maximize their global performance. In addition, it is necessary for society to succeed in creating the new value (value added). The main indicators that reflect the value creation for shareholders, separated on the basis of literature covered, would be: Economic Value Added –EVA, Market Value added –MVA, Cash Value Added- CVA, Total Shareholders Return- TSR, Cash Flow Return on Investment –CFROI.

3.4. PERFORMANCE IN TERMS OF GROWTH IN THE CONTEXT OF SUSTAINABLE DEVELOPMENT

In the current context of sustainable development, it becomes more and more important the increase in growth and value creation for all the participants in the economic life (stakeholders) and not only for the shareholders. In this context, the role of relationship between the company and the environment, with the employees, the civil society, the customers, the suppliers, the managers of state grows very rapidly. These issues have development more and more the role of nonfinancial analysis in their main demarche for determining their global performance. In this sense, the nonfinancial criteria refer to the orientation of the strategic management on long term and they derive from the social responsibility and from the intangible capital value held by the company.

- Making an international economic literature review we can find the following:
The aspects of the need to create value for stakeholders and not just for shareholders, are widely discussed by the various authors. We can only mention the reference studies of the following authors; Philip Kotler and Nancy Lee (2005), David Vogel (2005), William B. Werther, Jr and David Chandler (2006), William C. Frederick (2006).

- Making a national economic literature review, the first approaches of the global performances in the context of sustainable development were made by Niculescu M. (2003). In this respect, the author talks about some economic and technical indicators which refer to the relationship between the company and the environment, such as: the emission rate of substances affecting the ozone layer, the biodegradability index, the
energy consumption per product, the gravity of work accidents, the occupational diseases share, the expenses on safety, the number of organic products, the employee training costs, etc..

Thus, both these non-financial and financial indicators come to provide a complete picture of the company’s global performance by increasing the value not only for the shareholders but for all the stakeholders (participants in economic life). Later, also the others Romanian authors such as Stancu A. & Orzan M. (2006), Feleaga N. (2006), Mironiuc M. (2009) were concerned about non-financial analysis reflected in matters of social responsibility and about the quantification of the human capital value.

Browsing the literature mentioned above, we can conclude that the final target of the strategic management in terms of global performance is to create and increase the company’s value, not only for the shareholders but for all the stakeholders (all the participants in economic life).

4. LITERATURE REVIEW REGARDING THE CORELATIONS BETWEEN PROFITABILITY/RETURN/GROWTH

In the literature, the concept of performance is often associated with the concepts of profitability, return and growth, and also the various correlations between these were widely studied, in order to meet the needs of information on company’s performance for various categories of business partners.

Preoccupations in the area of correlation analysis of these indicators exist and they are extremely different. Among these we can mention the studies of Bacidore J., Boquist, Milbourn T., Thakor A (1997) which highlight the fact that growth rates of profits or sales, abnormally high, involve a systematic risk upon the company, which will not be reflected accordingly to increase the value of the entity to the owners.

All these studies converge on the general idea of the authors Khanna and Palepu (1999) which is that managers should make changes in their strategy based on “growth now, profitability later” to “profitability now, growth later”.

Tom Copeland (2002) concludes, based on his study, that the most representative indicator to reflect increases in value for shareholders, in case of listed companies, is given by the Total Return to Shareholders (TSR).

Between the growth indicators taken into account (Earning per Share Growth, Economic Value Added, or even the percent increase in Economic Value Added and Total Return to Shareholders), the latest one is the most strongly correlated with market expectations. As a consequence, the indicator Total Return to Shareholders could be successfully used by the management in the long term policies adopted.

As concerning the non-financial indicators, their correlation with total shareholder return was tested in case of customers’ satisfaction index. Thus, Banker et al. (2000), Behn and Riley (1999) found out a direct relation between the degree of customers’ satisfaction and the enterprises expected profitability from the hotelier and airlines activity sectors. A same analysis was made by Ittner an Larcker (1998) and they emphasized the non-linear relation between the level of customers’ satisfaction and the enterprises’ expected profitability. The results obtained, have varied from an activity sector to another and in certain cases they found out an inverse or insignificant correlation. Foster and Gupta (1994) have got the same results on their analysis based on available information about the
customers, satisfaction of an en-gross drinks distributor. One big problem of these kind of studies is represented by the way of information guttering, needed to quantify the customers’ satisfaction index. The types of questions included in the questionnaire have a major impact on the intensity and the sense of the relation between customers’ satisfaction index and enterprises’ expected profitability. From this point of view, guiding the enterprise management through these non-financial performance indicators is extremely difficult.

5. CONCLUSIONS

The business performance concept is a very complex one. The understanding of the methodologies used to maximize the global business performances is very useful for any company’s strategic management.

Trying a general summary of all the concepts presented above, we think that the profitability is the essential condition to ensure business success of an economic entity and it is measured by obtaining positive results after comparison of the financial effects with the financial effort involved. The profitability level of a company must be assessed differently, according to the answers to the general questions about the profitability, return and growth concepts, questions raised in the introduction of our article. Thus:

- Can any profitable activity also have a good return ratio? The answer is NO: not every profitable business has a good return ratio; it is possible for the company to obtain profit from its activity (the revenue to exceed the expenses) but the rates of return to be unfavorable (both in the level and in the evolution).
- Are there any activities that have a good return ratio although they don’t register any growth values? The answer is YES: there are companies that, although perform their work in conditions of efficiency (rate of return are favorable), have their growth rates not enough to lead increasing company value.
- Has a company which registered growth value also good return ratio? The answer is YES: The value added can be realized only in conditions of work’s efficiency.
- Is a company that has a good return ratio also profitable? The answer is YES: Achieving a satisfactory return implies a level of effects higher than the level of the efforts, so the effects could be only positive, in other words it is represented by profit.
- Are there entities that are profitable but not have a good return ratio? The answer is YES: A profitable company does not necessarily have a good return ratio. If efforts involved (under the form of assets or equity of shareholders) exceed the results of the entity (even the result consists in profit) or the increasing rate of efforts exceeds the increasing rate of effects, the state of good return ratio no longer exists.

A summary of the conclusions of our present article referring to the correlation of performance- profitability-return--growth is graphically represented as follows:
Based on the above figure, we can see that not every profitable business has also good return ratio. As a consequence, there are profitable business which not work efficiently. Going further, not every efficient activity (that has a good return ratio) could lead necessarily to growth. In other words, one can run profitable activities but does not record growth and as such not raise their value. But it is clear and obvious that any that recorded growth from one period to another, requires at the same time both a profitable business and an efficient one (that has a good return ratio). All these are achieved in conditions of maximizing (optimizing) both the state of efficiency and the efficacy.

REFERENCES


8. Kotler P. and Lee N Corporate Social Responsibility: Doing the Most Good for Your Company and Your Cause”, (Hoboken, NJ: John Wiley & Sons, 2005);


10. Toma M. Initiere in evaluarea întreprinderilor”, Ed. CECCAR, București, 2009


15. Feleagă N. Criza financiară la cumpăna dintre secolele XX și XXI și guvernanța întreprinderii”, Revista Economie Teoretică și Aplicată, Nr. 9, 2006;


19. Petrescu S., Apostol C, Analiza prin crearea de valoare Valoarea economică adăugată, Supliment of Theoretical and applied economics, Bucharest, 2009;

20. Radu F, Taicu M Considerații privind conceptul și indicatorii performanței economico-financiare, Supliment of Theoretical and applied economics, Bucharest, 2009;


