AN ANALYSIS OF THE COMPANIES' ECONOMIC GROWTH CAPACITY

Associate Professor PhD. Camelia BURJA
University „1 Decembrie 1918" of Alba Iulia, Romania
cameliaburja@yahoo.com
Professor PhD. Vasile BURJA
University of „1 Decembrie 1918" Alba Iulia, Romania
vasileburja@yahoo.com

***Abstract**:*

The sustainable economic growth of companies constitutes a strategic management objective as it is of general interest. The companies' accrued net worth and their capacity to generate profit result in increased competitiveness. This paper presents a general model to analyze the companies' economic growth grounded on the invested capital profitability that is illustrated in an adequate case study. The described model highlights the major factors influencing economic growth at a microeconomic level as well as the direction they act, providing the possibility to better substantiate decisions that serve this purpose.

Key words: economic growth, net worth, financial profitability, invested capital, factor analysis

JEL code: O47, O12, D92, D61

1. INTRODUCTION

In the market economy, the success of a business requires well-founded management decisions, based on the analysis of the information received from inside and outside the company. On these lines, the company's economic performance analysis is and the assessment of its economic growth capacity implies a continuous process, which is a part of the basic responsibilities of the management. This is the necessary instrument able to supply information to the various stakeholders [9].

Because the main objective of the *management's* actions targets the increase in efficiency and profitability, the financial analysis techniques must underline the quality of the leaders' decisions [16]. The coherence of their actions determines the optimum capital budgeting, the efficient use of all resources, aspects that can lead to the growth of the business' value if integrated into the right financial strategies and policies.

The information resulted from the analysis are also important for other beneficiaries. For the *investors* (shareholders), the economic viability of the firm is important. The company must first show the business continuity through its activity and its resource management. At the same time, the capital owners are interested in the possibility of the company to improve the financial profitability on the long term, and based on this, to increase the value of the owned shares and of the collected dividends.

Regarding the *creditors*, who finance the business for a certain period of time, they trace the economic and financial performance of the firm, especially from the point of view of its existence and from the perspective of the positive cash flows proving the company's liquidity and a warranty for the recovery of the loan.

The firm's growth capacity also satisfies the *employees'* interests, because this ensures their job's safety. The salary packages often include clauses regarding remuneration from the company's profit or participation to its social capital. At the same time, *the local communities and the national economy* in its whole benefit from the growth of the companies' potential because the favoring elements for the economic environment of the enterprise become factors of the economic growth at a macroeconomic level [12], and the paid taxes and duties will contribute to achieving the local and general objectives.

Under these circumstances, all the stakeholders interested in the success or the failure of the business follow the assessment and the prediction of the economic performance, which synthesizes its capacity for economic growth. To reach this objective, the analysis of the indicators is of real interest. It defines the net assets of the company, the profitability, the cash-flow, the economic value added, the growth of the owners' equity, the market performance, the stability and financial autonomy, etc.

The analysis of the businesses' performances constitutes a necessary step to identify the company's growth reserves.

2. AN ANALYSIS MODEL FOR THE COMPANIES' ECONOMIC GROWTH CAPACITY BASED ON THE NET WORTH INDICATOR

A starting point in the analysis of the company's economic growth capacity is the *Net Worth indicator* (*NW*), studied in its dynamic.

The net worth is an element with great information value for the investors, creditors, etc. It represents the net assets of a company and is calculated as a difference between the amount of the total monetary assets and of the non-monetary assets which the company holds (*At*) and the monetary and non-monetary debts (*Dat*) [14]:

$$NW = At - Dat \qquad (1)$$

The Net Worth usually has positive values and, if in time it shows a growing trend, this indicates a good management of the company's total assets, a growth of the equity and thus, an increase of the shareholders' wealth, reflecting a sustainable economic growth. The growth of the Net Worth is determined by the reinvestment of some of the net profit and other accrual elements: regulated provisions, subsidies, reserves, etc.

In the cases where negative values are recorded for the net worth, there is a bankruptcy risk because the real assets exceed the level of contracted debts, which signifies insolvency. A decreasing dynamic of this indicator reflects a reduction of the owners' equity and thus, depletion for the shareholders. Obviously, the prospect of the company's economic growth is not possible unless we record an increase of the shareholder's equity and the financial policy of the firm is adequate, realistic and can ensure this trend in the future [2].

Stated in absolute units, the companies' economic growth capacity for a time period is given by extend of the net assets' growth:

$$\Delta NW = NW_1 - NW_0 \qquad (2)$$

Yet, it is not enough to diagnose that a company has the capacity for economic development based solely on an indicator that includes all the influences of the various variable factors, but it is necessary to identify those elements that impact its change.

The factorial analysis of the economic growth capacity needs to find a complex model that presents the factors leading through their action to the growth of the net assets and of the shareholders' equity.

Because increasing the capitals is only possible in the case of an efficient activity of the company, the economic growth capacity is closely tied to the analysis of the profitability trend. If in time the company is defined by profitability, and thus has an income from the operational, investment or financial activities, a capital increase and the reinvestment of a profit's part can take place, which contribute to the growth of the business' economic value.

Among the profitability indicators is considered that *the financial profitability rate* (Return on equity) reflects the best the idea of performance and economic growth, which results from the management of the invested own capitals [15]:

$$Rf = \frac{Pn}{Kpr} \qquad (3)$$

where:

Rf is the financial profitability rate;

Pn - net profit;

Kpr - invested own capitals;

If the entire obtained net profit is reinvested (no dividends are paid) and the company works without loans, the financial profitability rate reflects the economic growth capacity of the company and the analysis model is [8]:

$$g = Rf \;; \qquad g = \frac{Pn}{Kpr} \qquad (4)$$

in which *g* represents the growth rate of the own capitals (net worth) in relative sizes.

But, if we take into consideration the most frequent case, which is the existence of a certain degree of indebtedness and of the payment of dividends, then, *the general analysis model of the economic growth* is the following [8]:

$$g = \mathrm{Re} \cdot Gp + \frac{Dat}{Kpr} \cdot \left(\mathrm{Re} - Rd\right) \cdot Gp \qquad (5)$$

where:

Gp is the proportion of the non-allotted profits in the net profit;

Dat - debts;

Re - return on invested capital (ROIC);

Rd - the interest rate.

In its turn, the financial profitability and, implicitly, the economic growth of the company, is influenced by the rotation speed of the invested own capitals (expressed by the number of rotations done through the turnover - *VRKinv*) and by the commercial profitability rate (the net profit correspondent to a certain level of the turnover - *Rcom*). On these lines, the previous model (5) becomes:

$$g = \frac{CA}{Kinv} \cdot \frac{Pn}{CA} \cdot Gp + \frac{Dat}{Kpr} \cdot (Re - Rd) \cdot Gp \qquad (6)$$

where:

Kinv represents the invested capital *(Kinv= Kpr + Dat)*, or:

$$g = VRKinv \cdot Rcom \cdot Gp + \frac{Dat}{Kpr} \cdot (Re - Rd) \cdot Gp \qquad (7)$$

The obtained model suggests that the good management of the invested capitals positively affects the rate of the economic growth, by a high commercial profitability, as well as the amount of the reinvested profits (non-allotted profits as dividends). At the same time, the degree of indebtedness can also contribute to the development of the business, only if the structure of the capitals preferred by the managers is advantageous and generates profitability above the cost of the debt (the leverage effect).

Next, in order to show the influence of the mentioned factors over the rate of economic growth, the development of the model is presented:

- The influence of the invested capitals' rotation speed:

$$\Delta g(VRKinv) = Rcom_0 \cdot \Delta VRKinv \cdot Gp_0 \qquad (8)$$

- The influence of the net commercial profitability rate:

$$\Delta g(Rcom) = \Delta Rcom \cdot VRKinv_1 \cdot Gp_0 \qquad (9)$$

- The influence of the non-allotted profits' weight for dividends (reinvested profits):

$$\Delta g(Gp) = [Rcom_1 \cdot VRKinv_1 + \frac{Dat_0}{Kpr_0} \cdot (Re_0 - Rd_0)] \cdot \Delta Gp \qquad (10)$$

- The influence of the financial structure (degree of indebtedness):

$$\Delta g\left(\frac{Dat}{Kpr}\right) = \Delta \frac{Dat}{Kpr} \cdot (Re_0 - Rd_0) \cdot Gp_1 \qquad (11)$$

- The influence of the difference between the return on invested capital and the interest rate:

$$\Delta g(\mathrm{Re} - Rd) = \frac{Dat_1}{Kpr_1} \cdot \Delta(\mathrm{Re} - Rd) \cdot Gp_1 \qquad (12)$$

The analysis of the influence factors over the company's economic growth potential shows that a firm on the rise needs investments in fixed and circulating assets financed from equities and debts, which will contribute to an adequate turnover and a high profit.

3. APPLICABILITY OF THE ECONOMIC GROWTH CAPACITY MODEL. A CASE STUDY

The case of an industrial company is shown to substantiate the general model of economic growth capacity and to highlight its essential aspects. The indicators necessary for the analysis were extracted from the financial statements, for two consecutive years (table 1).

Table 1. Economic- financial indicators (thousand RON)

Indicators	Basic period	Current period	Deviation	
			±	%
Total equities	18089	19599	1510	8.3
Debts	2483	3299	816	32.8
Invested Capital	20572	22898	2326	11.3
Net profit	3800	4357	557	14.6
Turnover	27461	31197	3736	13.6

Interests payable	425	525	100	23.5
Allotted dividends	570	436	-134	-23.5

Source: company's financial statements

The dynamic of the main factors that contribute to the economic development of the company is presented in table 2.

Table 2. Influence factors of the economic growth (%)

Indicators	Symbol	Basic period	Current period	Absolute deviation (±)
The rate of the reinvested profits	*Gp*	85	90	5
Degree of indebtedness	*Dat/Kpr*	13.72	16.83	3.11
Interest rate	*Rd*	17.1	15.9	-1.2
Return on invested capital	*Re*	18.47	19.03	0.56
Commercial profitability	*Rcom*	13.83	14.02	0.19
The rotation speed of the invested capitals (number of rotations)	*VRKinv*	1.33	1.36	0.03
The difference Return on invested capital – Interest rate	*Re-Rd*	1.37	3.13	1.76
The economic growth rate	*g*	15.79	17.63	1.84

We can see in table 2 that for both time periods, the economic growth rate has higher values (over 10%), which places the enterprise in the category of companies with a fast economic growth [7]. The economic growth rate of the analyzed firm, calculated on the basis of the model suggested, has increased by 1.84%, which indicates a high quality management. The growth was determined by the influence of the mentioned factors, as follows:

- The change in the invested capitals' speed rotation, expressed through the number of rotations indicator based on the turnover:

$$\Delta g(VRKinv) = Rcom_0 \times \Delta VRKinv \times Gp_0 = 0.1383 \times 0.03 \times 0.85 = 0.35\ \%$$

- The change of the commercial profitability:

$$\Delta g(Rcom) = \Delta Rcom \times VRKinv_1 \times Gp_0 = 0.0019 \times 1.36 \times 0.85 = 0.22\ \%$$

- The change of the reinvested profits weight:

$$\Delta g(Gp) = [Rcom_1 \times VRKinv_1 + \frac{Dat_0}{Kpr_0} \times (\mathrm{Re}_0 - Rd_0)] \times \Delta Gp =$$
$$= (0.1402 \times 1.36 + 0.1372 \times 0.0137) \times 0.05 = 0.96\ \%$$

- The change of the company's financial structure:

$$\Delta g\left(\frac{Dat}{Kpr}\right) = \Delta \frac{Dat}{Kpr} \times (\mathrm{Re}_0 - Rd_0) \times Gp_1 = 0.0311 \times 0.0137 \times 0.9 = 0.04\ \%$$

- The change of the difference between the financial profitability rate and the interest rate on the capital market:

$$\Delta g(\mathrm{Re} - Rd) = \frac{Dat_1}{Kpr_1} \times \Delta(\mathrm{Re} - Rd) \times Gp_1 = 0{,}1683 \times 0.0176 \times 0.9 = 0.27\ \%$$

The results of our analysis show that the company had, for each of the two time periods, a good statement regarding the economic growth potential.

In the analyzed period, the wealth of the shareholders was consolidated; the equities increased by 1510 thousand RON, which represents 8.3%. The net profit increased by 557 thousand RON (14.6%) and the turnover increased by 3736 thousand RON (37%). The company's degree of indebtedness increased as well, but the returned on invested capital was on a rise (by 0.56%) and was superior to the interest rate, which shows an efficient use of the loaned capital (the leverage effect). The figures also show that company had a growth potential for its activities each year, illustrated by the economic growth rate, which was 15.79% in the first year and 17.63% in the second year.

All the factors that influenced the economic growth rate actively contributed to the improvement of the firms' development capacity. Foremost, the favorable action of the reinvested profits' weight was of importance, by 0.96%.

The rotation speed of the invested capitals has also positively influenced (0.35%) the economic growth rate. This is actually a representative element of the profitability, which shows that besides the size of the profit allotted for development actions and re-equipment, the efficient management of the capitals invested in assets is just as important for the qualitative growth, which must be materialized in a higher turnover and, implicitly, a higher net profit.

With a 0.22% contribution, another important influence factor was noticed and namely commercial profitability. Through advantageous marketing strategies, the company succeeded in increasing its sales and their profitability in time.

Another important factor, which had a significant influence over the improvement of the capacity to increase equities, was the difference between the financial profitability of the company and the amount of the interest rate practiced in the inter-banking system (its influence was of 0.27%). If the company's management succeeds to efficiently capitalize the bank credits, the good management of the invested capitals will lead to a higher Return on Invested Capital in comparison to the loan cost (leverage effect), which will favorably contribute to the development of the business.

A smaller contribution to the improvement of the economic growth capacity is owed to the degree of indebtedness (0.04%). It must be mentioned that in the period studied at the company, the financial structure of the capitals changed. The degree of indebtedness increased by 3.11% that shows, that more loans were used for financing the activity. This is an option of financial policy for the cases when the profitability is higher than the cost of the loaned capital.

CONCLUSIONS

The factors that stimulate the fast economic development of the companies are tied to external variables (the economic-social conjuncture, the legislation, the features of the entrepreneurial environment, the specific economic-financial instruments, the economic policies) and internal variables, such as the strategy and the particularities of the company, the sales increase, creating new products and services, taking risks and the technological endowment.

Moreover, studies show that one of the essential elements for the economic growth of the firms is the quality of the human capital [3] - [12], reflected by the knowledge and competences of those who work to improve profitability [4] - [10].

The particular case that was analyzed during the study has availed the knowledge of essential aspects tied to the economic growth potential of the companies, and the used model highlights the analysis possibilities of the factors that influence the growth. The resulted conclusions can be generalized and adopted by companies in order to increase competition and satisfy the interests of those involved in their activity:

- The economic growth is a major objective of the company's functioning, being at the same time a condition to maintain the company in the competition system of the market, because it is tied to the profound value creating mechanisms and, especially, to the efficient functioning.
- For a firm to have an economic growth capacity, it must apply an efficient management that ensures an optimum administration of all its economic resources. The operational, investment and financial activities will be able to generate positive cash flows and to favorably contribute to forming profits only with rational and well-substantiated managerial decisions.
- The net worth indicator offers information about the owners' equity of a company, which are largely constituted as a result of the obtained and reinvested profits. In other words, the level of the net assets widely reflects the quality of the previous earnings' management [5]. The growing dynamic of the net worth shows a company in economic expansion, which generates profits and is strengthening its financial position. Maintaining such a trend is a warranty of the company's growing economic value and of the financial advantages that are given to the shareholders, creditors, managers, employees and other interest groups.
- The annual economic growth potential of a company is given by the growing rate of the equities, whose essential element is the amount of the obtained net profit.
- The firm has an economic growth potential only to the extent to which it rationally allotted the financial resources, so that the invested capitals for financing the assets are efficiently managed and generate net profit.
- The financing structure of the company's activity is a financial policy option and has a wide extent of variation between the two extremes – development on its own with the help of equity or development through financial loans. Choosing a rational proportion between owners' equities and loaned capitals can help reach objectives such as: financial security and autonomy, lowering the financial risk, increasing the possibilities to develop the investment and production activities [11]. Inside the companies, the preferences of the capital owners are conformed to the pecking order theory (the internal financing resources are used first, before any debts) and the main motivation are the aims of independence and control [6]. The main requirement of good management for the capitals' structure is to use the degree of indebtedness as a financial leverage, which means having in view the resources' efficient use in order to obtain a higher profitability than the costs of the loaned capitals. Otherwise, the degree of indebtedness can cause negative effects for the company, even leading to a decrease in the economic growth potential.
- The profitability of the assets managed by the company increases significantly with the help of the efficient sale of its products. Sales connect the company to the external environment [13]. The adequacy of marketing mix elements will find its effect in the turnover's size and in the earnings obtained with its help. Thus, the commercial profitability indicator becomes an important influence factor of the economic growth capacity.
- The company's capacity to record profit can also increase significantly as a result of better using the invested capitals (equities and loans) [1]. When economic actions that accelerate the faster retrieval of invested money are stimulated, the conditions to obtain higher earnings are also created through several cycles of the economic circuit. An improvement of the profitability can be obtained by accelerating the rotation speed of the used capitals and thus, create resources for financing the economic growth of the company.
- An important decision that affects the development possibilities of the company is the option regarding the allotment of profits. A rewarding policy for the shareholders, based on paying higher dividends, limits the financing possibilities, which, in the end, will lead to a lower economic growth capacity.

The multiple implications caused by the influence of the factors that act in the business environment enforce the careful analysis of their implications for the firms' economic growth potential. Only if the decisions adopted by the managers are substantiated by economic rationality criteria, if they meet the prudence, coherence and economic efficiency requirements, only then will the business be more reliable.

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