

## CHAPTER 31. STRENGTHENING ECONOMIC SUBJECTS' INTERNAL CAPACITIES - IMPROVEMENT OF DECISION-MAKING PROCESS<sup>1</sup>

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### **Abstract:**

*Corporate restructuring is the essential of many economic subjects in the modern society. By choosing the appropriate strategies and techniques for company restructuring, the performance could be improved, and additional value for the shareholders could be created. Adverse changes in the capital and product markets, competition strengthening and insufficiently successful management, are common reasons for undertaking numerous activities aimed to basic changes in corporate structure. Changes in management structure, and the forming of a competent leading team impact on decision-making process improvement, and consequently, on strengthening the quality of corporate governance. The aim of this chapter is to analyse the managers' competence and modern information systems, as tools to improve decision-making process. This chapter emphasize the importance of professional and ethical values to improve the effectiveness of decision-making process, giving special attention to the mechanisms of managers' control. Mechanisms of professional and independent supervision, along with ethic codex and proper motivation system allows the creation of partnership environment where managers, conducting business in the interests of company owners and other stakeholders, keep working in their favour. The rest of the chapter highlights the need for information system that provide promptly respond to the managers' requirements with relevant information, giving particular reference to the decision support system and BSC system. The separate part of the chapter presents a contribution of cash flow analysis to improving decision-making process, by analysing*

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*cash flow performance measures and cash flow analysis in function of individual decision-making.*

**Key words:** *Managers' Competence, Decision Support System, BSC System, Cash Flow Analysis, Decision-Making Process.*

## INTRODUCTION

Factors of modern enterprise environment, such as technology, competition, legislation, financial innovations, became over time more changeable. Very important is their impact on performance level of an enterprise, while the adaptation to environment changes is often crucial to very survival of the company. The need to adapt the internal structure of the company to the rapid changes in environment encourages the restructuring process. Corporate restructuring involves the implementation of certain measures taken in order to increase the competitiveness of the company and its values. According to many authors, the restructuring will play in future an increasingly important role in the pursuit of creating value and improving performance.

At some point, critical are the significant changes to the further company's development, or the issue of company's survival in the market. In conditions of crisis and unstable circumstances in the environment, the need for restructuring is growing due to objective difficulties the company is facing. The current global economic crisis requires reconsideration of the modern enterprise, the current level of performance, as well as the need for modifications in production, expenses, assets financial structure, etc. The redefinition of company management and the management structure are some of the techniques of corporate restructuring.

A key prerequisite for the efficient functioning of an enterprise is access to adequate internal capacities. When it comes to employees in managerial positions, the owners of the capital should offer attractive terms to entice managers of appropriate quality. Quality management, both in professional and in ethical sense is an important factor in the process of creating value for shareholders and an enterprise as a whole. By creating opportunities for managers' continuous professional development, additionally are improving their competences, and enhancing decision-making process.

### COMPETENT MANAGEMENT AS A FACTOR OF DECISION-MAKING SYSTEM IMPROVEMENT

The process of management and decision-making process are influenced by many factors that are relevant to long-term success and reputation of the company. Macroeconomic policy, the level of competition, legal and institutional environment, business ethics, awareness of the interests of environmental and social interests of the communities in which the firm operates, affect the efficiency of the system of corporate governance. Dispersion of ownership and risk, the limited liability of owners, the liquidity of equity securities and equity durability are the characteristics that make corporate governance an attractive form. However, the split function of ownership and management has resulted in distance of the owners of capital from the company and different degree of familiarity with the enterprises developments and performance, which can contribute to creating challenges in the relationship between capital owners and managers.

Managers contribute to the management process and decision-making quality by providing knowledge, professionalism, and respecting ethical values. Competence and integrity are qualities that capital owners expect from enterprise management. Competence management implies possession of appropriate professional capacities, continuous expansion of knowledge and skills, adherence to legal and professional regulations and ethical standards of corporate governance. The role of management is to manage the company capital in the interests of owners, but all the rights provided by its agent position, create space to satisfy its own interests, which are often in conflict with the interests of shareholders. Economic theorists were concerned with the relationship of principals and agents, or the conflict of interest between capital owners and management, and ways to overcome this gap. The solution of the problem is in control, adequate management motivation, and belief in the management integrity.

**Board of Directors.** The effective corporate governance comprises the decision-making system that at all levels of corporation separates management and control over important decisions. Board of directors has the responsibility to provide such corporate management that will provide answers to key questions related to build and maintain an effective decision-making process and its implementation, including selection of right person in terms of their abilities and values. Under domestic law, the board of directors is an important instrument of independent control of company's management. In the framework of defined competencies and responsibilities (Official Gazette of the Republic of Serbia, 2011) the Board of directors conducts an internal control of operations. The Board of directors that controls the executive directors can protect the interests of shareholders. The Board

of directors, among other, should take responsibility for set up and effective functioning of internal control system, and audit committee, while the audit committee should enjoy the essential independence in relation to company management.

**Internal Control System.** A credible internal control system creates additional confidence of creditors in reliability of information presented by companies' management. The companies with an effective system of internal control present less probability of material errors and fraud, and greater possibilities of their detection if occur. The results of research conducted by KPMG on sample of 5,000 U.S. companies may serve as response to the question whether and to what extent the system of internal control could affect the detection of fraud occurred in the company. Studies have revealed that the percentage of fraud discovered through internal control was 51%, while the independent audit found only 4% (Aleksic, 2004). According to a study of the same organization, the most common reasons for fraud are weak internal control (59%) and violation of internal control (36%) (Prga, 2002). It should not be ignored the fact that among the perpetrators of fraud are the managers at various hierarchical levels, where their status in the company makes it easy to circumvent internal control.

Company management is responsible for implementation, maintenance, and functioning of the internal control system (Stickney et al., 2007), while the preparation and presentation of reports regarding deficiencies in design and operation of internal control in the company becomes the obligation defined by legislation. The U.S. Sarbanes-Oxley law, created after numerous financial scandals in the United States contains provisions dealing with the regulation of the internal control system, which points to the fact that the bankrupt companies, among other things, had a problem with the inefficiency of the internal control.

**Mechanisms of external control.** External audit and auditors work supervision are important mechanisms of external management control. Monitoring could be carried out by controlling the management privileges and limiting managerial decisions. The more the supervision takes place among the managers and their shareholders, and as more both are monitored, the less is likely to occur conflicts of interest in the business (Van Horne and Wachowicz, 2007). Countries with developed corporate regulation, through the mechanism of minority shareholders rights' protection, have the additional capabilities of external management control. The possibility of minority shareholders to require additional review, when doubt the objectivity of the financial statements and auditor's reports has resulted in the improvement of management control and reduce potential conflict between management and shareholders (Dragasevic and Lakicevic, 2007).

**Ethical standards.** The fact that managers' activities are subjected to supervision, to some extent reinforces discipline in their behaviour. It could not be expected to perform the checking of all managers' activities carried out in different functions, the owners of capital based on belief that managers' integrity is not compromised. If management does not have integrity, there is a strong possibility to find out material errors or irregularities in managers conducting activities, as well as connections to the auditors, financial and legal advisors in the creation of various frauds.

High ethical standards are in the long term interests of the company as an instrument by which it gains credibility and confidence in the activities conducted. Codex that is respected throughout the company serves as a standard of conduct for board and key executives, creating a framework for statgrounds to deal with different and often conflicting groups. Professional responsibility of company management to their shareholders constrains them to respect the ethical codex. The continuous improvement and promotion of ethical behaviour presents the support to enhance the quality of decision to be taken and to avoid activities that violate the company's reputation. The respect of good corporate governance practice, including ethical behaviour of management, could lead to increased investor confidence, reduce the capital cost, stable source of funding and developing of financial markets (OSCE Mission to Serbia and Montenegro, 2004).

**System of motivation.** Specifying business rules, rights and obligation of managers through the legal, professional, and internal regulations, the partnership crates a climate where managers, conducting business in the interests of owners, work in their favour, too. An adequate system of compensation is important for attracting quality management, but also one of the mechanisms to prevent conflicts of interests between principals and agents. Full engagement in finding profitable and avoiding unprofitable investments, shareholders can only expect from properly motivated management. Motivation in form of bonuses, share of profit, equity, and participation in privileges that carry high hierarchical functions, is in accordance with performances of the company. Enterprise's financial position and performance are usually a measure of the management ability to manage activities to meet goals, considering that unscrupulous managers can try to shape the company's performance in order to meet the criteria provided for the acquisition of rights to compensation.

#### **STRENGTHENING OF INFORMATION BASIS AIMED TO THE IMPROVEMENT OF DECISION-MAKING PROCESS**

The changes in the nature of company's management are the result of variable competitive environment. The growing emphasis is placed on the managers' ability

to make quality business decisions. The firm's managers are required to perform higher professionalism from one side, while the management demands more information that will be able to support decision-making in future. Those requirements are the result of the spread of information needs, both in quantitative and qualitative sense. In accordance with the often-suggested rule that firm information should be available to the adequate managers at the right time, it is important to obtain information characterized by a higher degree of relevance and disposal timeliness for each key decision facing the company's management.

Company's adequate information system providing to the management the relevant information for decision-making, at the same time improves decision-making process. The large number of available data and the shortage of time to make important decisions are the characteristics of the modern enterprise, which includes an information system that may respond to the demands of managers with relevant information, at any time. Information base for decision-making the management draws primarily, in the information provided by the company's accounting information system. Although, it is the only complete source of quantitative information, although it should not be ignored the quantitative and qualitative information provided by external sources and other sources within the enterprise business system. Macroeconomic and industry information from the environment, as well as the one from the production, marketing, financial and human resources, present an important information support for management activities.

The process of decision-making is difficult to imagine without the instruments of management accounting. Management accounting prepares, and in internal reports indicates, information intended for the individual decisions of the manager. In modern enterprises, the accounting information system can provide information that will be relevant to management only if, apart from monitoring the internal process puts emphasis on external focus, and the company's environment and learning process, which would undoubtedly be able to improve management, and decision-making process. Concerning the strategic decisions, managers can rely on the information support of strategic management accounting, which together with recording, analysis and reporting on consequences of already adopted decisions, enable the environment monitoring and forecasting of future activities.

The modern enterprise requires the information system likewise the decision support system, whose primarily task is generating of the relevant information for decision-making. In contrast to the common management information system created by the technical experts, the decision support system is based on decision-making process and on the managers who in collaboration with IT experts design a system, which meets the managerial levels. This system focuses on poorly structured decision problems that require management evaluation. The practice indicates that

it is done very little to improve intelligibility of information, and that in general, dominate the financial statements understood mainly by the financial managers and management accountants. Displaying information in an understandable way is critical to making the right decision, both by financial and nonfinancial managers. Contemporary information technology could further enhance the value of accounting information by allowing the selection of data, their intersection, multidimensional analysis, events simulation, consequence predicting, a remarkable precision in many calculations, ability to “storage” information according to different manager’s needs. (Milicevic, 2003)

***BSC system as information basis for decision-making.*** Balanced Scorecard performance measurement system improves decision-making as a core activity of company’s management. The information provided by the BSC system allows the management of the company to deal with the causes of identifies problems and not just their symptoms surface, to learn from own mistakes and therefore to observe the complete situation in advance instead of backwards.

BSC system as a complete system of performance measurement includes financial perspective, perspective of the company’s products and services buyers, business and process perspective, and the perspective of learning and company’s growth (Kaplan and Norton, 1996). The financial perspective of performance measurement in the system should indicate how the company deals with owner’s requirements, in order to produce the value for the company’s owners. As indicators of the value a company generates for the owners of the capital are commonly used the following: Return on Investment – ROI, Earnings per Share – EPS, Net Cash Flow, Cash Flow Return on Equity – CFROE, Economic Value Added – EVA and Market Value Added – MVA. Among the above-mentioned indicators, an important role in the decision-making process plays the indicators based on cash flows, which, due to their relevance and topicality, shall be the subject of a separate part of the chapter.

Return on Equity – ROE presents the capacity and the percentage of making profit in relation to the book value of net assets of the company. The rate of return on invested equity shows if the return is a result of successful investments, effective asset management, or it is a consequence of the degree of indebtedness of the company. The current and potential shareowners are interested in the company that achieves a satisfactory amount of earnings per share. The ratio of net income available to holders of common shares and weighted average number of common shares represent a ground floor for adopting conclusion on the earning capacity ability of a company. The indicator known as the Price-Earning Ratio – P/E could be used for estimation of growth and prospects of a company in a future period. This ratio shows how much investors are willing to pay for enterprise’s one-dinar profit (Stevanovic and al., 2009). The indicators’ special significance is also seen in the fact

that by multiplying it with the value of projected earnings per share, it is possible to consider the expected market value of company's shares.

The financial company's perspective reflects the financial success indicators, such as economic value added and market value added. Economic Value Added – EVA is determined as a difference between net operating profit after taxes and overall capital costs, which indicates whether the value for shareholders is realized, and to what extent the value is above the expected returns of the shareholders and creditors. It can be argued that only the management that is able to broker the gain in the amount that is greater than the cost of the capital in general creates the value for shareholders. Market Value Added – MVA is also regarded as a measure of the value generated for shareholders, given that it represents the difference between the market value of capital and the amount of capital invested by shareholders (Fabozzi and Peterson, 2003). In theory, the market value added is viewed as the present value of all expected economic value added.

An important task of company's management is to create value for owners, not ignoring at the same time the interests of other stakeholders of a modern company. Improving decision-making process involves a continuous learning process, monitoring and analysis of appropriate activities within the company, as well as the activities in the environment. Accordingly, the performance of modern enterprise should be seen from multiple perspectives. The examples of indicators by which it is possible to test the value that company creates for its customers are the criteria such as: sale percentage of new products, timeliness of delivery, profitability, and customer rank, level of defects and failure, customer partnership, number of cooperative efforts of engineers to adapt the design and functionality of the product to the customer requirements (Milicevic, 2003). The value that company proposes to deliver to customers, affects customer's satisfaction, thus, the loyalty of existing customers, and attraction of new ones. Only satisfied customers could contribute to the success of the enterprise. Considering the business-process perspective, the level of success can be improved by the introduction of innovative processes, by improving business process and providing after-sale services to the customer. It is important that management, through the analysis of business-process perspective within the BSC system, or through analysis of criteria such as efficiency and effectiveness indicators, indicators of cost and quality level, identify the process in which the company possesses unique abilities. These processes, together with the professionalism of personal, appropriate information systems, and systems of motivation and reward can affect the creating value for customers and owners of company.



### CASH FLOW PERFORMANCE MEASURES AS FACTORS OF DECISION-MAKING PROCESS

The expansion of stakeholders' information demands in the modern enterprise environment resulted in a need for additional information on functioning of enterprises. The information on cash flows is by nature an important basis for decision-making. Along with other financial information, the information on inflows and outflows of cash enable the creation of a complete picture of the company's achievements.

The measures of company's performance based on cash flows are in the developing process and serve as a complement to the traditional measures. Investors, creditors, and analysts have focused attention from profitability flows to cash flows that represent the beacon that guides them through the risky waters of modern financial analysis (Mulford and Comiskey, 2005). A significant reason for this is that performance measures are based on profitability flows subjected to manipulative activities due to the fact that in applying accounting policies it is possible a greater degree of freedom of choice and subjectivity. Unlike the profitability flows, the process of determining cash flows is less subjective, while cash inflows and outflows are more realistic. The advantage of the cash flows' concept in relation to the earning concept, among other, is reflected in the fact that existing and potential investors are not interested in accounting categories, but only in cash, therefore, the enterprises should concentrate on generating cash flows, not accounting profits. Concerning the financial perspective of the company, among other things, includes the monitoring of return strength indicators, based on cash flows, which can be systematized as shown in Table 1.

*Table 1: Cash Flow Indicators*

Name	Elements
Cash Flow per Share	$= \frac{\text{Net Operating Cash Flow} - \text{Preferred Share Dividends}}{\text{Weighted Average Number of Common Shares}}$
Price - Cash Flow Ratio	$= \frac{\text{Market Price per Share}}{\text{Cash Flow per Share}} \times 100$
Cash Flow Return on Equity – CFROE	$= \frac{\text{Net Operating Cash Flow}}{\text{Average Own Capital}} \times 100$

Name	Elements	
Cash Flow Return on Assets – CFROA	$= \frac{\text{Net Operating Cash Flow}}{\text{Average Total Assets}} \times 100$	

Observing the relationship between net operating cash flow available to owners of common shares and the weighted average number of common shares may be assessed the management ability to create and pay the returns to the owners of the company. Based on cash flow per share could be determined the available funds for ordinary shareholders as a framework for the payment of dividends. Price-Cash Flow Ratio enables assessment of the company's profitability from the perspective of investors, as well as the evaluation of growth opportunities and risk of investing in company shares (Brigham and Houston, 2004). The value that investors are willing to pay for a single currency of net operating cash flow available to holders of common shares, indicates how investors evaluate the company operations in prior periods, and how they estimate the company performance in future. The ability of company to return the own invested capital from the net operating cash flow is determined on the basis of Cash Flow Return on Equity – CFROE indicator. Monitoring the trend of return on owners' capital, and the one of own capital generating net operating cash flow, makes the evaluation of enterprise's profitability more realistic.

The level of pay outs to shareholders based on dividends and capital gains for the monitored period, considered in relation to the market share price at the beginning of the period, indicates the growth of shareholders' wealth in relation to the initial investment value in the monitored period (Stevanovic and al., 2009). According to the same principle, it could be made some estimations of future return, which could be of great importance for decision-making about investing in monitored company shares, dropping from investing, or even selling existing shares. The present value of expected cash inflow from dividends and sale of shares at the end of the projected period, considered in relation to the current market share price, may be used as a measure of future returns to investor. The willingness of investors to invest their own funds in a company shares, may depend on cash inflow based on the expected returns on invested funds (Stevanovic, 2009).

***Analysis of cash flows as a function of individual decision-making.*** The process of business management involves making many decisions related to maintenance and growth of current business activity, investment and financing. Given that the effects of management decisions on the movement of enterprise performance unavoidable, it is important to perceive future benefits on right way before adoption and implementation of important decisions. The adoption of most of the decisions is related to consideration and assessment of company needs financing and the

evaluation of possible harmonization between sources and fund investment, giving priority to the information on cash flows.

If the creation of value for shareholders is observed as a mission of the company, the management has to provide the information on the size and certainty of expected cash flows as a generator of enterprise value, in order to approach the making of investment and financial decisions. Without a stable source of cash at a satisfactory level, there is no real basis for decision-making. The positive and stable cash flows from operating and financing activities suggest the ability to generate cash and ability to access external sources, on which basis could be considered primary about the further investment activities, as well as the payment of dividends, debt repayment or redemption of own shares. Before making an investment decision for each potential investment it is necessary to estimate the expected future benefits and how they contribute to the generation of funds in the future, therefore, an investment should be considered as a lucrative and the investment decision as justified.

Making the right business and investment decisions requires a detailed analysis of the funding provided for investment, while in the process of making decisions about funding a significant role has information on cash flows. Analysis of cash flows facilitates consideration of enterprise capacity to generate internally cash funds necessary to finance business, investment and financial expenditure. The extent of obtaining funds from external sources depends on the overall needs for funds, the amount of net operating cash flow and access to external sources of funding. The company that achieved a positive and satisfying amount of net cash from operating activities is able to attract capital based on the emission of shares and debt securities together with creditor's capital, under relatively favourable conditions. Negative short-term net operating cash flow, usually in the companies in development, does not disturb the access to borrowed capital. On contrary, the long-term inability to generate net cash from operating activities is a bad signal to potential owners of new emitted securities, and potential creditors, so that the degree of obtaining external sources of cash is usually not the desired one, based on financing activities.

## **CONCLUSION**

The efficient functioning and company development in an unstable and uncertain market environment is conditioned by continuous search for better solutions that will provide a good market position and satisfactory level of business and financial performance. The necessity to adapt internal structure to rapid changes in environment encourages a process of corporate restructuring in order to provide

valuable growth in line with market trends and expectations of management. Improving internal capacity, among other, is a significant prerequisite for the efficiency of the company, its profitability, and competitiveness. Only quality management, both in professional and ethical sense, can realize value creation for owners and for an enterprise as a whole.

The process of decision-making as a core activity of company management should be supported by adequate information system, which at any time may respond to requests for relevant information. Aiming to improve decision-making process, the authors emphasize the importance of improving information base and relevancy of Balance Scorecard performance measurement and Decision Support System. Considering that the process of enterprise management involves making many decisions related to maintenance and growth of current operating activities, investment and financing activities, and taking into account the advantages of cash flow concept in relation to profitability flows, the attention was focused to the performance measures based on cash flows, as a supplement to traditional performance measures.

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