

Literature review on Factors Affecting Financial Performance of firms

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Abstract: *Financial performance is a critical aspect of evaluating the success and effectiveness of a firm's operations. It encompasses various measures and indicators that assess the company's profitability, efficiency, liquidity, solvency, and overall financial health. Understanding and analyzing financial performance is essential for businesses, investors, and stakeholders as it provides insights into the company's ability to generate profits, manage resources, meet financial obligations, and create value for shareholders. There for this paper explores the key factors that impact the financial performance of a firm.*

Key words: *Financial performance, factor,*

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I. Introduction

The literature review on factors affecting financial performance of firms provides valuable insights into the various factors that can impact a firm's financial performance. Some of the key factors identified in the literature include the firm's size, capital structure, the level of debt, the level of liquidity, leverage ratio and the level of profitability, etc.

One of the key findings of the literature review is that firm size has a significant impact on financial performance. Larger firms tend to have greater access to resources and are able to take advantage of economies of scale, which can result in higher levels of profitability. However, larger firms may also be more vulnerable to economic downturns and other external factors that can impact their financial performance.

Another important factor identified in the literature is the level of diversification. Firms that are more diversified tend to be less vulnerable to economic shocks and more resilient in the face of changing market conditions. However, there is also some evidence to suggest that overly diversified firms may be less focused and less efficient in their operations.

Capital structure refers to the way a company finances its operations and investments by utilizing a combination of debt and equity. It represents the mix of different sources of funding that a company uses to support its activities and achieve its financial goals.

The level of profitability is a key indicator of a firm's financial performance. Firms that are able to maintain high levels of profitability are generally more successful and more likely to attract investment and other forms of financial support. However, profitability can be impacted by a wide range of factors, including the firm's market position, its product offerings, and the level of competition in its industry.

The leverage ratio is a key financial metric that measures the extent to which a company relies on debt financing in its capital structure. It indicates the proportion of a company's total capital that is funded by debt compared to equity. The optimal leverage ratio varies across industries and depends on factors such as business risk, industry norms, and market conditions. What may be considered an appropriate leverage ratio for one company or industry may not be suitable for another.

Overall, the literature review highlights the complex and multifaceted nature of financial performance and the many factors that can impact a firm's success. By understanding these factors and their interrelationships, firms can make better-informed decisions and take steps to improve their financial performance over time.

II. The factor impact on financial performance of firms

The research conducted by Demirhan and Wassem (2014) categorizes four groups of factors that influence the financial performance of a business, including (1) "liquidity," which is measured by the current ratio and the acid-test ratio, two ratios that provide information about the ability of the business to meet short-term debts; (2) "profitability," which evaluates the profit-generating capability of the business through net profit margin, operating profit margin, and return on assets; (3) "asset management efficiency," which is measured by inventory turnover, accounts receivables turnover, and total asset turnover; (4) "financial leverage," which is

measured by return on equity and debt-to-equity ratio. Financial leverage refers to how much a company utilizes debt to finance its operations. A business's leverage, or return on equity, increases when the company earns more from investments funded by borrowed capital than the interest paid (Brigham & Houston, 2012).

Sulairnan, Jili, and Sanda (2001) investigated business failures in Malaysia. They developed a logit model and studied factors that can be used to predict failure. Various financial ratios were used in the study, but three main ratios were found to have significant predictive power. These ratios include leverage, interest rate, and total asset turnover. Another study by Abdullah et.al (2008) compared different methods for predicting the operational efficiency of businesses. They concluded that among the ten factors examined for predicting business performance, leverage, net income growth, and return on assets were deemed to have significant predictive power for operational efficiency.

To determine the factors that will impact the financial operations of a business, two approaches can be applied: the resource-based view and the contingency theory. According to the resource-based view, the key to improving a business's performance is to consider its internal characteristics (Barney, 1986; Afrifa & Taurigana, 2015). The contingency theory helps explain how the design of a business will only be practical and applicable in certain specific environments when certain conditions are met (Otley, 1980; Uyar & Kuzey, 2016). Since the conditions and environments of each business vary, the design of that business will also differ. Developing innovation strategies, implementing management accounting information systems, and managing internal business processes can play a role as underlying factors influencing the business's financial operations (Hariyati & Tjahjadi, 2018).

A business needs to have an excellent strategy to achieve a competitive advantage in an industry. However, external factors such as industry-specific factors can influence building a good strategy. The Industry/Organisation (I/O) model emphasizes that external environmental factors, particularly industry factors, significantly impact the operational effectiveness of a business. Experimental research supporting this model was conducted by Schmalensee (1985), which demonstrated that industry factors influence business performance by approximately 20%, while in the case of McGahan and Porter (1997), industry factors affect business performance by around 19%. Conversely, internal factors within a business, such as management practices and the characteristics of the organization, can address business issues or facilitate the expansion of products, services, or processes (Makhija, 2003). Unlike external factors that are beyond the control of a business, internal factors encompass the resources and capabilities of the business, both of which can be controlled (Galbreath & Galvin, 2008).

The Resource-Based View (RBV) argues that competitive advantage and sustainability depend on how a business controls and effectively utilizes its internal resources. This theory focuses on the resources and capabilities of a business that determine its operational effectiveness. Resources, including assets, skills, and capabilities, determine the process of empowering the business to create its competitive advantage. Teece, Pisano, & Shuen (1997) suggest that competitive advantage relies on a business's resources. This idea is further extended by Barney (1986), who suggests that resources can be broadly defined as assets, business processes, firm attributes, information, or knowledge, all of which are controlled by a business and can be utilized to develop and implement the business's strategies. Barney, Wright, & Ketchen (2001) explain that a business is a collection of resources, capabilities, and abilities. The differences between businesses can be attributed to their respective resources, capabilities, and abilities, all of which can determine the business's competitive advantage. Therefore, a business's management accounting information system and its business processes serve as significant resources that can help businesses generate superior financial performance.

The Contingency Theory explains why accounting systems can vary between different conditions or environments. Otley (1980) findings suggest that three concepts determine the effectiveness of an accounting system: (1) technology, (2) organizational structure, and (3) environment. Harash, Al-Timimi, & Alsaadi (2014) suggest that the contingency approach is suitable for analyzing and designing control systems, particularly management accounting systems. Researchers in the field of management accounting, such as Chong and Chong (1997), have conducted studies to identify the relationships between variables in the context (or underlying factors) such as environmental uncertainty, task uncertainty, organizational structure and culture, strategic uncertainty, and the design of management accounting information systems. The contingency approach is used to explain how underlying factors can influence a business's competitive advantage or operational effectiveness. Using contextual or underlying variables such as innovation strategy, management accounting information systems, and the effectiveness of internal business processes as factors can help a business achieve financial efficiency.

Innovation

Financial performance is an important aspect of a business as it reflects the result of management's efforts in utilizing the company's resources to maximize shareholder value. A report on financial performance can indicate whether a company's strategy contributes to improving profitability. Kaplan (2009) suggests that a company's financial operations can be enhanced through two approaches: growth strategy and product strategy.

Businesses can generate profits by improving productivity through innovation - including product innovation and process innovation. Productivity improvement can be achieved by (1) reducing direct and indirect costs or by using financial and physical assets more efficiently and (2) reducing working capital and the required investment to support a certain level of business. A linked strategy from a financial perspective emerges when companies balance growth and productivity. The three key indicators used to measure financial performance effectiveness are (1) revenue growth, (2) cost reduction or cost savings and increased asset utilization efficiency, and (3) increased customer value.

Innovation

Innovation is defined as a process created within a business to examine how skills and resources are utilized to develop new products and services or establish new production systems and operations to meet customer needs (Gao, Hsu, & Li, 2018). Innovation is necessary for creating value, for example, penetrating new markets, retaining existing market share, and improving competitive advantage. Innovation is a vital component of business strategy. Through innovation, businesses are better equipped to succeed in global competition. Innovation has also become a central focus in academic and industrial research. Numerous studies have recognized the importance of innovation in achieving sustainable competitive advantage in global competition (Hitt, Ireland, Camp, & Sexton, 2001; Kuratko, Ireland, Covin, & Hoprnsby, 2005).

The goal of innovation is not only to reduce costs but also to help companies improve the quality of their products and services. This is crucial in the era of globalization, where product life cycles have become shorter due to evolving customer needs and diverse demands. In summary, innovation is highly significant in developing new products and services, creating business models, and implementing marketing techniques. The research by Evangelista, Sandven, Sirilli, and Smith (1998) indicates that companies need to innovate more to maintain competitiveness. Global competition requires companies to enhance product innovation and their technological capabilities in producing products or services at lower costs. Therefore, companies need to apply their organizational structures and business processes, enhance core competencies, and develop new structures to meet new market conditions and customer demands (Ulusoy, Özgür, Bilgiç, Kaylan, & Payzın, 2001). The success or failure of a business in achieving exceptional performance is determined by its innovation (Hamel, 1999).

Businesses must effectively implement their innovation strategies to ensure good financial results. These strategies need to be executed through strategic activities or processes. Companies must manage their internal business processes to achieve excellent operational management, customer management, innovation management, and regulatory compliance management. To achieve operational efficiency, businesses must be supported by a skilled workforce, reliable information systems, and substantial financial resources. Kaplan and Norton (2001) classified internal business processes into four groups. The first group relates to operational management processes, including transactions with suppliers, product manufacturing, customer distribution, and risk management. The second group pertains to customer management processes. This involves how businesses expand and deepen their relationships with target customers. Customer management encompasses four factors: selecting target customers, attracting target customers, retaining customers, and expanding the customer base. The third group is innovation management processes, which consist of four steps: identifying opportunities for new goods and services, managing the investment portfolio for research and development, designing and developing new products, and introducing new products to the market. The fourth group is legal and social processes, which refer to ongoing activities that enable businesses to operate within a specific community, ensure safety and health, and promote employee activities as well as community development.

The financial activities of manufacturing businesses in East Java province (Indonesia) are influenced by factors such as innovation strategy, management accounting information systems, and the effectiveness of internal business processes (Hariyati & Tjahjadi, 2018). The government encourages manufacturing businesses to collaborate with universities to enhance their competitive advantage and operational efficiency in the face of global competition, especially from Chinese enterprises, in the ASEAN Economic Community (AEC) era. This movement reflects the government's recognition of innovation strategy as an essential factor in achieving good financial performance from a global competitiveness perspective.

Enterprise Scale

The scale of an enterprise also influences its financial performance. Hvide et.al (2007) concluded in their study that larger enterprises have better efficiency. Rozaimah et al. (2018) argued that larger enterprises outperform smaller ones in exploiting economies of scale in transactions and enjoying higher profitability. Athanasoglou et al. (2005) affirmed that increasing the scale of an enterprise enhances its financial performance. Almajali et al. (2012) suggested that the scale of an enterprise can affect its financial activities. However, for massive enterprises, the impact of scale may be negative due to bureaucracy and other reasons (Yuqi, 2007).

Studies by Lin and Fu (2017), Mishra and Kapil (2017), and Shin-Ping and Hsien (2009) have shown that enterprise-scale significantly and negatively affects the financial activities of businesses because larger enterprises tend to face more agency problems. In contrast to these findings, Bhabra (2007) argued that enterprise-

scale has a significantly positive impact on the financial activities of businesses because larger enterprises have better economies of scale.

Enterprise Age

The age of an enterprise has a relationship that affects the financial performance of the business. Many researchers suggest that their operational efficiency tends to decline as businesses operate longer. For example, Sorensen and Stuart (2000) argue that the age of an enterprise impacts its operations. They further contend that the inertia of long-established firms tends to make them inflexible and unable to accurately assess environmental changes. However, long-operating businesses can also become outdated and cause business decline (Agarwal & Gort, 2002). If performance gradually diminishes as businesses age, this may explain why most of these businesses eventually undergo succession (Loderer, Neusser, and Waelchli, 2011).

On the other hand, several studies indicate that long-operating businesses have high operational performance. Liargovas and Skandalis (2008) report that mature businesses possess higher skills because they benefit from learning advantages and are less susceptible to the liabilities of newness, resulting in superior performance. Loderer et al. (2009) found a positive and significant relationship between a business's operating time and profitability.

Board of Directors' Scale

The scale of the board of directors is also believed to have an impact on the financial performance of a business. The Board of Directors' scale is used to measure the effectiveness of the board's monitoring activities. The board of directors' scale variable has been found to have a significant positive impact in the studies conducted by Mishra & Kapil (2017) and Ping & Hsien (2009) as it provides better monitoring and can prevent managers from acting solely in their interests. In contrast, Cheng et.al (2008) argues that the scale of the board of directors has a significant negative impact on the business's financial performance because larger boards create difficulties in coordination and communication, thus leading to more conflicts and agency problems (Cheng et.al, 2008).

Business Ownership

Lin & Fu (2017) and Mishra & Kapil (2017) argue that business owner has a significant positive impact on the financial performance of the business because investors play an active monitoring role, proactively overseeing the activities of the business to reduce agency issues and agency costs (Lin & Fu, 2017). In contrast, Ping & Hsien (2009) present a contrasting view, suggesting that business ownership does not significantly impact the financial performance of the business because investors act as passive monitors, only concerned with short-term interests. Internal ownership has a positive impact on the financial activities of the business because internal ownership creates a link between the interests of the agent (manager) and the principal (owner), thus reducing agency issues and agency costs (Jensen & Meckling, 1976). Conversely, the study conducted by Lin & Fu (2017) has shown that internal ownership negatively impacts the financial performance of the business because insiders may try to maintain their position through anti-takeover actions that reduce the business's financial efficiency (Lin & Fu, 2017).

Internal Ownership

In businesses where ownership is separate from management, the agency problem, also known as the principal-agent problem, can occur (Chandra et al., 2015). This problem arises when the manager (agent) acts in their interest without considering the interests of the owner (principal) (Jensen & Meckling, 1976). Businesses incur additional agency costs to mitigate this agency problem and enhance the owner's wealth. These costs are associated with monitoring management actions, ensuring managers do not engage in dishonest actions, and providing incentives for managers (Gitman, 2017). One possible way to reduce agency problems and agency costs is for businesses to increase internal ownership and insider ownership, which can improve the business's financial performance (Bathala, 1994).

Effective internal business operations can lead to a healthy enterprise, enabling it to achieve its objectives. In summary, the effectiveness of internal business processes affects the business's financial activities.

Leverage Ratio

Leverage in finance refers to using borrowed funds to generate larger returns by incurring a small cost. Leverage specifically refers to the debt-to-equity ratio in a company's capital structure. The decision to finance or leverage is an important management decision as it affects the profitability and risk for shareholders as well as the market value of the business. The debt-to-equity ratio impacts shareholder dividends and risk, which in turn affects the cost of capital and the market value of the business (Pandey, 2007).

Several studies have shown a positive relationship between leverage and financial performance (Ghosh, Nag, & Sirmans, 2000; Berger & Bonaccorsi di Patti, 2006). However, Gleason et al. (2000), Simerly & Li (2000),

and Zeitun & Tian (2007) demonstrate a negative relationship between financial performance and the degree of leverage.

Some researchers have examined the use of debt by businesses and proposed factors that determine financial leverage, suggesting that decisions regarding the debt-equity ratio of a company often depend on the trade-off between tax advantages and financial costs (Upneja & Dalbor, 2001). According to the trade-off theory of capital structure, an optimal level of debt balances the benefits of debt with the costs of debt (Gu, 1993). Therefore, using debt with a certain debt ratio leads to a higher return on equity, but the costs beyond this capital structure level outweigh the benefits of debt. In other words, the more a business uses debt, the lower the corporate income tax but, the higher the financial risk. Based on the trade-off theory of capital structure, businesses can use debt to generate higher profits on equity.

Another control variable, specifically the leverage ratio, the ratio of debt, has been found to have a significantly negative impact on the financial activities of the business by Lin & Fu (2017), Mishra & Kapil (2017), and Ping & Hsien (2009) due to higher interest costs associated with higher debt levels, thereby reducing the income of the business. In contrast to these findings, Ahmad & Jusoh (2014) propose that the leverage ratio has a significantly positive impact on the business's financial activities as businesses receive additional monitoring from creditors and can earn more income compared to not using debt.

Capital structure

Capital structure, also known as financing structure, refers to the way in which a company finances its operations and investments by utilizing a combination of debt and equity (Akeem et al., 2014). It represents the composition of a company's different funding sources to support its activities and achieve its financial objectives. Understanding the relationship between capital structure and financial performance is crucial for both businesses and investors, as it provides valuable insights into optimal financial decisions that maximize profitability, stability, and overall financial success.

A company's capital structure typically includes long-term debt, such as bank loans, bonds, and other forms of borrowing, as well as equity, which represents the ownership interest of shareholders. The debt-to-equity ratio in a company's capital structure can vary based on various factors, including industry standards, company size, growth prospects, and risk tolerance.

Debt financing involves borrowing capital from external sources that the company must repay over time, along with interest. By utilizing debt, a company can leverage its operations and investments, potentially increasing its profitability. However, debt also entails obligations, such as regular interest payments and principal repayment, which can create financial strain if not managed effectively.

On the other hand, equity financing reflects ownership in the company and is typically raised by issuing shares to investors. As a result, equity holders have entitlements to the company's profits and assets, and they can benefit from capital appreciation if the company performs well. In addition, unlike debt, equity financing does not require regular interest payments or principal repayment. However, it involves sharing ownership and control of the company with shareholders.

The capital structure decision is highly significant for companies as it influences financial stability, risk profile, and cost of capital (Bhutto et al., 2021). The choice between debt and equity financing involves trade-offs. Debt offers tax advantages and can provide a fixed cost of capital, but it also increases financial risk and may limit flexibility. On the other hand, equity provides greater flexibility. It does not create a legal obligation to repay, but it dilutes ownership and can be more expensive in terms of return expectations.

The optimal capital structure for a company depends on various factors, including industry dynamics, growth prospects, profitability, cash flow stability, and risk tolerance. Striking an appropriate balance between debt and equity financing is essential to maximize shareholder value, minimize financial risk, and support sustainable growth (M'ng et al., 2017).

Liquidity

Liquidity is a vital aspect of a firm's financial management, encompassing its ability to meet short-term obligations and efficiently manage cash flows. Maintaining an optimal level of liquidity is essential for businesses as it ensures smooth operations, supports growth initiatives, and mitigates financial risks. Understanding the relationship between liquidity and financial performance is crucial for managers, investors, and stakeholders in assessing a company's overall financial health and sustainability.

Several studies have examined the impact of liquidity on profitability, a key indicator of a firm's financial performance. For example, Durrah et.al (2016) found a positive association between liquidity measures, such as the current ratio and quick ratio, and profitability indicators like return on assets (ROA) and return on equity (ROE). Bolek, & Wolski (2012) concluded that higher liquidity positively influences profitability and market value of Polish firms. Efficiency measures assess how effectively a firm utilizes its resources to generate outputs. The relationship between liquidity and efficiency has been investigated in various studies. For instance, Tahir and Anuar (2016) examined Pakistani textile firms and found that liquidity positively impacts efficiency ratios, such

as asset turnover and inventory turnover. Solvency refers to a company's ability to meet its long-term obligations. Liquidity plays a crucial role in determining solvency, as it provides the necessary resources to honor debt payments. Kim and Sohn (2013) examined the relationship between liquidity and solvency in Korean firms and found a positive association between liquidity ratios, such as the cash ratio and debt ratio, and solvency indicators like debt-to-equity ratio. Creating shareholder value is a fundamental objective of businesses. Liquidity influences a firm's ability to generate value for its shareholders. (Bogdan et.al, 2012).

Accounting Activities

According to Chenhall and Morris (1986), accurate and reliable information stems from a reliable management accounting information system with the criteria of breadth, timeliness, synthesis, and integration. The effectiveness of a business's operations is demonstrated by the interaction between the management accounting information system and the business strategy (Ali, Rahman, & Ismail, 2012; Almajali, Masa'deh, & Tarhini, 2016). The information the management accounting information system provides plays a crucial role in managerial decision-making. However, a reliable management accounting information system requires information technology readiness (Masa'deh, 2013; Masa'deh, Obeidat, & Tarhini, 2017). Cohen, Chang, and Ledford (1997) use the Return on Assets (ROA) ratio to measure a firm's accounting profitability. Market analysts widely use ROA as a financial efficiency measure, as it gauges the effectiveness of assets in generating income.

To develop a business, an innovation strategy must be implemented alongside the business process. The internal business process of a firm involves managing operations, customer management, innovation, process management, and society (Kaplan & Norton, 1997; Erhemjants, Li, & Venkateswaran, 2013). Innovating the process is closely tied to efficient production processes, timely delivery to customers, and post-sales services. The performance of the business process affects cost efficiency and product quality improvement, facilitating effective asset utilization, thus positively impacting the business's financial activities. The accounting information system and the efficiency of the business process play vital roles in generating value in these processes. Therefore, the effective implementation of a business's innovation strategy can influence its financial activities, requiring support from a reliable management accounting information system and an excellent business process (Masa'deh, Shannak, Maqableh, & Tarhini, 2017).

III. Conclusion

This comprehensive literature review offers valuable insights into the multifaceted factors that can impact the financial performance of firms. It suggests that the size of a company can play a crucial role in determining its financial success, with larger firms typically enjoying greater access to resources and economies of scale. However, it is important to note that larger firms may also face increased vulnerability to external factors and economic downturns. Furthermore, the capital structure of a company including the mix of debt and equity financing, is a critical determinant of its financial performance, with the optimal leverage ratio varying across industries and depending on various factors such as business risk and market conditions.

The contingency theory and resource-based view provide useful frameworks for understanding how internal and external factors interact to impact financial performance, with industry-specific factors and internal resources and capabilities of a firm both playing significant roles. Moreover, innovation is identified as a crucial factor in improving financial performance, with businesses encouraged to foster innovation in product development, process improvement, and marketing techniques to achieve sustainable competitive advantages and enhance profitability. Other factors that can impact financial performance include enterprise scale, enterprise age, and the scale of the board of directors.

By taking into account and considering these various factors, firms can make informed decisions and take appropriate steps to improve their financial performance over time. Further research and empirical studies are necessary to deepen our understanding of these factors and their interrelationships. In conclusion, this review provides a comprehensive understanding of the various factors that can impact financial performance, and highlights the importance of strategic decision-making and innovation in achieving sustainable growth and profitability.

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