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IMPACT OF PROMOTIONAL COSTS ON COMPANY'S PROFITABILITY

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ABSTRACT

The purpose of this paper is to theoretically identify and delineate the specifics of various costs of promotion and to assess their influence on company's profitability, assuming that the companies that invest more in promotional activities generate higher income and more profit. In addition, the current study will examine whether there is a difference in the amount of investment in promotion with respect to the legal structure and the size of the company, starting from the assumption that large enterprises and public limited companies have more funds at their disposal, and consequently invest more in promotional activities. The study was conducted on a random sample of 67 companies in 2012, and the obtained results show that the share of promotion in the overall costs significantly affects company's profitability, while there is no significant difference in promotional investment neither regarding the legal structure nor the size of the company.

Key words: *promotional costs, profitability, company size, legal structure*

1. INTRODUCTION

Changes in the environment caused by technological innovation, globalization, deregulation, privatization, strengthening the power of consumers, convergence of different industries and disintermediation have led to the increased market competition (Kotler, 2001: 15). In such a situation, companies have to compete in winning the consumers' favour and they have to create the demand for their products and services among the prospective customers. In order to succeed, many resort to promotional activities that will get through to the consumers and encourage them to buy their products or services. However, in the periods of economic crisis managers often apply the policy of cost-cutting, which has recently led to a continuous decrease in investment in promotion.

Promotional costs are regular operating costs, which are recorded in the enterprise's accounting. They represent tax deductible expenses, and the taxpayer may use the right of pre-paid tax deduction because it is a service that is related to his taxable transactions. Tax aspects of these costs are regulated by the Income Tax Act (Official Gazette 177/04 - 143/14), the Regulations Concerning Income Tax (Official Gazette, 95/05 - 157/14), the Value Added Tax Act (Official Gazette, 73/13 - 143/14) and the Regulations on Value Added Tax (Official Gazette, 73/13 - 157/14).

Based on the above, the following objectives of the current study have been established: 1. to theoretical identify and delineate the specifics of various promotion costs; 2. to determine the impact of these costs on business profitability; 3. to investigate whether there are differences in investment in promotion with respect to the legal structure and size of the company.

2. THEORETICAL DETERMINATION AND CLASSIFICATION OF PROMOTIONAL COSTS

Adopting the language of marketing, promotion is *any form of communication whose role is to inform, persuade and/or remind people of products, services, image, ideas or involvement* (Previšić, 2004: 231). Promotional costs are the costs incurred to promote a particular company and its products and/or services. *Promotion seeks to better inform customers (current and prospective), and improve sales* (Dojčić, 2013: 87).

However, in the regulatory context, there is no single definition of what is considered a promotional expense. The main legal acts that define these costs are the Income Tax Act and the Value Added Tax Act and their associated regulations. According to the Income Tax Act, promotional costs can be defined as those that include items that are not considered entertainment costs, i.e. such taxpayer's products and goods that are adapted for this purpose and marked "not for sale", and other promotional items with the name of the company, products and other forms of promotion (e.g. cups, coasters, pencils, etc.) provided for use in the retail store, and if given to consumers should be up to HRK 160.00 per item without VAT. Similarly, by categorizing them as gifts of small value, the promotional costs are defined in the provisions of the Value Added Tax Act. Promotional costs are defined in the Regulations Concerning Income Tax, according to which the promotional costs for which the tax base is not increased are the *costs incurred by using the mass media, the advertising columns and slabs, telops, flyers, catalogues, trade shows, the costs of prize competitions in accordance with the regulations concerning the organization of prize and similar games, and the costs used to promote the taxpayer's name, goods or services in any other way in public* (Regulations Concerning Income Tax, Art. 24, paragraph 1). As such, promotional costs represent the costs of the current period and are, in terms of income tax, fully tax-deductible expenses, i.e. they do not increase the income tax base. On the other hand, the Regulations on Value Added Tax exclude the following from the list of promotional costs: delivery of goods and services that are not considered to be periodical, as well as those whose individual value exceeds HRK 160.00, prize contests gains of more than HRK 160.00 without VAT where these are subject to value added tax (Regulations on Value Added Tax, Art. 11, paragraph. 5).

Summarizing all the relevant provisions of the above-mentioned laws and by-laws, the promotional activities can be classified into the following categories: (1) the costs of promotion through the media, i.e. advertising, which refers to the *paid, impersonal communication of a particular organization identified in the message through various media* (Previšić et al, 2004: 246); (2) promotional materials, such as leaflets, brochures, catalogues, and the like, which are given free of charge to present or prospective buyers; (3) sales promotion, which involves the use of any kind of stimulation to prompt intermediaries and/or consumers to purchase a particular brand (Previšić et al, 2004: 246); (4) sponsorship, where the donations require a favour done in return, i.e. promotion of the company, product or sponsor's logo (Regulations Concerning Income Tax, Art. 30 paragraph 2); (5) entertainment costs, which sometimes also have a promotional character for an organisation that aims to achieve the best possible cooperation with business partners - however, it is important to determine the difference between the promotional and entertainment costs because entertainment costs are only partly recognized as an expense in terms of tax and the prepaid tax is not recognised at all.

3. REVIEW OF PREVIOUS RESEARCH

A large number of studies on the impact of promotion on company's performance date back to the 1970s. For example, Lambin (1970) and Peles (1971) conclude that promotion has a long-term impact on sales, which indicates that it increases business efficiency. In their study Sherman and Tollison (1974) found that industrial promotion has no direct influence on the profit gained, explaining it by the fact that the promotion cannot be treated as a real independent variable, but as an indirectly dependent variable that depends on technological factors and prices. After the 70s, the studies of the effects of promotion were again popularized at the beginning of the 21st century. Thus, for example, Iftekhar, Hunter and Roswell (2000) studied the impact of the promotional costs on performances and asset management in the savings and loan institutions. Their results showed that the relationship between the promotional costs and performances measured by return on assets is not statistically significant, where the defined direction of the impact is negative. However, when they broke down the return on assets into non-interest return on assets and interest return on assets the relation between the non-interest return on assets and promotional costs proved to be statistically significant and of a positive direction. In his study Roberts (2003) found that the profitability of the companies that have increased spending on marketing during the recession has not been reduced. On the contrary, after the recession, their profits have increased significantly, as opposed to companies that reduced promotional activities. By applying the VAR model methodology Srinivasan (2006) analyzed the weekly data from the automobile industry collected in course of six years to investigate how the investment in promotion contributes to creating additional revenue from the brand. Based on the results, the author concluded that promotion has a positive cumulative effect on the revenues from brand in the long term.

In Croatia research on this topic are rare. Frančišković and Tomljanović (2001) studied the impact of promotion on the effectiveness and efficiency of travel agencies. They used a simple linear regression model in which the independent variable is the cost of promotion, while the dependent variable is income from sales, on the grounds that higher sales revenues generate greater profits, and the results confirmed the hypotheses.

Based on previous studies, to our knowledge, there are no such studies that consider the legal structure and the size of the company when examining the impact of promotion on the profitability of companies from various industrial sectors, which has been established as the subject of this paper and its main scientific contribution.

4. SAMPLING AND RESEARCH METHODOLOGY

Based on the defined problem and subject of the research, and in accordance with the theoretical background and previous relevant research the following research hypotheses are defined:[1]

H1 - There is a statistically significant positive correlation between promotional costs and enterprise profitability.

Although costs, by definition, represent an item that reduces profits, it is expected for investment in promotion to contribute to the growth of demand of the company's products, which will contribute to the growth of sale and thus higher profitability.

H2 - There is a significant difference in the amount of investment in promotion with respect to the legal structure of company organization.

Since the public limited companies are larger than limited liability companies, they have a larger value of assets and have more funds, it is expected that they would invest more in promotion than the limited liability companies.

H3 – There is a statistically significant difference in the amount of investment in promotion with respect to the size of company.

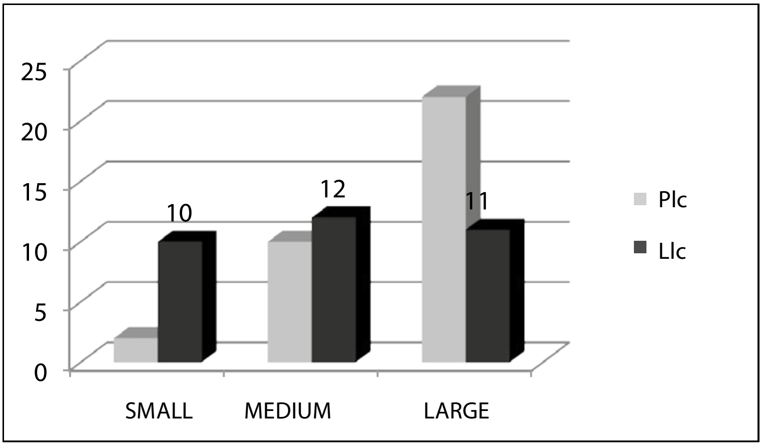
Similar to the previous hypothesis, it is expected that larger companies, which are assumed to have more funds available, would invest more in promotion than SMEs.

A random sample of 67 companies was created in 2012 to meet the needs of the study. The sample included only capital companies, i.e. public limited companies and limited liability companies, since these are the most common legal structures of business organisations established in Croatia. The companies' financial statements the research is based on were retrieved from the public register of financial statements of the Financial Agency (FINA), available at rgfi.fina.hr. Below is a brief description of the sampled companies.

As can be seen in Figure 1, the sample consists of a total of 34 public limited companies, 2 of which are categorized as small enterprises, 10 as medium, and 22 as large enterprises, and 33 limited liability companies, of which 10 are in the category of small, 12 in the category of medium and 11 in the category of large enterprises.

1 The research presented in this paper is part of a broader research, see Knezović (2014).

Figure 1: the sample structure according to the size of business entity and the legal structure



Source: Authors' calculation (2014)

Financial information from the retrieved financial statements was extracted in the Microsoft Excel spreadsheet and the required indicators were calculated using the nested functions. PASW 18.0, statistical package for social sciences was used in data processing.

The next step was to define the variables based on the defined problem, the subject of the research, and the set research hypotheses: profitability, the share of promotional costs in total costs, the legal structure of a company and the size of the business entity. In order to measure the ***profitability*** the traditional indicator of return on assets (ROA) was used and its equivalent from the group of cash-flow indicators of profitability, cash return on assets (CROA). Return on assets (ROA) is calculated as the ratio of total capital to total assets which makes it the most comprehensive indicator of return on investment. It measures the ability and efficiency of management in the effective use of company's assets in order to make a profit, and it is calculated by putting the operating profit in relation to the average total assets. Among the financial indicators of profitability the equivalent of the traditional ROA indicator is cash return on assets (CROA), which calculates the ratio of the operating cash flow to average total assets. It measures the ability of assets to generate cash-flow from operating activities. According Aljinović Barać (2008: 148), the advantage of the cash return on assets compared to the traditional indicator of return on assets lies in its ability to indicate the actual ability of the company to pay return on assets, while the main disadvantage is neglecting the amount of provisions for future investments and liabilities. The second variable measures the level of investment in ***promotion*** expressed by the cost of promotion. For the purpose of relativization (for better comparability) this indicator is put in relation to the company's total costs. ***The legal structure*** of companies is defined under Art. 2, paragraph 2 and 3 of the Law of Business Organisations (Official Gazette 152/11 - 68/13). For the study purposes the sample consists of the public limited companies and limited liability companies. ***The size of business entity*** is defined in accordance to Art. 3 of the Law on Accounting (Official Gazette 109/07 - 121/14) where they are classified as small, medium, and large enterprises.

5. RESEARCH RESULTS

5.1. DESCRIPTIVE STATISTICS

The first step was to generate the descriptive statistics for all variables used in the statistical tests, as shown in Table 1.

Table 1: Descriptive statistics

	ROA	CROA	PROMOTION
N	67	67	67
Arithmetic mean	-0.928303	-0.828800	0.024157
Standard deviation	7.1057039	6.0450090	0.0484827
Range of variation	59.4482	49.5540	0.3245
Minimum	-57.8367	-49.1178	0.0000
Maximum	1.6115	0.4362	0.3245

Source: Authors' calculation (2014)

The arithmetic mean of return on assets (ROA) for the sampled enterprises is -0.928, while for the indicator of cash return on assets (CROA) it is -0.829. Standard deviation, or the average deviation value of return on assets from its arithmetic mean is 7.106, and the average deviation value of indicators of cash return on assets from its arithmetic mean is 6.045. The range of variation, or the difference between the highest and lowest values of the indicator of return on assets amounts to 59.448, while for the indicator of cash return on assets it is 49.554, where highly negative values of both indicators can be noted (-57.8367 for ROA and -49. 1178 for CROA). The average share of promotional costs in total costs of the sampled enterprises is 0.02416, or 2.416%. The standard deviation of the share of promotional costs in total costs amounts to 0.048.

5.2.TESTING THE HYPOTHESES AND DISCUSSION

After the descriptive analysis of the observed variables was generated, in the second part of the study the set hypotheses were statistical tested.

The results of the univariate analysis by Pearson correlation coefficient are shown in the following table:

Table 2: Pearson's correlation coefficients

	PROMOTION	ROA	CROA	LEGAL STRUCTURE	SIZE
PROMOTION	1	-0.238*	-0.233*	0.059	0.023
ROA		1	0.999**	-0.137	0.234*
CROA			1	-0.140	0.237*
LEGAL STRUCTURE				1	-0.368**
SIZE					1

*** Correlation is significant with significance of 0.01 (two-way test).*
** Correlation is significant with significance of 0.05 (two-way test).*

Source: Authors' calculation (2014)

Table 2 clearly shows that the Pearson's coefficient of linear correlation between the share of the promotional costs in the total costs and the return on assets is -0.238, while the correlation between the share of the promotional costs in the total costs and the indicator of cash return on assets is -0.233. Both correlations are statistically significant at the confidence level of 99%, and indicate a weak negative relationship between the observed variables. The coefficients of linear correlation between the legal structure of enterprise and its size in relation to the share of promotional costs in the total costs are positive but are not statistically significant.

However, since the correlation coefficient indicates only the relationship between the two variables, but does not explain their causal relationship, the second degree polynomial multiple regression was applied. Although it is assumed that the promotional costs have a positive impact on the company's profitability, upon reaching a certain level, their impact on profitability will become inverse, because, by their nature, these costs are not purely variable, and they are also often classified as discretionary.

The proposed model is: , where the return on assets (ROA) or cash return on assets (CROA) are taken as dependent variables (, while the investment in promotion is an independent variable The obtained results are summarized in Table 3.

Table 3: Results of the regression analysis

Independent variable	**PROMOTION**	
Dependent variable	**ROA**	**CROA**
Constant	1,03 (0,321)	0,812 (0,359)
PROMOTION	-0,846 (0,004)	-0,834 (0,004)
PROMOTION**2	0,668 (0,020)	0,660 0,022
R	*0,365*	*0,360*
r2	*0,133*	*0,102*
Standard regression error	6,717	*5,728*
F test	4,930	*4,756*
Sig.	0,010	*0,012*

Source: Authors' calculation (2014)

Table 3 shows the calculated values of the correlation coefficient R = 0.365 and R = 0.36, which show a weak positive relationship between the variables of the achieved profitability, measured by return on assets (ROA) and cash return on assets (CROA) with the variable of share of promotional costs in the total costs. The coefficients of determination are r^2= 0.133 and r^2=0.129, which means that the estimated regression models have interpreted approximately 13% of the sum of squares of all deviations of the dependent variable from its arithmetic mean. Based on the ANOVA analysis of the estimated regression model and the F-test value it can be concluded that the regression model is statistically significant. In both models parameter β_0 is not statistically significant, while other parameters in the polynomial regression (β1 β2) are statistically significant. Thus, it can be concluded that the share of promotional costs in the total operating costs of enterprises statistically significantly affects the profitability measured by return on assets (ROA) and cash return on assets (CROA).

To test the second and third hypotheses about the impact of legal structure and size of company on the share of investment in promotion as compared to the total operating cost analysis of variance with one variable factor was applied. Upon completion of Levene's test of homogeneity of variance (L = 0.965 and α = 0.330 for legal structure; L = 1.716 and α = 0.188 for size) ANOVA test was conducted.

Based on the results obtained (F = 0.227; sig. = 0.635) it can be concluded that the variance of the variable factor of legal structure does not have a significant impact on the share of promotional costs in total costs. The results of ANOVA test of influence of variable factor of company's size on investment in promotion (F = 0.125; sig. = 0.882) also point to the absence of a significant impact of the variable factor of the company's size on the share of promotional costs in total costs.

Finally, it is important to point out the limitations that are imposed in the study, in form of the non-deductible expenses. These expenses affect company's financial results, and thus the profitability indicators, which in its turn affect the results of the present study, but their influence cannot be excluded due to the unavailability of data about them. In addition, the interpretation of results should take into account the impact of the quality of implemented promotional activities, the impact of promotional activities undertaken in earlier periods that would be reflected on the observed period, as well as the impact of other elements of the marketing mix that cannot be ignored.

6. CONCLUSION

In conditions of economic crisis, managers often resort to cost-cutting strategy, the marketing costs commonly being the first ones affected.

However, the question arises of whether such decisions would have negative effects on business performance, considering the promotion necessary to maintain and improve profitability. For this reason, the subject of this study was to determine the effect that the promotional costs have on the profitability of enterprises, and to research whether there are differences in investments in promotion with respect to company's legal structure and size.

The results indicate there is a positive relationship between investment in promotion and profitability of enterprises, while company's legal structure and size are not statistically significantly related to the amount of investment in promotion. Considering that and taking into account that the promotional costs in relation to the change in the level of activity are categorized as discretionary costs (which means that they arise solely as a result of manager's decisions and are designed to meet their wishes), managers can be recommended that prior to cutting these costs they should consider the negative consequences on business profitability that are expected to arise if they decide to do so.

Future researchers of the issues brought forward by this study can be recommended to expand the subject of the research by including items of non-deductible expenses, which also indirectly represent the promotional activities. Likewise, the subject of the research can be expanded by studying the contribution of particular promotional activities on profitability, and/or the impact of additional financial and non-financial performances, such as organizational factors, industry, etc.

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UTJECAJ TROŠKOVA PROMIDŽBE NA PROFITABILNOST PODUZEĆA

SAŽETAK RADA:

Svrha ovog rada je teorijski identificirati i razgraničiti specifičnosti različitih troškova promidžbe i utvrditi utječu li na profitabilnost poduzeća, pretpostavljajući da će poduzeća koja više ulažu u promidžbene aktivnosti ostvarivati i veće prihode i biti profitabilniji. Dodatno, predmetnim istraživanjem će se ispitati postoji li razlika u visini ulaganja u promidžbu s obzirom na pravni ustroj i veličinu društva, polazeći od pretpostavke da veliki poduzetnici i poduzeća koja su ustrojena kao dionička društva raspolažu s više novčanih sredstava, te posljedično više i ulažu u promidžbene aktivnosti. Istraživanje je provedeno na nasumično odabranom uzorku od 67 poduzeća u 2012. godini, a dobiveni rezultati pokazuju da udio troškova promidžbe u ukupnim troškovima značajno utječe na profitabilnost poslovanja, dok s druge strane ne postoji značajna razlika u promidžbenim ulaganjima ni prema pravnom ustroju niti s obzirom na veličinu poduzeća.

Ključne riječi: *trošak promidžbe, profitabilnost, veličina poduzeća, pravni ustroj*