

CASH FLOW RETURN ON INVESTMENT (CFROI) – METHOD OF MEASURING BUSINESS PERFORMANCE IN ENTERPRISES WITH HIGH INVESTMENTS

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Abstract: The paper aims to identify the essential factors affecting CFROI (based on a comparative analysis of theoretical sources, case studies and conclusions from our research) with a subsequent analysis of the implementation process of this method. The consequence of the connection is the systematic, holistically incorporated principles of the method into managers' decision-making. The procedure for applying the CFROI method consists of eight parts, namely data collection, determination of the value of depreciated assets and their useful life, calculation of the value of depreciated assets at current prices, calculation of the value of non-depreciated assets, determination of the value of the investment, quantification of cash flow, calculation of the CFROI indicator and its economic interpretation.

Keywords: Cash Flow Return on Investment, Performance in Enterprises

1 Introduction

The existence of any business depends on its success in the market, on the constancy of customers, on achieving set results and ultimately on competitiveness. The mentioned facts can be monitored in the business environment through performance. The enterprise can find out its current and prospective picture by implementing performance evaluation methods. Modern methods of performance evaluation include Economic Value Added (EVA), Market Value Added (MVA), Shareholder Value Added (SVA), Return on Net Assets (RONA), Cash Flow return on Investment (CFROI) and Cash Return on Gross Assets (CROGA). The mentioned methods provide an insight into the enterprise's performance from various areas of business activity. When deciding on their use, it is necessary to pay attention to their informativeness and to the ability to apply them to specific business conditions since not all modern methods can be applied to every business. These methods are often the result of several operations, which in many cases are difficult to calculate and time-consuming. Among the modern performance evaluation methods, Cash Flow Return On Investment (CFROI) has an essential position in investment-intensive production enterprises. It is challenging to implement in business practice but has good reporting ability. It is based on the principle of internal rate of return. A significant advantage is that the value of the invested property is not distorted by accounting depreciation and inflation. To quantify the operating return on investment, it is necessary to perform several calculations, thanks to which accounting data will be modified, and at the same time, individual indicators will be obtained, which will be used for the final quantification of CFROI. The CFROI indicator focuses on the ability of the monitored enterprise to evaluate its invested funds in the business. The operational return on investment expresses the operational performance of the enterprise's activity, which the enterprise would have achieved if, without additional investments, it had generated an operating cash flow in the same volume as it achieved in the monitored period during the lifetime of the operating assets. CFROI represents the enterprise's internal rate of return on existing investments, which is based on actual cash flows. In general, based on its comparison with the actual cost of capital, the enterprise can assess the quality of the investment. Reverse cash flow on investment helps determine the enterprise's return on investment, where the return must be greater than the cost of capital. Only in this case can the operational return on investment be considered positive. This concept also suggests that share prices in stock markets are set based on cash flows rather than earnings or business performance.

2 Literature review

By evaluating the performance, the enterprise can reveal faulty processes or procedures that prevent the improvement of the performance of individual processes as well as the enterprise as a whole. Increased emphasis is placed on the performance management of internal processes. Shareholders and managers are more oriented on long-term development and prosperity instead of orientation on short-term revenue achievement (Sujová, 2013). The business strategy is revised towards more sustainable production methods, business processes, resource efficiency, waste disposal, partnership building and communication efficiency (Hitka et al., 2019). Performance evaluation determines the efficiency of the production process but also the quality of the work of the employees who participate in this production process.

Authorized qualified enterprise management employees carry out performance evaluations. According to Ližbetinová et al. (2020), the ability to use human resources effectively is a key factor. According to Camaj et al. (2020), the need to estimate the consequences of investment decisions and the effort to penetrate the laws of investment processes lead to the development of analysis of investment decisions and the gradual discovery of factors that have the greatest impact on the future efficiency of investment. Decision-making about investments in an enterprise is related to the level of education and subsequent financial literacy, which is one of the most important competencies of individuals living in a modern global society (Kozubíková, 2016). Decisions require flexibility to respond to market demands, so managers need a flexible information system with a high-quality selection of information (Chodasová & Tekulova, 2016). These relationships should lead to efficient business. For all stakeholders involved, it means achieving maximum results with minimum investments (Prusa et al., 2020).

It is possible to use classic and modern methods of evaluating the enterprise's performance, from the simplest procedures based on cost criteria to traditional methods (payback period, profitability) to methods that consider the time factor (Chovancová et al., 2017). Classic performance measurement methods are mainly based on profit maximization as the basic goal of business. They use a large number of often incompatible ex-post and ex-ante analysis indicators to express the goal. The shortcomings of classical methods are primarily the respect of accounting data and the accounting result of management, failure to take into account risk, the impact of inflation, the time value of money, influencing the profit by the used valuation techniques, the creation of reserves and provisions, the depreciation policy, the accrual of costs and revenues. The shortcomings of traditional performance indicators stem from their exclusive focus on accounting data and do not consider the impact of the market on the value of capital. More and more often, classic methods of measuring business performance are insufficient, and it is necessary to turn to new modern ones that have a higher informative value. The substantial criteria during the assessment are represented by the amount and return on investment but also by qualitative criteria, (Malichová, 2018). They consider the risks arising from business, are largely linked to share value methods, use opportunity costs, and cash flow when measuring. According to the study by Deari et al. (2022), is the use of cash flow ratio to develop the analysis firms by dividing them as healthy and unhealthy. The enterprise is affected by current market trends such as globalization, rapid scientific and technical progress, expansion of enterprises into new markets, and changes in enterprise management. Modern trends cannot avoid the measurement and evaluation of business performance. According to Chodasová et al. 2015, at the same time, these requirements are related to the requirements for the organization of production and its management. Modern methods try to connect all the activities of the enterprise and its

participants to increase the value of the funds invested by the enterprise's owners.

In their research, the authors Malichová and Mičiak (2018) say that 85% of IT enterprises and 88% of industrial enterprises use profitability indicators while appraising the investment variants. The payback period of the investment is used by up to 92% of IT enterprises and by up to 81% of the industrial ones. When focusing on the other evaluation methods of investment efficiency, denoted as dynamic methods, a strong difference can be observed in the use compared with the static evaluation methods. The category of economic profit is implemented in the indicators, which takes into account, in addition to current costs, the so-called opportunity cost of capital, which represents the business owner's untapped investment opportunities that carry the same risk as the business.

The advantages of modern methods of evaluating the enterprise's performance are primarily that the basis of their quantification is the adjusted accounting value to the market value (use of the current price), they are oriented to the market value of the enterprise's shares (shareholder value), they take into account risk and the share of capital components in their total volume. The authors Maříková and Mařík (2005) claim that a modern indicator should also be linked to all levels of business management, support value management, evaluate performance, and at the same time, allow the valuation of the business and take into account only the main activity of the business when measuring. According to the author Hitka (2019), the business strategy is being revised towards more sustainable production methods, business processes, resource efficiency, waste disposal, partnership building, and communication efficiency. According to research by the author Rajnoh (2013), a modern performance indicator should enable the use of as much information as possible provided by accounting, calculate with risk and take into account the extent of committed capital, enable a clear and transparent identification of the link to all levels of enterprise management, enable performance evaluation and at the same time valuation of the enterprise. The efficiency of an investment project is usually evaluated via four fundamental indicators: net discounted income, profitability index, the payback period of investments, and internal rate of return on investment. Still, one of the most effective means to assess the effectiveness of an investment is the net present value (NPV), the total amount of discounted net cash flow received during the study period (Hoshovska, 2023). The Cash Flow Return On Investment (CFROI) method has significant explanatory meaning for manufacturing enterprises.

Decision-making plays a significant role in enterprises' future success and competitiveness in investment. (Malichová and Mičiak, 2018). CFROI can evaluate the internal rate of return on existing investments based on cash flows. Because free cash flow greatly impacts value, managers and investors can use FCF and its components to measure a enterprise's performance. (Brigham, 2014). Its significant advantage is in the use of the value of the property without its distortion by inflationary effects and accounting depreciation. During the calculation, it is necessary to carry out a larger number of calculations to quantify the operating return, due to which it is possible to arrive at the adjustment of accounting data and obtain individual indicators for the resulting quantification of the operational return on investment. Jacková (2021) states that the indicator expresses financial performance, similar to the ROA (Return on Assets) indicator for the enterprise, regardless of the financing structure. The conceptual difference between ROA and CFROI is that CFROI is based on cash flows, and ROA is based on profit or loss. The value of Cash Flow Return On Investment mainly depends on the expected net cash flow in the future, converted to a present value using a discount rate that reflects investors' profitability expectations. This model works exclusively with real values - values adjusted for inflation. Thanks to this, it is possible to compare the performance of the given enterprise over time, but also the performance of the enterprise in different countries. (Pavelková and Knápková, 2009). It was necessary to determine the individual values of the indicators of the lifetime

of the assets, non-depreciated assets, the value of the investment and the gross monetary formula. Subsequently, they can be used in the calculation of the CFROI indicator.

3 Materials and Methods

The paper contribution results from identifying the problem, which is the concern of managers to use methods that are difficult to collect and process data. The CFROI method belongs to the methods in which it is necessary to perform a series of calculations in sequence. Previous research revealed that even though the principles of the CFROI method are applied in enterprises, they need to be systematically and holistically processed. The paper aims to identify the essential factors influencing the CFROI, followed by an analysis of the implementation process of the CFROI method. The consequence of the connection mentioned above is the systematic, holistically incorporated principles of the method into managers' decision-making process. The primary basis for achieving the goal was the implementation of a comparative analysis of theoretically processed documents from modern methods of measuring business performance and case studies. Additional data were obtained from the implemented implementation of the eight parts of the method. The chosen form of quantitative research was based on the need for financial data obtained from the financial statements and internal records of a specific investment-intensive enterprise. In order to track developments over time, the processed data covers the period from 2019 to 2022. The CFROI method is complicated due to the determination of data groups, namely the value of depreciated assets, the useful life of depreciated assets, the value of depreciated assets at current prices, the value of non-depreciated assets at current prices, the value investments, cash flow, calculation of the CFROI indicator. The essence of the CFROI indicator is calculating the internal revenue percentage. Performance measurement at CFROI can be understood as an estimate of the real rate of return on all the company's assets. It can be calculated using the following relationship:

$$CFROI = IN - \sum_{t=1}^n \frac{CF_n}{(1+i)^t}$$

where:

CFROI (Cash Flow Return On Investment) - operational return on investment

IN – capital expenditure, gross value of the investment

i – interest rate, or internal rate of return

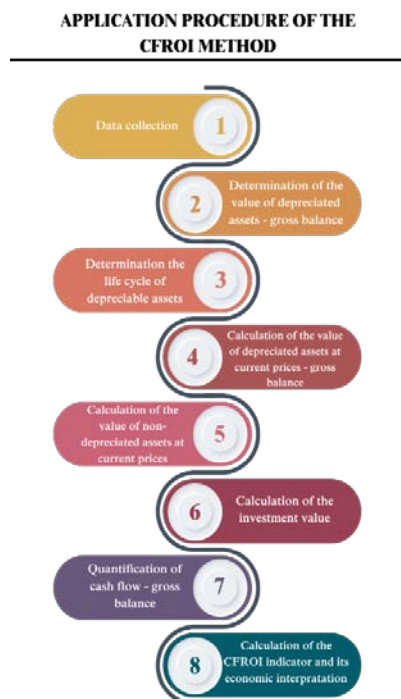
CF – gross cash flow from operating activities

CFROI compares the inflation-adjusted future taxable cash flow available to corporate investors. The recalculation is based on the assumption that the activity will not change over time and the cash flow will be constant throughout. At the same time, it is necessary to estimate the economic life of the enterprise's depreciable assets and also the value of assets that are not depreciated (Pavelková and Knápková, 2005).

4 Results and Discussion

The CFROI method can be defined as the operating performance that the enterprise would achieve if it could generate operating Cash Flow in the same volume during the lifetime of its operating assets but without additional investments. Operating return on investment helps evaluate the performance of an investment or enterprise. It can also be used as a calculation to help the stock market determine the prices based on Cash Flow. Two groups of data are needed to determine the level of operating return on investment, namely the value of the investment and cash flow. CFROI can be found in relative value or percentage terms, advantageous for comparison over time or to compare individual investments.

Figure 1: Application procedure of the CFROI method



Source: own processing

The practical application of the procedure for applying the CFROI method, as documented in Figure 1, includes eight consecutive steps. They are based on specific enterprise data, and their content and conclusions from an application are described. CFROI is one of the modern methods of evaluating business performance, and it is challenging to determine the initial data for calculating the CFROI indicator. The CFROI indicator depends on the availability of the necessary information.

1. The process of applying the CFROI method begins with data collection. These are data from the Financial statements, specifically its parts Balance Sheet, Profit and Loss Statement, Internal company records, Inventory cards and monitoring of the current price level of assets.

2. The value of depreciated assets is the sum of the purchase prices of the enterprise's long-term tangible and intangible assets. From this sum, it is subsequently necessary to deduct the value of the land and the value of the enterprise's unfinished long-term tangible and intangible assets. Acquisition prices are the prices at the time of acquisition of specific property components, including the costs associated with acquisition. They express the gross state of long-term tangible and long-term intangible assets.

Tab. 1: Value of depreciated assets of the enterprise – gross balance

Item	Unit of measure	2019	2020	2021	2022
Gross – intangible assets	€	29 787	29 787	28 478	28 478
Unfinished intangible assets	€	0	0	0	0
Gross – tangible assets	€	5 733 302	6 734 905	7 937 970	8 921 073
Land	€	701 930	701 930	701 930	701 930
Unfinished tangible assets	€	0	0	0	0
Gross depreciable assets	€	5 061 159	6 062 762	7 264 518	8 247 621

Source: Own processing according to the financial statements

3. The life span of the depreciated assets represents the average number of years for the enterprise during which they are

included in the property register. It is determined as a share of the enterprise's gross depreciable assets and the value of annual depreciation.

Tab. 2: The life span of the depreciated assets

Item	Unit of measure	2019	2020	2021	2022
Gross depreciated assets	€	5 061 159	6 062 762	7 264 518	8 247 621
Annual depreciation	€	313 931	320 062	391 547	584 404
Life span of assets	Period (year)	16	19	18	14

Source: Own processing according to internal records

According to Table 2, the lifetime of the enterprise's assets for individual years of the monitored period has a decreasing character. It is a consequence of increasing annual depreciation values. Their value has increased since 2019 by more than 200 thousand euros, while the gross value of depreciated assets has increased. This state may be due to the wear and tear of equipment in production during the constant operation necessary to satisfy customer requirements.

4. Calculating the value of depreciated assets at current prices is based on knowledge of the years of acquiring individual assets. In the starting year, a coefficient of 1.0 was applied. In subsequent periods, the price index based on consumer price index values was used. The current cost of depreciable assets can be determined by the product of the depreciable assets and the coefficient for each reporting period.

Tab. 3: Value of depreciated assets at current prices

Item	Unit of measure	2019	2020	2021	2022
Depreciated assets	€	5 061 159	6 062 762	7 264 518	8 247 621
Coefficient	Coef.	1	1,02	1,05	1,18
Depreciated assets in current prices	€	5 061 159	6 184 017	7 627 743	9 732 193

Source: datacube.statiscs.sk, own processing

The resulting values for individual monitored periods include the increase in the value of depreciated assets at current prices. This is due to the gradual increase in depreciated asset values and the price index for individual years of the monitored period.

5. The value of non-depreciated assets consists of monetary assets (long-term and short-term financial assets, receivables, deferred assets). The difference between monetary assets and non-interest-bearing liabilities can be used to obtain the value of net monetary assets. Subsequently, it is necessary to find out non-depreciated assets at current prices, which the enterprise will complete by adjusting net monetary assets for stocks at current prices and land forming part of long-term financial assets.

Tab. 4: Value of non-depreciated assets at current prices

Item	Unit of measure	2019	2020	2021	2022
Short-term financial assets	€	0	0	0	0
Long-term financial assets	€	0	0	0	0
Receivables	€	529 873	326 362	909 845	1 173 206
Accrual of assets	€	2 017	1 962	2 551	22 088
Monetary assets	€	531 890	328 324	912 396	1 195 294
Long-term non-interest-bearing liabilities	€	0	0	0	0
Reserves	€	37 483	37 764	52 795	71 583
Short-term non-interest-bearing liabilities	€	128 702	194 417	506 866	912 676
Accrued liabilities	€	1 520	0	0	139 800
Non-interest-bearing liabilities	€	167 705	232 181	559 661	1 124 059
Net monetary assets	€	364 185	96 143	352 708	71 235
Land	€	0	0	0	0
Inventories at current prices	€	1 612 187	1 609 422	2 417 330	3 089 892
Non-depreciated assets in current prices	€	1 976 372	1 705 565	2 770 038	3 161 127

Source: Own processing according to the financial statements

6. The value of the investment is determined by the sum of the values of depreciated assets at current prices and non-depreciated assets at current prices.

Tab. 5: Investment value

Item	Unit of measure	2019	2020	2021	2022
Non-depreciated assets in current prices	€	1 976 372	1 705 565	2 770 038	3 161 127
Depreciated assets in current prices	€	5 061 159	6 184 017	7 627 743	9 732 193
Investment value	€	7 037 531	7 889 582	10 397 781	12 893 320

Source: Own processing

The value of investments in individual years (Table 5) of the monitored period shows an increase. It is evidence of the efforts of the monitored enterprise to invest free funds.

7. Gross cash flow is based on the economic result from ordinary activities after taxation, adjusted for profit or loss from the sale of depreciated and non-depreciated assets, depreciation and interest costs.

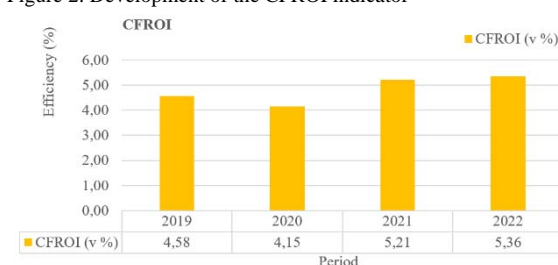
Tab. 6: Cash flow of the enterprise

Item	Unit of measure	2019	2020	2021	2022
Profit after tax from operating income	€	-293 993	-35 575	71 531	272 562
Gross profit from the sale of material and fixed assets	€	365 454	88 635	197 561	67 106
Depreciation	€	313 931	320 062	391 547	584 404
Cost interest	€	153 012	161 000	190 132	226 554
Gross cash flow	€	538 404	534 122	850 771	1 150 626

Source: Own processing according to the financial statements

The operational return on investment indicator points to the enterprise's ability to evaluate its invested funds. For the sake of clarity, it can be displayed via a graph.

Figure 2: Development of the CFROI indicator



Source: Own processing

An economic interpretation of the resulting values of the CFROI indicator is necessary for managers to make decisions. It is implemented through:

1. comparison of development over time. A positive phenomenon is the positive value of the indicator throughout the monitored period. Between 2019 and 2020, there was a decrease in value, which is a negative phenomenon—years 2021 and 2022 increased value, which is a positive result. In order to increase the performance of the enterprise, managers are advised to increase the value throughout the period. It is necessary to take measures to maintain the indicator's growth trend.

2. comparison of the indicator with the average cost of capital WACC and that if
 $CFROI > WACC$ increases the value of the enterprise for shareholders.
 $CFROI < WACC$ there is a decrease in the value of the enterprise for shareholders.

Another comparison is possible through the net CFROI, which is referred to as the spread.

$$CFROI \text{ spread} = CFROI - WACC \quad (2)$$

CFROI - operational return on investment, financial performance of the enterprise

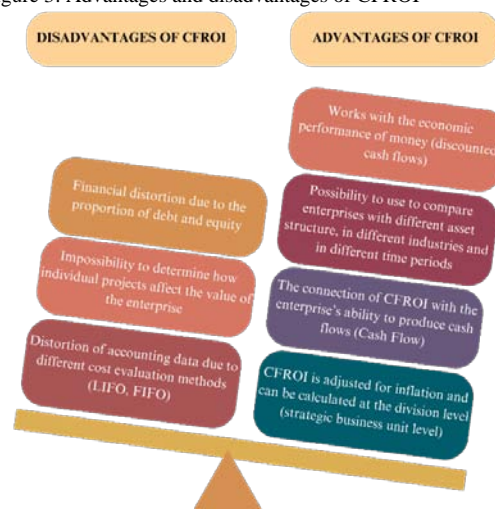
CFROI spread - net CFROI

WACC - average cost of capital

- CFROI spread can subsequently acquire a positive or negative value.
- $CFROI \text{ spread} > 0$ net operating return on investment is positive, and the enterprise creates new added value for shareholders.
- $CFROI \text{ spread} < 0$, the net operating return of the investment takes on negative values, and there is a depreciation of the shareholders' invested assets.

CFROI is mainly used by managers who can influence it with proper actions. CFROI represents the percentage rate of the return on the valuation model. The CFROI method has advantages and disadvantages, which are the content of Figure 3.

Figure 3: Advantages and disadvantages of CFROI



Source: Own processing

The advantage of the CFROI method is increasing the performance of processes thanks to a larger amount of relevant information with greater explanatory value. The enterprise can improve based on knowledge of the current situation in the business environment. Thanks to continuous improvement, the enterprise gains competitiveness in the market by using the essential information obtained from the performance value indicators.

The disadvantage of the CFROI method is that to calculate the CFROI indicator, on which the entire method is built, it is necessary to obtain a large amount of information and, simultaneously, to interest many people. It is necessary to prevent various types of errors from incorrect data, calculations and carelessness. For the correct introduction of the method and its subsequent use to define the performance value, it is necessary to determine the time, which is necessary to process the most accurate results. Processing the results of the indicators is a very demanding process, and a certain level of education is required, without which it is not possible to develop the resulting values of the indicators.

As stated in the paper, used methods in business conditions are complicated and demanding for data collection and processing. From the processed conclusions, it follows that the efforts of managers bring possibilities of use for evaluating the choice of investment, and performance of the enterprise, for determining the price on the stock market (the ratio of cash flow to the market value of invested capital), determining the return cash flow of the investment (the return must be higher than the cost of capital), an estimate of the total useful life of the enterprise's assets. It is intended to help managers and senior employees maintain a stable position of the enterprise in the market where it

operates, as well as ensure continuous development and growth, which impacts increasing competitiveness. From the scientific investigation of the CFROI method, it is possible to conclude and recommend to managers that the most suitable business activity is a high volume of sales with low controlled costs and low investment in assets.

5 Conclusion

The article presents the fulfilment of the goal, which was to identify the essential factors affecting CFROI with a subsequent analysis of the implementation process of this method. The consequence of the connection mentioned above is the systematic, holistically incorporated principles of the method into the decision-making of managers. The substantive content of the stages of applying the CFROI method was created, emphasising quantitative expression. The procedure for applying the CFROI method consists of eight parts, namely data collection, determination of the value of depreciated assets and their useful life, calculation of the value of depreciated assets at current prices, calculation of the value of non-depreciated assets, determination of the value of the investment, quantification of cash flow, calculation of the CFROI indicator and its economic interpretation. It points out the importance of conducting business performance evaluations through CFROI, which directly impacts business processes. The CFROI method is typically used annually, with an inflation-adjusted cost of capital adjustment. We concluded that through this comparison, it is possible to find out the rate of return on capital invested in assets through cash flow and the enterprise's operational performance achieved without additional investments during the life span of the assets. CFROI monitors not only the measure of economic performance (Cash Flow) but also the enterprise's value; the given measurement also affects managers' decisions. Based on it, it is possible to determine the percentage return of cash flows with respect to the market value of the capital that was used for investment. The contribution of the paper is the provision of new and unexpected views on the possibilities of using the CFROI method in the managers' decision-making process in investment-intensive enterprises, the proposal of practical steps to solve problems with investments, the opening of new directions for future research, the provision of space for polemics about the complexity of this process.

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