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Capital Investment Decision

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Summary – 1. Aspects concerning financial decisions – 2. The decision of investing capital – 3. Conclusions

Abstract:

In this paper, the authors present several aspects regarding the options of the decision makers in the case of investment decision. Thus we stress the main correlations and indicators that the investor has to analyse carefully when he desires to develop a business, to maintain a business or to retire from a business.

Key words: financial decision, economic capital, financial capital

1 – Aspects concerning financial decisions

The financial decision is a resolution, a rational process of choosing an action line made basing on analysis and multiple information regarding the activity with direct effects on capital. Financial decision implies choosing an option or a solution from several possible ones.

From the point of view of the complexity of the decision, it can be: current (operative), strategic (of perspective).

1. Financial current decisions are related to the current activity and have an interactive or repetitive character. Such decisions belong to the individuals with responsibility functions.

2. Financial strategic decisions refer to the line to be followed in performing the activity for a longer period of time and concern activities of great proportion at the level of the economic agent.
3. Decisions of correcting the operational or strategic trajectory of the enterprise, in the case of a deviation from the initial stipulations. Eventually, the objective of each decision has a financial character consisting mainly of ensuring liquidity, obtaining profitability and minimizing risks. Strategic decisions are based upon vast documentation, as well as using certain external and internal information resources.

In the category of *current or operative financial decisions*, are taken into account:

- decisions of fiscal nature;
- decisions of banking nature;
- decisions of commercial nature;
- decision of salaral nature;

In the category of *strategic decisions*, there are taken into account, in our opinion, three main categories:

- investment decision;
- the decision of financing current activity;
- the decision of profit administration.

If current decisions refer to the short term financial policy of the enterprise, strategic decisions refer to the financial strategy adopted for the shareholders and managers for a longer period of time.

The decision of fiscal nature refers to the calculation, holding, paying and recording taxes due to state budget by the employer.

The decision of budgetary nature has two components: on the one hand drawing the necessary credits for performing current and investment activity, and on the other, the repayment of borrowed capital and paying its cost.

The decision of commercial nature takes places in the contractual relations that the enterprise has with a third party. In this context the financial decision, on the one hand, refers to the creances of the enterprise and, on the other, to the obligations of the enterprise towards suppliers.

The decision of salaral nature refers to the calculation, payment and recording of incomes of salaral nature from the collective work contract and from individual contracts signed with each employee.

The main decisions concerning financial policy made by the enterprise are: investment decision, financing decision, self-financing decision and the decision of giving dividends.

2 – The decision of investing capital

The investment decision made by an economic agent, respectively of placing capital in a certain operation is the result of direct correlation between the cost of the used capital – own or borrowed – and the expected profitability.

Most of the specialists from the economic field assess that, generally speaking, the investment decision is the fundamental decision of the enterprise. This view is relative, being valid in the case of newly-founded enterprises. In the other cases, investment actually means a capital placement for extending and diversifying the activity of the enterprise, thus ensuring the continuity of the activity. Very often, in a growing enterprise, the investment has an additional, even marginal role.

Table 1 presents the way in which investment decision and financing decision modify the economic capital and the financial capital of the enterprise and which are the effects produced by such a decision.¹

Table 1 – Investment and financial decisions' effects

Assets	Decision effect	Liability
Economic capital	Volume	Financial capital
Liquidity	Structure	Exigibility
Mobility / divisibility	Flexibility	Leverage capacity
Risk of economic activity	Risk	Financial risk
Asset's profitability	Diferential profitability	Financing cost

Investment decision does not radically change the situation of the enterprise, but only a succession of investment decision may progressively influence the orientation of the enterprise. Moreover, the changes brought along can be temporary. Inertial phenomena play an important role. The effect of differentiated profitability generated by the leverage effect is only one of the aspects that the enterprise should take into account at the time of the decision. Traditional financial analysis stressed profitability. The possibility that the enterprise has of adapting, easier or more difficult, to a change in environment, depends both on the structure of its asset, and on its leverage capacity. The administration of the enterprise can be analysed as the administration of an assets portfolio, it future depending on the structure and the efficiency of this portfolio at a certain time, but especially on the progressive adaptation of the portfolio's composition to the

¹ Onofrei M. (2004), *Firm's Finances*, Economica Publishing, Bucharest [45]

evolution of the environment. The confrontation, due to which the enterprise represents „the heart” of the contemporary economic evolution, and that is the confrontation between saving and investing, stresses a very complicated financial behaviour scheme at the level of the enterprise. The two financial constraints, that of the equilibrium and of profitability, stay fundamental, but the condition of achieving them implies taking into account the whole of the environment’s elements, especially of the financial environment, within which the enterprise is a dialogue partner, together with the state, banks, unbanking financial institutions, unions, employees, local communities, etc.²

For every business, the investment process represents the source of its growth, since the investment sustains the competitive strategies of the managerial team and is usually based upon plans (referring to income and expenses budget, capital evaluation, etc.) regarding the drawing of own or borrowed funds in three major fields:

- work capital (circulant capital), (cash fluctuation, creances and stocks, less commercial credit from suppliers and other current obligations)
- corporeal assets (land, buildings, cars, equipment, stationary, lab equipment, etc.)
- research and development programmes, concerning the diversification of products and services, promotion programmes, purchases, etc.

3 – Conclusions

Choosing the optimum type of investment that, put into practice, generates incomes bigger than the cost of capital represents a major responsibility for the management and that refers to the increase of the enterprise’s value. Any new investment represents actually the key for successfully introducing *the growth strategies* of shares’ value, but only if the expected profit is achieved.

If, after a careful analysis, it is demonstrated that the economic results and expectancies are under the standards ones for a particular market or activity, then the alternative solution is represented by the withdrawal of the invested funds. The basic criterion that helps managers to analyze the types of new investments or to decide about withdrawing from a business, is usually based the present updated value, which measures the correlation between the funds invested at a certain point and the future benefits reflected in the updated cash flow. The indicator that measures the efficiency of the existing investment is represented by the investment recovery ratio.

² Manolescu Gh. (1995), *Financial Management*, Economica Publishing, Bucharest [263-265]

In the investment decision, the cost of capital is related to the minimum profitability requested by the investors in order to finance the investment projects of an enterprise. In other words, the cost of the capital used in business represents the price that the enterprise has to pay for performing, on the damage level, the respective business.

On the other hand, the cost of capital makes a direct connection between the profitability of investments and the profitability expected by the investors. In the case in which the enterprise invests in projects that have profitability inferior to the cost of capital, then the enterprise will be economically sanctioned on the market:

if the enterprise finances itself by leverage, it will record losses since the financial incomes are smaller than the financial expenses of the exercise;

If the enterprise is self-financed from own resources, then the loss suffered by the enterprise will have a negative effect on own capital that may be diminished.

On the other hand, if the enterprise invests in projects with profitability higher than the cost of capital, irrespective of the financing manner, it will not only have no problems in supporting financial expenses, but there will also be created real possibilities of increasing own capital.

As a result of the things presented above, we can formulate the following reasoning:

<p>All the investments the profitability of which \geq capital cost, may be accepted All the investments the profitability of which $<$ capital cost, should be rejected</p>

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