THE SUBSTANTIATION OF THE INVESTMENT DECISION

Assoc. prof. Mădălina Gabriela ANGHEL PhD.
„ARTIFEX” University of Bucharest
Prof. Constantin ANGHELACHE PhD.
„ARTIFEX” University of Bucharest, Bucharest University of Economic Studies
Emilia STANCIU PhD. Student
Marius POPOVICI PhD. Student
Bucharest University of Economic Studies

Abstract

In this paper, we have analysed the mode in which an investment project is substantiated. Starting from the role played by the investments in securing economic growth and macro-stabilization, we granted full attention to conditions and stages to be taken into account in investment design. Of course, an important element in investing are the resources, internal or external, involved in investments. Simultaneously, there must be studied the effect of the economic objectives achieved through investment, especially the modality and recovery of expenses made.

For such analysis of investment substantiation, we have followed the design of a model that would be relevant in the impact study. Furthermore, it must be stated that the impact study must be subjected to a procedure of simulation, in the scope of guaranteeing the efficiency of expenses. In the scope of presenting this topic, we have made clear some aspects regarding the investments concept; the classification of investments, the financial contents and elements regarding the investments; the role of investments in the social-economic evolution of a country. In this context, together with the theoretical aspects, we have presented some indicators used in the analysis and substantiation of investment projects.

Key words: investment, management, investment project, financial decision, valuation, forecast

Introduction

The choices made as regards investments represent essential aspects of the company policy, generally speaking, and its financial administration, particularly, being considered as one of the main determinations of its future development.

The financial administrators of the company must evaluate the investments achieved in the past and assess the investments requirements for
the future. The effects of the previous investments must be analyzed while the projects aimed for the future must be forecasted.

The investment represents the starting point in every financial decision. Finishing the procedures to evaluate and take a decision implies a prior delimitation of the operations representing investments. Defining certain criteria for evaluating the projects leads to the selection of the most advantageous projects.

If we investigate rigorously the signification of the concept of investment, we shall notice that it raises complex problems regarding the delimitation and classification of the investment.

**Literature review**


**The investment concept**

The investment defining is made through more or less extensive formulations:

a) The accounting and juridical defining of the investment

In a narrow definition, the expense materializing in an acquisition of goods of long-term use only is considered as investment. More precisely, the concept of investment designates in this case the acquisition or construction of new corpora, financial or non-corporal assets. Thus, the acquisition of a building, terrain, car, equities or patent shows up as investment operations.

In other words, the investment designates the allocation of an available treasury for getting a fix asset which will generate financial flows of exploitation incomes and expenses.\(^1\)

This approach of the investment concept is submitting a double interest. On the one side, it allows the superposition of an accounting vision

and a juridical vision on the investment since the patrimonial elements only are kept; on the other side, such a definition can be easily applied, mainly in the moment of the balance sheet analysis, since it presents an doubtless objective character, ascertained by the accounting evidence.

However, such an acceptation of the investment concept is bearing a restrictive character since it does not allow taking into consideration the investments without incidence of the company active or those not suited to an explicit money evaluation. This patrimonial vision on the investment is excluding in fact, all the expenses letting the future potential of the company to increase, as they do not make the assets value increasing (an advertising company for launching a new item, studies concerning the labour organizing, professional training operations, aiming the development in time of the qualification and productive potential of the employees). This exclusion is not justified since recent studies evaluate at 40% only the share of the patrimonial investments within the global investment effort of the company underlining thus the decisive role, of 60%, of the “immaterial” investments, which do not find again in acquisitions of simple elements of active..

b) Defining the investments in a financial sense.\(^1\)

While the previous approach emphasizes the nature on the acquired elements through making certain expenses, the financial definition underlines the investing individual or company’s intention, insisting thus on the fact that the investment leads to the lagging of the consumption in time.

From this perspective, the investment means to give up the immediate goods on exchange of future goods or, according to other formulation, the exchange of an immediate satisfaction and certain, against an expectation for a better satisfaction in the future. This formulation shows well enough the “psychological constraint” which the investor must bear as he must make a choice between the present and certain resources (money amount) and the probability to get higher income.

c) The monetary definition of the investment

In contrast with the previous approaches, the monetary definition considers as investments all the expenses made in order to get incomes in the future.

Such an approach is diluting the investment concept into the expense concept so that the investment policy becomes objectless.

\(^1\) Some authors consider it as being a „psychological” definition of the investment.
d) The operative definition of the investment

It implies a delimitation of the field of the investment policy; thus, it is considered that the field of the investment policy includes any operation consisting of the commitment on long-term basis of the monetary, material or human resources in order to increase the potential and performances of the company.

Subsequent to these observations, the following conclusions may result:

• The investment is present effort which, like any other effort, must be dimensioned, forecasted and argued in order to be sustained by those involved in the matter.

• The investment aims a better future which must be scientifically and realistically outlined, through pertinent and complex studies.

• The financing source of the investment consists of giving up the present consumptions, possible and certain, in favour of future consumptions, higher by probable.

• The defining elements of the investment concept are the following:
  o The concrete, material content of the investment accomplishment;
  o Time factor – the duration of the period during which the economic parameters of the investment project must be materialized;
  o The efficiency, finality of the projects;
  o The risk, arising for very fact that the expected effects are spread over future periods, these effects being expectations and not total certainties.

The investment classification

We established the fact that, in its own essence, the investment is a permanent allocation of capitals for the acquisition of assets (physical and/or financial) which, by exploitation are meant to generate possibilities to acquire yields superior to the normal rate of profitableness.

The investments typology can be made in relation with a number of criteria but, generally, there is no net distinction which might be made.

The internal investments represent an allocation of capitals for the acquisition of material and non-material assets (equipment, constructions, licences etc.) meant to allow the production and distribution capacity to grow and improve. Meantime, the company would invest – in order to achieve this strategy – in research-development, personnel specialization, advertisement etc. Hence, the internal investments have an individual and/or commercial character.

Thus, the portfolio of investment projects gets underlined, characterizing the investing activity of the company, as a whole, since in order
to follow up and reach the main target of the increase of the company value a global analysis of the investments is more relevant. However, the possibility to diversify the portfolio structure is much more reduced as comparatively with the case of a bonds portfolio.

Depending on their goal, the investments may be technical (the acquisition, construction, assembling machinery, equipment, conveyance means etc.), human (training or specialization of the personnel), social (building up a canteen within the company enclosure), financial (buying participation equities of other commercial company), commercial (publicity and advertising) etc.

Depending on the involved risk, the following types of investments are to be considered:

• Of low risk – investments meant to replace the worn-out equipment (without technological modifications) and to modernize certain equipment (non-essential corrections of the fabrication technology);
• Of medium risk – investments meant to develop, expand some sections, plants, new factories, to acquire new equipment, commercial investments (aiming to enlarge the distribution market);
• Of high risk – strategic investments (setting up new branches in new geographical zones, merging with another commercial company).

Resorting to an exclusively monetary analysis, we are allowed to distinguish the main types of investments defined by the mode of succession of the monetary flows which they are generating. Thus, we can perceive four types of investments:

1. Some of the investment projects are requiring a certain size of the allocated funds and generate a certain size of the obtained outcomes, which are obtained in totality at a final moment, as a certain date. The projects of this type are relatively rare in industry and are typically met in agriculture, forestry activities.

2. Other investments are requiring a certain size of the invested funds but entail spread out cashing. This case is illustrated by numerous investments in industrial equipment.
3. Other projects are requiring a spread out investment of the funds and release all the returns by the end on the investment period. The complex industrial assemblies, delivered “at key”, may be examples in this respect.

4. Certain projects are asking for spread out expenses generating also spread out returns. This is the case of the majority of the industrial investments or of the investments in infrastructure which implies funds allocations over many more years before putting the objective, totally or partially, into exploitation.

Each one of these types generates a different approach of the cash-flows when up-dating them at the moment T0. Corrections of the treasury flows relating to each moment are compulsory as against the inputs and outputs corresponding to these moments. Even if it does not represent a general case, the investment type with a single input at the moment T0 and several annual cash-flows to be cashed is the most frequent to be met in the evaluating models as it is the most suitable to be handled.

**The financial elements of an investment**

The effects and the investing effort may be partially identified by knowing the basic elements of an investment:

- The total amount of the investment or the initial investment expenses is established in connection with the mode of achieving the investment. For instance, in the situation of acquiring a fix asset from suppliers, the invested amount is calculated as equalling the acquisition price plus customs duties (if existing), the transport and assembling expenses, other taxes and commissions.
If produced under self-supervision conditions, the investment amount is given by the costs of the consumed materials, the direct expenses with the manual labour and the quota of the relating indirect expenses.

Generally, the following expenses categories are taken into account:
- The funds invested for acquiring immobilizations;
- Expenses involved by putting the investment in function;
- The NFR variation entailed by the project;
- Opportunity costs;
- The effects generated by the transfer of other investments;
- Fiscal incidents: outputs of funds of fiscal origin.

• The life duration of the investment (n) is, also, a concept implying several meanings:
  - The fiscal, accounting, duration – the normal servicing duration of the fix assets, out of the catalogue of the amortization norms, according to the amortization Law;
  - The technical duration – the duration established by the technical ad functional characteristics, particular to each fix asset;
  - The commercial duration – established by the life duration of the goods being produced with the respective investment;
  - The juridical duration– the duration of the juridical protection on the concession right of exploitation, on a patent, on a licence or fabrication mark.

• Additional benefits generated by putting in functioning the objective of the investment; they are designated as cash-flows, calculated as difference between returns and payments; they cannot be established otherwise than on forecasts basis, being connected with the time factor. But the real value of the investment is truly characterized by the net treasury flow, available after covering the subsequent economic growth of the investment project. Generally speaking, this is referring to the net increase of the stocks and exploitation liabilities (the NFR variation), but we can also consider a net increase of the immobilizations (Δlmo).

Hence, the available cash-flow (CFD) is the monetary expression of the exploitation cash-flow, resulting after financing the economic growth.

\[ CFD = Cfexpl - (\Delta lmo + \Delta NFR) \]

The available cash-flow will be in the position to remunerate the shareholders who financed integrally the investments project. The return will materialize in a net flow of dividends, after deducting eventual additional allocations of capital for additional investment to the initial project, only.
• The residual value (VR) is representing the value possible to recover after the moment the investment life duration finishes (through sale, valorisation of parts or sub-assemblies resulting after cassation etc.). For long time economic life duration (10 and more years), the residual value is considered null, insignificant. For shorter life time durations, estimating the residual value becomes significant; if the life time duration is smaller than the technical one, the residual value may be higher than the value left un-amortized and generates a capital gain which increases the taxable profit; some legislations, such as the French or the Canadian ones, grant taxes exemption for half of the capital gain in order to reduce the fiscal impact.

• The up-dating rate (k), although not a specific element of the investment, is considered as a fundamental factor of it: the present value of the cash-flows is depending on its dimension; usually, it is considered as being an opportunity cost of the invested capital. Hence, this is the financing cost of the investment own capitals and will be appreciated as a profitableness rate required by the investors in the respective project. Implicitly, it is assumed that the treasury flows are re-invested at this rate of profitableness and that the financial market has unlimited opportunities of placement.

In a certain economic environment, the investment is riskless and the profitableness rate required by the investors of capital is the riskless interest rate (the financial market is in equilibrium). We are talking about the nominal interest rate which is integrating also an inflation rate (ri) anticipated as being constant. The up-dating rate k which must be utilized is calculated as follows: 

\[(1+k) = (1+\text{real rate})(1+\text{anticipated inflation rate})\] for one year, resulting: 

\[k = r + ri + r * ri - 1\]

\[(1+k)^n = (1+\text{real rate})^n(1+\text{anticipated inflation rate})^n\] for n years, resulting: 

\[k = (1+r)^n(1+ri)^n - 1.\]

In an uncertain environment, the up-dating rate is represented by the risk cost, namely the riskless rate + a specific risk premium (the model CAPM).

There are also other methods to set up this rate.

**The role of the investments within the economic and social gearing**

Any investment project will generate additional needs or demands within the related upstream sectors (suppliers of raw materials, materials, utilities etc.), or downstream (consumers and/or distributors of offered goods...
and services). Implicitly, a chained increase of incomes would take place at the level of all involved economic agents.

The implementation of investment projects or programmes is entailing changes on the labour market, generating an additional need of labour force within the sectors which are preparing and achieving investing activities (research-design, constructions, equipment and working installations production etc.) and mainly at the level of the investment beneficiaries who are exploiting the new production capacities. This has as an immediate effect, the diminishing of the pressure of the generating unemployment factors.

Meantime, the investment constitutes the material support for promoting the technic-scientific progress in the frame of various sectors of activity. The applied investment projects are actually the main mean to valorise the technical and technological solutions offered by the scientific research.

Thus, the role of the investments consists of generating this solid support of the wealth growth. The development and modernization of the society productive force are due to them as well as the simultaneous increase of the living level of the population, by generating improved conditions of life.

**Conclusions**

In this paper, we have aimed to present the concept of investments, its role in economic development, and other aspects significant in substantiating analysis models and investment decisions. We have emphasized the definition of investments in operative, financial and monetary sense, surprising the essential elements of the investment act.

From the point of view of the general policy of the company, we can distinguish two criteria of investment, each one corresponding to a strategy of development: internal investments and external investments. The internal investments are the result of a strategy meant to specialize the production and consolidate or expanding the position of the distribution market for the company goods and services.

The external investments are motivated by a strategy meant to diversify the activity and consist of placements of capitals meant to increase the financial participation to the forming of other commercial companies. Consequently, their character is a financial one, aiming to get synergetic advantages, of “at scale” economy, to reach the optimum “:bulk”.

When evaluating an investment the ration effort – effect must be always estimated; even is the effort is easily identifiable (being given by the expenses generated by the investment), the effects are hardly quantifiable (mainly in the case of the less tangible investments in exploitation: social, commercial, human).
In the frame of the economic circuit, the investment activity plays a double role:

On the one side, the economic agents who implement various investment projects, are increasing their offer of goods and services by increasing their productive capacity, getting thus additional incomes.

At the social level, the investment plays the role of regulator/compensator as far as the labor force and the improvement of the life quality are concerned.

References