PARTICULARITIES OF BUDGETING OF INVESTMENTS YIELD

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ABSTRACT: The paper presents some particularities of the budget process of all the investments as a main aspect in taking the best decision according to the main use of all the firms’ resources. As a measure method of the investments yield the main one is that which describes the relationship between the profit and the investment which improves the decissional process.

KEY WORDS: investments; investment yield; manager; decisional process; evaluation methods of investments yield; profit; profitability rate speed of rotation.

JEL CLASSIFICATION: M1.

1. THE INVESTMENTS YIELD – IMPORTANCE, USAGE

For the most of businesses, perhaps no other aspect of decision - making isn’t so important to its success than the use and evaluation of resources. The management is constantly faced with the variety of alternatives concerning the institutional resources and is responsible for the funds which were given to its care. The selection of the most profitable alternative, the recognition of availability of funds and necessary resources to finance the investment can be considered as major functions of the management during the budget allocation process.

The main objective of a financial manager is to use the funds of the company within its managerial authority, so that at long-term the firm obtains the investments yield at least as high as that which could be achieved through alternative investments, with similar risks. The second important objective is to maximize the present value of investment resources to achieve the higher yield as possible, without existing the undue
risk. For maximization of the earning capacity of the firm, the resources are allocated in such a way that the earning are allocated in such a way that the earning capacity is transformed into a high efficiency as possible for the company. For achieving these objectives the measurement methods are needed to evaluate the company performance. A basic measurement method is the return on investment (ROI), which describes the relationship between profit and investment.

It is assumed that the main objective of a business is to generate a satisfactory return for its owners. As we will discuss, it is necessary to reduce in a higher degree as possible the intuitive factors of decision-making in favor of a more systematic and mathematical approach.

However, it is important to recognize that this concept of return on investments will never replace the rational business judgment, but it helps to raise some questions such as the validity of these factors on business judgement. This indicator is a financial management instrument that defines the problem, assesses and weighs the possible alternatives of investments and brings in the center those qualitative factors affecting the decision and that that can’t be expressed in quantitative terms.

The return on investment is important because it helps to maintain the firm growth by measuring the historical results and it contributes to the evaluation of short-term budgets and medium-term plans of the company. It is also important because this technique is acceptable for investors, business and financial communities, economists and many students in business theories. Of course, it is recognized by most countries, internally, as a budgetary and evaluation technique. Given this kind of recognition and that the ROI (return on investment) can provide a technique for assessing of alternatives of change in the relative attractiveness of a company in comparison with the concerned community, it is easy to understand why ROI is so important.

Nowadays, the complex business environment, technological, economic and submitted to the competitive pressures tends to complicate the adoption of management decisions. This management instrument represents for managership an easy way of evaluation and to accelerate the development of past performance and that future anticipated, in an attempt to increase the development growth and productivity. The following list highlights why ROI is recommended and shows how it can ameliorate this concept of decision-making process:

- **Force planning.** The management of the company must have a plan, indifferently if it is a matter of short or long term, in view of measurement of efficiency or settlement of objectives. This fact is realized during the process of drawing up of budgeting and the planning at the longer term;
- **As a support for decision making.** It translates some decisions from the area of intuition on the area of quantitative and support basis;
- **In evaluating of investment opportunities.** Here can be included not only initial capital investments, but also additional labor costs, the economic cycle of investment and its effect upon the profitability of company;
- **It helps the management performance.** This would include the responsibility performance and total performance of the company or predetermined objectives. It helps to eliminate the inequities that may occur between managers and executing units, caused by differences in size;
and composition of operations, ie, strong capital intensified operations against distributive operations that may have reduced capital investment. In addition, the performance measurement can be used by managers to evaluate the use of assets, cash flow, capital, equipment or other skills and also for the internal control;

- As answer to the market. It measures the answer of management to the market changes concerning the prices and requirements as well the profitability and cost reduction.

To understand the ROI, it is necessary to analyse the term itself. Sometimes there is great confusion regarding the term ROI. The efficiency refers to the additional amount of money expected from an investment over or near the initial investment. This efficiency can be before or after taxation. An investment can be defined as engagement of economic resources, such as years, technology and equipment, labor, etc., based on the anticipation of an income in the form of revenue, estimated value, greater efficiency or cost savings. This gain is measured over a period of time. For that reason the investments efficiency measures the gain of economic resources over a period of time, usually in the form of rate.

Management involvement is required during the process of establishing the budget because the justification for any investment opportunity is directly related to the participation of people who have technical knowledge and expertise capacity to recognize the link between input data. This is also part of the training and managers skills development. Management should be aware that the development of profitable investment opportunities often starts at lower managerial levels, with technical and non-technical staff. In addition, the management helps both in determining the areas of responsibility and authority level.

Taking into account that the list of uses and applications can be quite extensive, it is important to identify the major applications and to be noted that these applications and/or techniques can be used by a company in order to serve the best needs:

- External measurement. A technique used to compare the calculation of ROI with other companies and industries;
- Internal measurement. A technique for evaluation of internal segments of the company, reflected in increase of earnings by reducing of the costs and/or profit improvement;
- Improvement of assets utilization. Ways of improvement of utilization of money available funds, stocks, capital receivables and assets for greater profitability;
- Evaluation of capital expenses. The best known technique for providing the instruments with the view of efficient allocation of capital resources;
- Disinvestment. Used to reflect the impact of business disinvestments or of some segments for improvement of ROI;
- Profit objectives. By internal and external measurement can be determined the profit objectives of the company;
• Acquisitions. They measure the impact of acquisitions on company growth at short and long term;
• Management incentives. The technique of incentives approach based on measurement of efficiency ROI;
• Elimination or addition of production lines. The techniques that have pointed out the profitability or non-profitability which exist on the new production lines;
• Manufacturing or purchasing decisions. They measure the impact of ROI for manufacturing or purchasing of a product;
• Leasing or acquisitions decisions. Similar to the techniques of evaluation of capital expenses used in comparison of learning decisions with those concerning acquisition in view of acquirement of capital assets;
• Evaluation of human resources. With the help of this concept can be determined the efficiency of human resources;
• Stocks control. It measures the changes in stocks and earnings growth as a result of additional investments;
• Prices. They guide pricing a product using the required rate of return.

Technique of investments efficiency in internal and external performance evaluation as an instrument for management decisions should be used with caution. As with all methods of evaluation can appear improper interpretation by measuring different comparative data, relying too heavily on a single measurement method. The instrument of return on investment is vital one, but certain precautions must be recognized in its use.

Too often managers make decisions by comparing the absolute links between data sets, without paying attention to the intelligible relation data components. This outlook error can lead to bad decisions if there is no further interpretation, until the understanding of results. Therefore, the first caution in terms of ROI is not to provide exclusively absolute numerical results in the calculation of ROI rates, indifferently if are compared products, departments, divisions, companies or industries.

The nature of comparative products, product quality, the nature of sales, production costs and company structure are only a few aspects to be considered before arriving at any rational conclusion. The rule of consistency is perhaps one of the most important precautions that can be mentioned. Wee will continually refer to this rule, because it is the basis of the concept ROI: there must be consistency if we desire making the correct decisions.

Since ROI measures the comparative data for a period of time, it is important to be consistent in the measurement of such data. Once chosen a method of comparison, the basic rules should remain the same. For example, if some comparisons are made using certain allocations, these allocations must be used continuously in future comparisons to obtain valid conclusions. If the basic rules change, both the calculations of past and the future ones must be changed accordingly to develop a correct trend of operations. This rule shall be valid for all comparisons of data and is the most important in measuring ROI. ROI represents the only tool to support in reaching these decisions and not the final solution.
The failure of using other helping methods for measuring performance can lead to a focus exaggerately on ROI as a management tool. The other rational methods should be used for assessment to support the conclusions obtained by ROI calculations, such as growth rates and other techniques and processes that are found in the aspects of business planning and budget allocation in the short and long term. It is important to properly allocate net sales, net profits and segment investment for performance evaluation. These segments can be divisions, product lines, departments, centers, etc. market segments. The question is whether if all data should be allocated or only the data for which a manager has responsibility and authority?

If we accept the rule of consistency, no matter if the allocation is made as long as there is consistency in measurement, as data, from one period to another. Final yield rate can be adjusted upward if the lower investments are allocated and adjusted downward if the higher investments are allocated to the segment.

Therefore, the best method should be adopted to measure only the data for which a manager responsible, according to the authority which is given to a manager. It is recommended that only the data can be identified as being verifiable by a manager to be used. Other data that could be allocated and are not under the authority of the manager, could lead to erroneous decisions and the involvement of an operational segment in decisions to the prejudice of the operation, what happens if the prices increase for reaching of ROI objectives. Other unallocated data can be used to complete the entire operation of the company in setting overall goals.

It is suggested to use the profit before taxation on controllable components and net profit in the entire company. As the taxes on individual segments are difficult to be calculated, only the net profit should be used for overall assessment. In addition, it is recommended that for short evaluation period (for example less than a year), the end period balances must be used as a basis for investments.

For longer periods (e.g. a year or more) should be used the balances of the end of year as a basis for investments or a variation of the average of beginning and ending balances of the year, changing environments or any other variation. The conclusion will not change as long as there is consistency. Let’s remember that absolute rates are not so important as profit changes that occur from one period to another. This fact indicates the performance trend and will action as an indicator of performance both past and future.

Net sales and net profits should be collected for each period from 3 months for a quarter, six months for a semester, etc. It is not necessary an average of balances for net sales and net profits, because they are not balanced at any time as in case of balance, but are needed performance data for each period of operations and can be collected for any desired period.

2. THE ELEMENTS OF RETURN ON INVESTMENT

The return on investment uses the data from two most of most used financial statements, profit and loss account and balance. ROI don’t represent nothing else than a series of rates in a logical succession, in an effort to develop management decisions based on past and anticipated profits and use of assets. With this in mind, ROI can be
divided into two basic components, using three sets of data from profit and loss account and balance. These components are profitability and speed of rotation.

2.1. Profitability rate

Profitability rate is calculated by dividing net profits by net sales. This rate shows how big are the profit generated by a dollar sales and it measure success concerning the control of costs. The rate is one common in majority of businesses and plays a major role in running the business. This rate has the greatest influence in generating higher profits for a company, because when sales fall, most businesses will face lower profits. To offset the lower sales, reduced, typically, expenses, profits expected to maintain certain. Therefore, immediate action can be taken to compensate for the temporary operation of a business failure.

2.2. Speed of rotation

Speed of rotational is calculated by dividing the investment by net sales and is expressed as a ratio. This rate of speed rotation reflects the rapidity with which the capital of an operation is used. The biggest problem of this rate is to determine what basis to use for investments, because the results will vary depending on the type of investment used. There may be many different types of investments. However this basis will suppose a certain type of ROI used. For example, using total assets, the ROI would be referred as being the return on total assets. Using capital employed, the ROI would be referred to as return on capital employed. Therefore the investment basis will determine the technique used, since ROI measures the performance of certain investments.

2.3. Relationship between profitability rate and speed of rotation

Taking into consideration the profitability rate of the speed of rotation it results:

Following the above components, we can notice that net sales can be canceled in both equations:

\[
\frac{\text{Net profits}}{\text{Net sales}} \times \frac{\text{Net sales}}{\text{Investment}},
\]

consequently

\[
\frac{\text{Net profits}}{\text{Investment}}
\]

As previously we have mentioned, the rate is divided into two parts, for analysis of the relationship between earnings and sales and the rapidity with which is effectively used the capital employed.
In addition, we can see that in order to improve ROI rate, a manager can increase profitability rate by increasing sales rate, reducing expenses or its combination. Also ROI rate can be increased by intensification of existing investments, in this way increasing the speed of rotation. It is assumed that all these factors are under the control of the manager, being measured. For example, we assume that the two managers are responsible for individual operations. For illustration the following data are presented:

Table 1. Indicator for manager A and B

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Manager A</th>
<th>Manager B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>1500000 lei</td>
<td>1500000 lei</td>
</tr>
<tr>
<td>Net earnings</td>
<td>90000 lei</td>
<td>120000 lei</td>
</tr>
<tr>
<td>Investment - Capital employed</td>
<td>700000 lei</td>
<td>937500 lei</td>
</tr>
<tr>
<td>Profitability rate</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Speed of rotation</td>
<td>2.14</td>
<td>1.6</td>
</tr>
<tr>
<td>Return on investment</td>
<td>12.86%</td>
<td>12.8%</td>
</tr>
</tbody>
</table>

It can be seen that both managers have the same sales and the same ROI rate. Which of these managers is more effective? Without a detailed analysis of each operation, the manager B can be considered better because he had a greater flexibility in controlling the profitability rate based on the data above. In any way caution is needed in the analysis of details that shows the results of manager B, both for financial data and for those non-financial.

Applying the profitability rate and speed rotation in case of manager A it results the following efficiency of capital:

Profitability rate = Speed of rotation

Net profits / net sales x Net sales / Capital employed

or

\[
\frac{90000 \text{ lei}}{1500000 \text{ lei}} \times \frac{1500000 \text{ lei}}{700000 \text{ lei}}
\]

equals: 6% x 2.14, resulting: 12.86%
REFERENCES: