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PROFIT REINVESTMENT: MAIN MOTIVES SUPPORTING FINANCIAL DECISIONS

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Abstract

Reinvestment decisions are based on basic the economic literacy of entrepreneurs because they do not want to affect future liquidity or development activities. The main goal of the article is to suggest a simple decision tree model to describe profit reinvestments in a general way based on results of a primary pilot study (128 interviews), where reinvestment behaviour is affected by specific factors like risk taking, competitive advantage or business experience. After that a decision-making tree is suggested to explain the process of reinvestment as determined by the manager.

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Introduction

Economic theory proclaims that the primary goal of a business is to maximize profits, as Baumol along with Blinder assumes in Principles of Economic Policy (2016) or Kaczmarek (2014). To support this principle, several definitions are used, especially in the Czech business environment, such as the purpose of entrepreneurship activity as activity carried out on one's own account and the responsibility of a gainful activity in a trade or similar manner with the intent to do so consistently (New Civil Code 89/2012, § 420). In opposition to that, Veber and Srpová (2012) mentioned another dimension of success - linked to the entrepreneur's ability (creativity, initiative or activity). Obviously, there is a certain trend in the direction of reinvestment, and therefore these directions and a company's strategy would change. Globalization and the openness of the market is conducive to the development and expansion of companies, and hence the potential for growth of its competitors. Accordingly, the main goal of this paper is to introduce a different approach to profit reinvestment across the research world, where the research gap can be seen in different definitions and wide possibilities to measure optimal reinvestment revenues are noted. The paper is divided into three main parts, the first summarizes the theoretical background to profit reinvestment and possible financial ratios for the decision-making process, the second part introduces methods and data sources used in the paper. This part is followed by key findings from the analysis and a final decision-making tree, which could help to explain behaviour in the reinvestment process according to real experience.

Profit reinvestment strategy

The distribution of revenues, the acquisition of financial resources, investment, reinvestment, and the ability to create value are thus required to run a successful business in the long term (Režňáková, 2012). Reinvestment is therefore a re-investment of part of the company's profits into the same company with the expectation of higher profits in the longer term, Synek (2007), dividing it into three areas (financial, tangible and intangible investments). In many ways, this investment (reinvestment) has its own risks, so it is a good risk to diversify, reinvesting into various business areas. This is determined by the type of company, especially for those with innovative potential. Reinvestments are mostly realized in science and research and human resources, which means to attract new employees hired to develop innovation, which help companies make more profit (Hasuch & Pyka, 2007; Chakravarty & Xiang, 2011). When the company reinvests profits in themselves, the money is used for research and development, debt repayment, or possibly to have a net cash flow from investment activities. On the contrary to that, a joint stock company which pays out to shareholders, usually increases dividends and buys back its shares.

Internal reinvestment strategy

The main motivation to plan this process would be (1) profit maximization; (2) maximizing the current value of future net cash inflows with cost minimization or (3) maximization of profits in the long run and the prestige of the enterprise according to the owner or owners (Kędzierski, 2017; Kaczmarek, 2014). The internal reinvestment supports an organic growth and it has a greater and more stable positive impact on corporate shares than the distribution of profits to shareholders. By contrast, companies driven by profit distribution to shareholders are often at the peak of their market potential and cannot grow any longer through organic growth (Hall, Hutchinson & Michaelas, 2004). It can be divided into five basic phases, completed with a final audit, so the whole process has six parts (Scholleová, 2009):

1) *reinvestment phase*, when profit from earlier business activities will be returned to the company in the form of reinvestment,

2) *the pre-reinvestment phase*, which consists of three parts:

a) identification of projects, when the aim of this phase is to find potentially workable projects by finding the basic parameters for success (achieving the goals of reinvestment),

b) selection of projects - the aim of this phase is to select projects according to reality and to evaluate projects with a proper method,

c) evaluation and possible decision - the aim of this phase is to select from the already short-lived project choices to those that will be applicable in real terms, including the calculation of the return on individual projects,

3) *the investment phase* sets up the conditions for a

successful start of reinvestment at this stage,

4) *operational phase* ensures reinvestments and eventual response to new conditions and barriers to reinvestment,

5) *disinvestment phase* is the termination phase at a given stage of reinvestment,

6) *post-reinvestment audit* is important for the decision-making and management of other similar reinvestments in the enterprise, it is a retrospective evaluation of reinvestment, not only in the field of economic returns but also in the level of achievement of the goals under the given conditions.

This process is closely connected with the possibility of equity financing and barriers to it. This process is followed with motives to reinvest profit and with the financial management of each company.

Financial Motives for Reinvestment

According earlier findings (Pokorná, Krejčí & Šebestová, 2019), several methods can be selected to evaluate investments and profit reinvestment. In general, these methods can be divided into two groups as static and dynamic methods (Altshuler & Magni, 2012; Kislingerová et al., 2011). Static methods are typically used for less significant projects or for projects where specific factors do not play a significant role, for example short-term projects. There are various methods, but the one mainly used is Return on Investment (ROI), Net Investment Income. In contrast to that, dynamic methods calculate with time factor depreciation. Also mentioned could be ratios like the profitability index, Net Present Value (NPV), Internal Return Rate (IRR), Modified IRR, or the Discounted economic value-added (DEVA).

Moreover, Michalski (2009) and Kędzierski (2017) suggested modified dynamic methods based on NPV, which are calculated with reinvestments, such as ANPV (Annualised Net Present Value) and MNPV (Modified Net Present Value) where information on discounted cost of equity capital and an additional reinvestment rate is added. As mentioned, several literature sources were used for the context analysis to propose a set of ratios, which could help to evaluate reinvestment (Altshuler & Magni, 2012; Dluhošová, 2004; Durrah et al., 2016; Neumaier & Neumaierová, 2014; Kędzierski, 2017; Kaczmarek, 2014; Michalski, 2009).

Kislingerová et al. (2011) have also mentioned preference of each method in the Czech business environment, so a final qualitative critical comparison has been made to find the optimal way for evaluation or future suggestions for respondents (Table 1) according to preference (High-average-low), ease of use (yes-no), ratio type (static-dynamic) and originality in previous research works (yes-no) as evaluated by the authors.

As presented the last three ratios would bring originality to the work, but they are not so easy to calculate. In line with originality of method for reinvestment evaluation,

Table 1: Critical comparison between ratios

Ratio	Preference	Easy to calculate Yes/No	Ratio Type	Originality/added value for future
Return on investment (ROI)	High	Yes	Static	No
Net Investment Income	High	Yes	Static	No
Net Present Value (NPV)	Average	Average	Dynamic	No
Internal Return Rate (IRR)	Average	Average	Dynamic	No
Modified IRR	Low	Average	Dynamic	Partly yes
Average IRR (AIRR)	Low	Average	Dynamic	Yes
Economic value added (EVA)	Average	No	Dynamic	Partly yes in case of logarithmic and functional methods
Discounted economic value-added (DEVA)	Low	No	Dynamic	Yes
Modified NPV (MNPV)	Low	No	Dynamic	Yes
ANPV (Annualised Net Present Value)	Low	No	Dynamic	Yes

Source: Author's elaboration

we must respect other ties between financial ratios in the company as mentioned by Durrah et al. (2016) and Neumaier and Neumaierová (2014) such as liquidity and profitability ratios.

Reinvestments are mostly realized in science and research and human resources which intends to attract new employees hired to develop innovation, which helps companies make more profit (Hasuch & Pyka, 2007; Chakravarty & Xiang, 2011).

Profit is usually limited in two ways. One, entrepreneurs don´t have so many stable customers to generate sustainable profits, secondly, limitation of enterprise ability, which limits the amount of orders that they can accept. In real life we could assume perfect adaptation to the business environment, but this depends on the economic literacy of the business owner, their experience and the problems of the company. There are so many different techniques for decision-making behaviour, which combine financial statements, business perceptions and business environment factors (Simon, 1979; Walker et al., 2011; Illés, 2016). All models want to answer the question of profit maximization, especially in profit reinvestment in explicit or implicit ways, when the main problem is not actually the reinvestment rate, but the critical reinvestment rate (Meyer, 1979).

A functioning financial system in each country is important for reinvestments, when the limited use of external finance by companies reflects not just a lack of loan supply but also a lack of loan demand and problems of access to financial resources (Johnson et al., 1999; Cull & Xu, 2005). Factors which could help to decide on reinvestment could be assumed in the following formulas (Johnson et al., 1999; Cull & Xu, 2005; Myers & Majluf, 1984):

$$I_d = I\,(p, s, r^l, r^e);\ I_d = R + L^E \quad (1)$$

where I_d = company's demand for investable funds,

p = expected (pre-extortion) profits,

s = amount of those profits that will be extracted by corrupt bureaucrats or criminals,

r^l = cost of external funds (the interest rate paid on borrowed money),

r^e = interest rate that can be earned by investing the company's profits outside,

R = reinvested earnings,

L^E = company's demand for loans.

Because external funds are so expensive, company owners use internal funds first to support reinvestment before asking for credit. Accordingly, a willingness to reinvest profit could be noted as:

$$I_d = R;\ if\ I_d \leq E_i + L^E\ if\ I_d > E_i, \quad (2)$$

where i = company,

E_i = total current profit.

Company i has the largest amount of money that it is willing to reinvest out of its current profits, E_i; this might be the total current profit, or it might be strictly less than that. This decision up to the business owner. Finally, factors which cause maximum reinvestment estimation could be assumed as (Cull & Xu, 2005):

$$R = I\,(p, s, r^l);\ if\ I_d \leq E_i\ and\ r^E < r^l; \quad (3)$$
$$R = E_i\ if\ I_d > E_i\,,$$

The optimal reinvestment rate is different, financial advisors recommend 64% of reinvestment, when reinvestments in engineering are recommended below 20 % (Walker et al., 2011). To be able to measure return rate, Illés (2016) proposed the following formula:

$$(E_{t-1}\,i + E_{t-1}) - H_t = E_t;\ H_t < E_{t-1}\,(1 + i);\ 0 < t < z, \quad (4)$$

where H_t = the yields of the difference of revenues and expenditures) in year t, where the value of H_t is always positive for years $0 < t \leq z$ by the terms of orthodox cash flow pattern and the initial investment occurring at the zero point of time,

E_t = the not-returned part of capital at the end of year t,

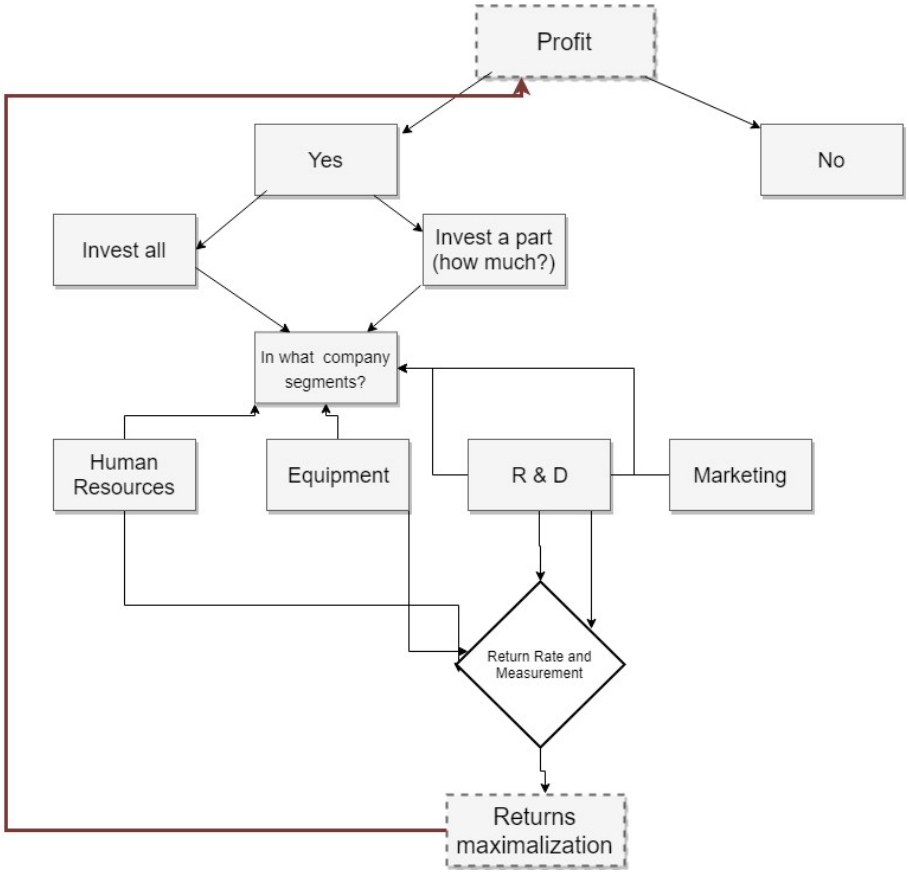
i = required rate of return,

t = serial number of years,

z = number of years of the pay-off period (including the last reinvested year).

Those formulas (1 to 4) give us the theoretical background for a theoretical decision-making tree for reinvestment, which will serve as conceptual framework for the paper (Figure 1). The illustration covers the main areas of reinvestment such as Human Resources (supporting new benefits, training, growth in company structure, teambuilding events, better personnel policy in recruitment, training, promoting job vacancies), Equipment – supporting new technology (more modern, other extension of production, new logistic systems, etc.), Research and development to support innovations and to create competitive advantage and finally to support marketing innovations and activities. Those areas are closely connected with the strategic goals of each

Figure 1: Conceptual framework for Reinvestment decisions



Source: Pokorná, Krejčí and Šebestová, 2019

company.

In order to show the problem of profit reinvestment, an explorational analysis of the return process has been described and explained. After that a decision-making tree will be suggested to accomplish the paper's goal of explaining the process of reinvestment according to the primary data results.

Research methodology and data

To get overall economic knowledge of entrepreneurs in the area of investment and their ability to measure them a semi-structured interview was used in this pilot study. The focus was economic activity, main economic indicators to measure financial success of companies. This approach was defined in studies by Walker et al. (2011) and Johnson et al. (2002) and Myers and Majluf (1984).

All interviews were based on personal visits or in cases where the entrepreneur was agreeable the interviews were done via direct phone call. Entrepreneurs were randomly selected from the database Merk, with a minimum turnover of 1 CZK in the last three years to be sure that it is an active company. A quota choice of one percent (1 ‰) of companies per region (14 regions, 1136 contacts) in the Czech Republic were selected to test questions within different regional conditions, where 128 interviews were successfully completed till April 2019. Results were administered online through a secure link to the electronic version and a record was sent to the entrepreneurs by email.

Main procedures from the qualitative research are summarized in Table 2 below. The time limit for each interview was set to 30 minutes. The pilot study procedure was based on principles presented by Shenton (2004) to get relevant and unbiased information. Data from the semi-structured interviews were coded into a matrix to be able to obtain some descriptive data. These interviews were completed in the form of one visit for a face-to-face interview with one entrepreneur (65%) and a phone-call interview with one entrepreneur (35%). Answers from the interview were re-coded on a Likert scale (1- strongly agree, 5 – strongly disagree) to illustrate the main motives

Table 2: Typical respondent

Variable	Female (N=34)	Male (N=94)
Age	41-55 years (70 %)	41-55 years (53 %)
Education	Secondary school, college (55%)	Secondary school, college (62 %)
Business experience	20+ years (38%)	20+ years (43 %)

Source: Survey data

influencing reinvestments (Table 3). Re-coding was based on a previously prepared table (e.g. when the manager mentioned the information directly, first idea = 1).

The sample consists of 73.4% male entrepreneurs and 26.6% female entrepreneurs. The average age was in the age group 41 to 55 years (35.3%) and 54.7% hold university degrees. A significant descriptive factor was their business experience; most of them had spent more than 10 years in business (65.9 %). A typical respondent differs from another only in innovative activity (by gender, Table 2). As confirmed, business experience will play a significant role in the next step of result evaluation.

Results below (Table 3) show that the interviewed business owners have a basic knowledge about economic literacy, and they are planning reinvestments because they prefer internal sources of financing. Most of the respondents stated that they don´t want certain reinvestments. On the other hand, more than half said that they have some investment plan. So, they want investment, but it means that what is important is where the money comes from.

When respondents are not risk takers and they prefer to plan their activities, it will be necessary to answer those research questions (RQ):

1) RQ 1: Which factors will be motivating to reinvest generated profit?

2) RQ2: Which evaluating tools will be used to support a decision for reinvestment?

Results

Data evaluation was done in three logical steps to be able to answer research questions and to model a proposal for a decision-making tree. Most - 81% - of respondents usually invest some percent of generated profit back in the company each year. Usually they invest 20% of company profit (47% of respondents). There is some group of respondents (mostly CSR oriented) who invested more than 80% of their profit (23% of cases).

Firstly, it was necessary to know their main reason to reinvest the profit in general. According to the interviews there were six groups of motivational factors to reinvest profit (Table 4):

1) interest rate for loans in banks (e.g. would be better to reinvest in "my company", it is cheaper, without additional bureaucracy),

2) payback period (short vs. long term investments),

3) tax reduction (reinvestments brings tax benefits e.g. innovations, patents),

4) more benefits (nontangible benefits),

5) competitive advantage

6) financial ratios (mentioned as interest rated, net profit, etc.).

The main motive to reinvest profit was "to get more benefits" in 85,9 % (Strongly Agree and Agree) in a short payback period (83,9 %). Taxes or financial ratio accounting wasn't significant for reinvestment decisions.

Table 3: Business Behaviour of Respondents

Statement	Value on scale	Comment
I am planning reinvestments	Positive (Strongly Agree)	74% is having an investment plan
I am not a risk taker	Positive (Strongly Agree)	71.1% are not "real" risk takers
I have a plan for maximum loss in my business	Neutral	52.4% set up the maximum loss
I have financial goals for my business	Positive (Strongly Agree)	81% have plans to solve it in the near future in line with investments

Source: Survey data

Table 4: Motives to reinvest profit

Likert Scale	Interest rate for loans in banks	Payback period	Tax reduction	More benefits	Competitive advantage	Financial ratios
	(%)	(%)	(%)	(%)	(%)	(%)
Strongly Agree (1)	14,1	23,4	7,0	41,4	28,1	12,5
Agree (2)	22,7	60,2	35,2	44,5	40,6	41,4
Don't know (3)	21,9	10,9	21,9	12,5	15,6	33,6
Disagree (4)	28,9	5,5	30,5	1,6	14,1	9,4
Strongly disagree (5)	12,5	0,0	5,5	0,0	1,6	3,1
Total	100	100	100	100	100	100

Source: Survey data

These motives affected the decision in which segments owners will invest more. To sum up (Table 5), they prefer short or mid-term reinvestments for marketing activities or HR development. Unfortunately, innovations and research are not as supported as they should be. Business owners prefer to buy ready-made technologies and equipment (in a share of 40 to 60 % of reinvestments).

On average, the same share of 20% is reinvested yearly into HR development, R&D and Marketing. Those managers prefer equipment investments by 40%.

Finally, a statistical evaluation has been made to confirm the relationship between length of the respondent´s experience and age. Unfortunately, variables such as level of education and gender were not statistically significant in most cases. A Cramer V coefficient was used to confirm the relationship between those two nominal variables on the significance level $\alpha = 0,05$.

When the decision on reinvestments is based on business experience, which supports also the importance of research and development of the company, the age of the respondent determines the level of outputs from reinvestments. When the business owners reinvest more profit or they are trying more reinvestment activities, they expect more valuable outputs, which could be measurable, and which could bring value added.

According to those findings it would be possible to create a decision-making tree, which is summing up the research findings, but also illustrating the measurable steps and determinants of profit reinvestments (Figure 2). This illustration could be divided also into three parts: (i) pre-reinvestment period – when the business owner is deciding on reinvestments and the budget, (ii) reinvestment period- in that part the business owner is deciding on the proper segment for reinvestment and is choosing reinvestment portfolio and measurable goals, (iii) reinvestment audit – measurable expectations after reinvestment to generate more profit to continue in that cycle.

According to this detailed analysis answers to two research questions where found, when the main motives for profit reinvestments are non-tangible benefits and payback period (Table 4, RQ 1). These motives are closely connected with the age of the respondent (Table 5). A return rate of reinvestment could be measured by

Table 5: Percentage share of profit reinvestment

Percentage share	Marketing	R&D	HR Development	Equipment
0%	46,1	57,8	39,9	26,6
20%	39,1	27,3	46,9	14,8
40%	10,2	9,4	10,2	22,7
60%	3,1	2,3	3,1	16,4
80% and more	1,6	3,1	0,0	19,5
Total	100	100	100	100

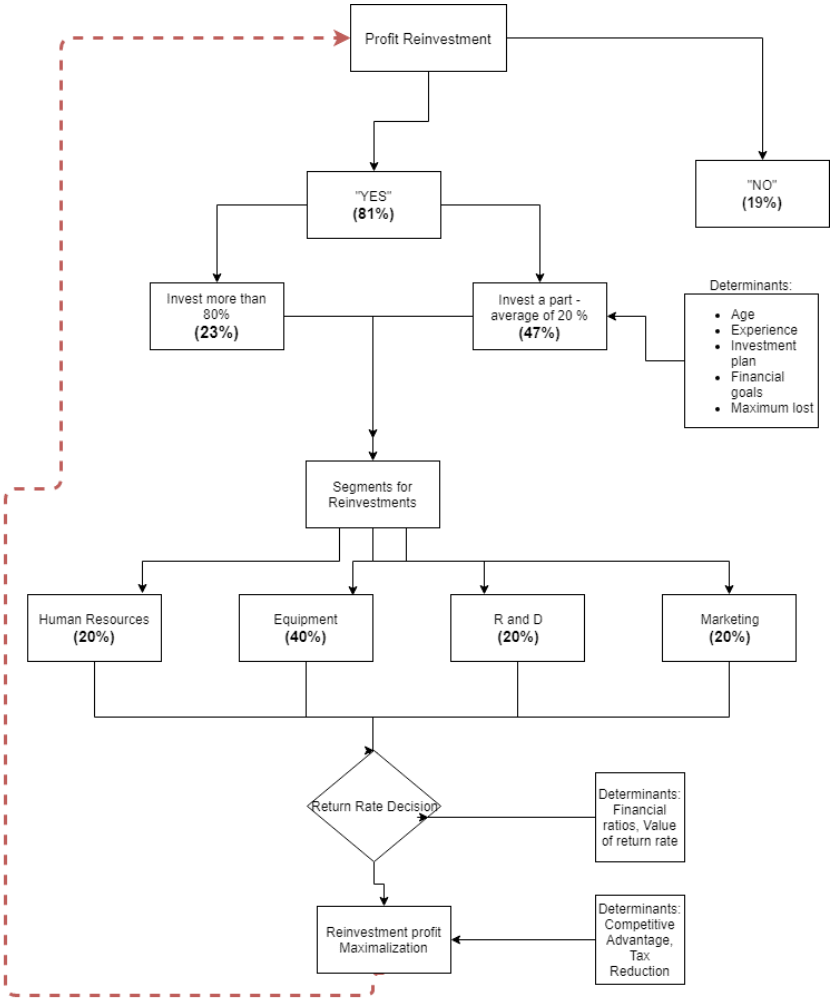
Source: Survey data

Table 6: Determinants of reinvestment by age and business experience

Determinants	Business experience	Sig.	Age	Sig.
Decision for reinvestment (Yes or No)	0,327*	0,003	0,218	0,195
Amount of Reinvestment	0,27*	0,006	0,217	0,086
Marketing	0,247	0,073	0,165	0,831
R&D	0,325*	0,000	0,212	0,291
HR development	0,217	0,113	0,178	0,434
Equipment	0,233	0,144	0,222	0,191
Interest rate for loans in banks	0,236*	0,045	0,239*	0,012
Payback period	0,17	0,270	0,253*	0,017
Tax reduction	0,141	0,812	0,18	0,407
More benefits	0,158	0,389	0,278*	0,003
Competitive advantage	0,139	0,829	0,233*	0,032
Financial ratios	0,167	0,567	0,161	0,84

*Source: Survey data, * statistically significant α = 0,05*

Figure 2: Decision-making tree



Source: Own elaboration

financial or non-financial ratios, unfortunately financial ratios didn't play a role in those decisions. More important is to gain competitive advantage or tax reduction (Table 5, RQ 2). More than that, a significant connection was found within the behaviour such as financial goals or investment planning (Table 2).

Conclusions

The majority of entrepreneurs confirmed that they had basic knowledge of the business economy and financial planning. Research shows that 74.3% of the interviewed entrepreneurs have some investment plan. On the other hand, 71.1% of respondents are not risk takers. Research findings confirmed the work of Walker et al. (2011), where companies reinvested 20% of profit on average, so the findings could be comparable internationally (Durah et al., 2016; Pokorná et al., 2019). The most important factor in the reinvestment decision was that business experience plays a significant role in the amount or segments in which entrepreneurs could reinvest their profit. The research shows the focus on the factors of experience in detail. These factors are important for successful entrepreneurial behaviour in line with the studies of Michalski (2009) or Illés (2016).

However, there are some limitations of the presented study. Our estimates were based on literature review and financial knowledge of business owners. If we take into account what questions respondents answered, the limitation of that study could be seen in their experience and personal point of view, which was statistically significant. The study has shown the main factors for reinvestment, but a future detailed study (in comparison with financial data) will show the effectiveness of those reinvestments for company development.

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