

**THE EFFECTS OF CAPITAL BUDGETING DECISIONS ON THE
FIRM'S PROFITABILITY: A CASE STUDY OF
MANUFACTURING COMPANIES IN
HARGEISA, SOMALIA**

BY

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**THE RESEARCH REPORT SUBMITTED TO THE COLLEGE OF
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UNIVERSITY**

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DECLARATION

I, ASHA ABDULLAHI ALI, declare that this research is entirely my original work done by me and has never been submitted to any university for any award.

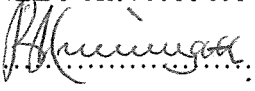
Signature..........

Date.....15 / JAN / 2013.....

APPROVAL

This research report has been prepared by MS/ .ASHA ABDULLAHI ALI under my supervision and submitted to the college of economics and management sciences with my approval as her university supervisor.

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DATE.....15/Jan/2013

DEDICATION

I dedicate this work to my beloved Mother **Sirad Aden Mohamed**, my father **Abdullahi Ali Abokor**, my supportive brother **Omar Abdullahi Ali** , and to all my family, friends relatives.

ACKNOWLEDGEMENTS

Praise is to almighty ALLAH who kept us in life enabled me to accomplish this research successfully. Especial thanks go to my supervisor DR.STANLEY KINYATTA for his tireless supervision, guidance and encouragement that has resulted in the production of this research work.

My humble gratitude goes to my family members, brothers and sisters and all those who have tirelessly supported me morally and financially throughout my educational journey.

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TABLE OF CONTENTS

DECLARATION	i
APPROVAL	ii
DEDICATION.....	iii
ACKNOWLEDGEMENTS.....	iv
ABSTRACT	ix
CHAPTER ONE.....	1
INTRODUCTION	1
1.1 Background of the Study	1
1.2 Problem Statement	3
1.3 Purpose of the Study	3
1.4 Research Objectives	3
1.5 Research Questions	4
1.7 Scope of the study	4
1.6 Significance of the study.....	4
1.8 Conceptual framework.....	5
CHAPTER TWO.....	7
LITERATURE REVIEW	7
2.1 Introduction.....	7
2.2 Overview of capital budgeting decisions	7
2.3 Replacement of Assets	9

2.3.1 Significance of Replacing of Assets.	9
2.3.2 Asset replacement analysis	11
2.3.3 Replacement planning.....	14
2.3.4 Choice of investment appraisal techniques.....	15
2.4 Critical review.....	20
CHAPTER THREE	22
METHODOLOGY	22
3.1 Introduction.....	22
3.2 Research Design.....	22
3.3 Target Population.....	22
3.4 Sampling Design and Procedure.....	23
3.5 Sample Size:.....	24
3.5 Data Collection Instruments	25
3.5.1 Data Collection Procedure	25
3.5.2 Validity and Reliability.....	26
3.5.3 Ethical Consideration.....	26
3.6 Data Analysis	27
CHAPTER FOUR PRESENTATION, INTERPRETATION AND ANALYSIS OF DATA	28
4.1 Introduction.....	28
4.2 The gender of the respondents	28
4.3 The age of the respondents.....	29
4.3 The marital status of the respondents.....	29
4.4 The education qualification of the respondents	30

4.5 Capital equipment acquisition decisions have a relation to the firm's profitability?	30
4.6 If your answer is yes, what effect(s) do these acquisition decisions have in the firm's profitability	31
4.7 Capital equipment acquisition has enhanced the capacity of the firm to meet the demand which in turns helps the firm generate a maximum profit.	32
4.8 Have you ever had minimum standards of profitability or returns on investment for capital budgeting decisions in your firm?.....	33
4.9 If your answer is yes, have you been able to realize or meet these minimum standards of profitability?.....	34
4.10 Replacement decisions of capital equipment have effect on the profitability of the firm?34	
4.11 Effect of replacement on the profitability of the firm	35
4.12 Which of the following reasons does you replaces machinery	36
4.15 Refer to question (15), state the reasons for selecting a particular techniques.	38
CHAPTER FIVE	39
SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS.....	39
5.1 Introduction	39
5.2. Summary of the findings.....	39
5.2. 1 Effect of acquiring long term assets on profitability.....	39
5.2 .2 Effect of replacing of long term assets on profitability	39
5.3 Conclusion	41
5.4 Recommendation	42
5.5 Suggestions for further Studies	42
5.6 Limitations of the study	42
REFERENCES	43

APPENDIX A: RESEARCH INSTRUMENTS.....	45
i. Questionnaire.....	45
ii. INTERVIEW GUIDE.....	49
APPENDIX B: TIME FRAME	50
APPENDIX C: BUDGET.....	51

ABSTRACT

This study was entitled “The effects of capital budgeting decisions on the firm’s profitability: a case study of manufacturing companies in Hargeisa, Somalia” was presented after a study conducted in eight selected manufacturing companies in Hargeisa, Somalia in the year 2012. Among the objectives of the study were to assess how acquisition of long term assets affect the profitability of manufacturing firms, to assess how replacement of long term assets affect profitability of manufacturing firms and to assess how investment appraisal techniques affect profitability of manufacturing firms in Hargeisa, Somalia.

The study employed a cross-sectional survey design extracted from Salkind, (2000), which examined several groups of people at one time. This was particularly chosen because it enabled the researcher to study the experience of different manufacturing firms on assessing the effect of capital budgeting decisions which are common in all manufacturing firms because they heavily rely on property, plant and equipment in the production and delivery of goods to its customers.

The analysis of the findings indicated that majority of the respondents reported that acquiring of long term assets affects the profitability of the firm, in which respect the manager’s objective is to select the equipment combination that yields maximum production at the best or most reasonable price. Managers must be able to understand costs associated with a particular piece of equipment.

The study concluded that majority of the respondents use payback period in evaluation capital projects and recommended that further studies be conducted on the impact of the challenges of capital decisions on financial performance in manufacturing firms and the significance of budgeting in the resources allocation of the firms.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Capital budgeting in manufacturing firms is the most important decision taken by finance managers. Decisions like purchase of new equipments, replacement of machinery, investment in research and development and expansion of existing facilities are helpful in improving the smoothness of the production system and deliver high quality products. On the other hand, expansion decisions are aimed to utilize the existing opportunities in the market and lead to the firm's growth.

As a result of today's increasing competition due to rapid changes in technology, managers in manufacturing firms undertake extensive capital budgeting decisions, while most of the managers without deeply analyzing the effect of these decisions on the profitability of the firm. On the other hand, managers in the firm propose and compete to have their capital projects funded even without adequately assessing the effect of this project on profitability of the firm. However the fact remains that decisions made actually affect the goal of the company's growth.

Shankar (2007), the decision to invest in long term assets by the firm is known as the capital budgeting decisions. In this decision, the firm acquires assets like plant, equipment and machinery, furniture and research and development benefits. The objective for capital budgeting decisions is to earn satisfactory returns on investments. Larson, Wild & Chiappetta (2002). But they require careful analysis because they are usually the most difficult and risky decisions that managers make.

Weygnad, Kieso & Kimmel(2002), the involvement of top management and board of directors in the process demonstrates the importance of capital budgeting decisions. These have significant impact on the company's future profitability. In fact poor capital budgeting decisions can cost a lot of money to the firm. Such decisions even lead to the bankruptcy of some companies.

Most acquisition and disposal impacts on the statement of cash flow because most acquisitions are immediate use of cash and the amount paid at the acquisition is deducted in the statement. Disposals of long term assets usually create immediate receipt of cash. When they do they are reported as source of cash, Wild (2002).

In replacement decisions the costs and accumulated depreciation associated with the old components can be identified, it can also be eliminated from the accounts and gain or loss may arise. If the result is loss, it reduces the profit of that particular period. Chasteen, F laherly & O'connor(1998).

To earn profit is the goal of business enterprise. Companies use measures that indicate profitability in the firm. First profit margin tells the decisions makers how much profit is generated. Second return on asset is an indication of the profit per dollar of assets. Finally, return on equity quantifies how well stockholders did the year by providing measures of productivity of their investments. Finch (2003).

However, this study seeks to explore and determine the relationship between capital budgeting decisions and financial performance in manufacturing firms.

1.2 Problem Statement

As a result of increasing competition and due to rapid changes in technology, manufacturing sectors are one of the sectors which require capital investment in order to produce and delivery of goods to customers. Recently in Somalia, the sector is the one of sectors which of recent engagement engaged in capital budgeting decisions.

Although Klammer,(1973) & Ehrhard Join,(2006), used capital budgeting to associate capital budgeting techniques with the firm performance and initial cash outlay uncertainly, no significant studies was conducted on assessing the effect of these decisions on the profitability of the manufacturing firm. Therefore, this study seeks to assess the effects of capital budgeting decisions on the profitability of manufacturing companies.

1.3 Purpose of the Study

The purpose of this study was to explore the effect of capital budgeting decisions on the profitability of manufacturing firms in Hargeisa, Somalia. The researcher used Survey Research design for collection of research information that aimed at assessing the effect of capital budgeting on the profitability of manufacturing firms. In particular, the study determined and described the relationship between capital budgeting decisions and profitability in manufacturing firms.

1.4 Research Objectives

The objectives of the study were as follows:

- To assess how acquisition of long term assets affect the profitability of manufacturing firms.

- To assess how replacement of long term assets affect profitability of manufacturing firms.
- To assess how investment appraisal techniques affect profitability of manufacturing firms.

1.5 Research Questions

The study sought answers to the following questions.

- What effect does acquiring of assets have on the profitability of manufacturing firms?
- How can replacing of assets affect profitability of manufacturing firms?
- To what extent does investment appraisal techniques have effect on the profitability?

1.7 Scope of the study

The study was concerned about assessing the effect of capital budgeting decisions on profitability of manufacturing firms. It focused on eight selected manufacturing firms in Jargeisa, Somalia between December 2012 up to March 2013 using survey research design and sample of eight manufacturing firms.

The study specifically sought to assess the effect of capital budgeting decisions on profitability of manufacturing firms.

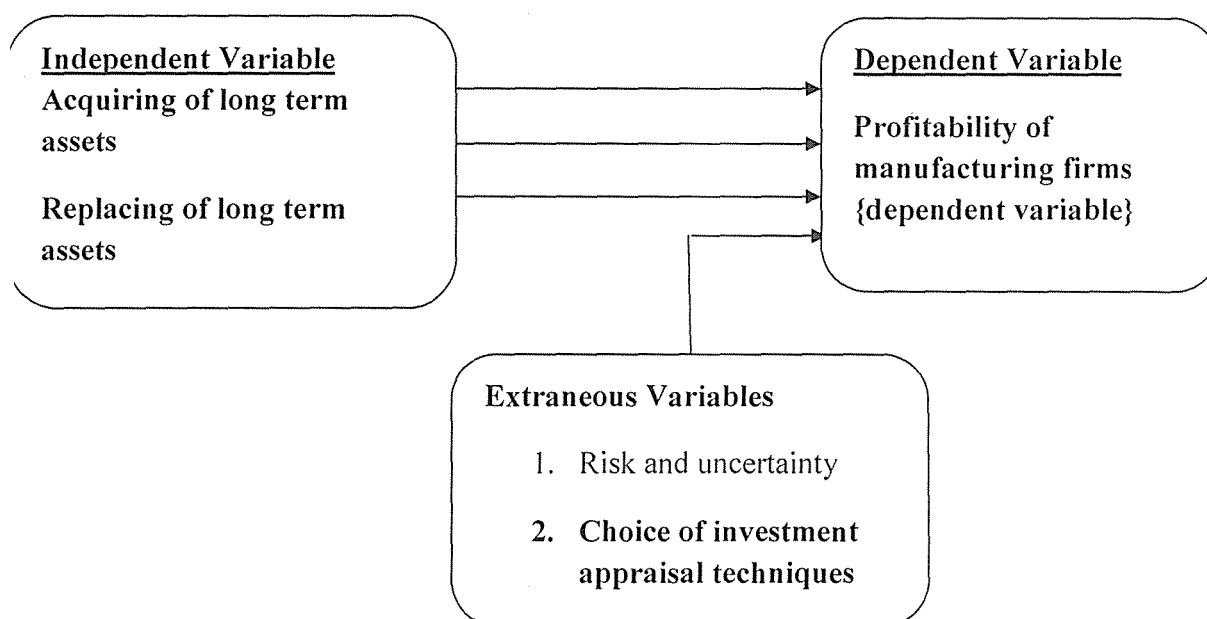
1.6 Significance of the study

The study yielded data and information that is useful for understanding the effect of capital budgeting decisions on the firm's profitability in manufacturing firms. The finding and the recommendations of this study are useful for decision makers of capital budgeting and do not

rely on hap hard personnel experience in making capital budgeting decisions, but make their decisions on concrete knowledge of understanding their capital budgeting decisions to the profitability of their respective firm, hence improving their financial performances.

The study is also benefited from by other researchers to get a basis for further research on impact of capital budgeting decisions on the profitability of manufacturing firm. This leads to the ideas for better understanding of capital budgeting decisions and profitability.

1.8 Conceptual framework



source: primary source.

Malpin & Woodhead (1980) argued that decisions regarding equipment type and combination can have a major impact on the profitability of a job. In this respect, the manager's object is to select the equipment combination that yields maximum production at the best or most reasonable price. Manager must be able to understand costs associated with particular piece of equipment.

Norgaard(1985) argued that replacement decisions effects the net income of the firm. He illustrated by using accounting rate of return and accounting numbers to calculate the effect of replacement decisions on the net income.

These are five commonly used methods of ranking different projects to determine the acceptable projects that add value to the firm. These include Net Present Value (NPV), Internal Rate of Return (IRR), Payback Period (PBP), Accounting Rate of Return (ARR) and Profitability Index. Some of these methods consider time value of money (NPV, IRR) while others do not consider the time value of money. Each of these methods has decision rules that allow managers to determine whether the project is acceptable or not

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The literature review provides background explanations of the elements of the research work such as capital budgeting decisions such as acquiring and replacing of assets and theories of methods of capital budgeting, techniques of capital budgeting with emphasis on the five commonly used methods (net present value, payback period, internal rate of return and profitability index). In relation to the profitability of the company.

Then and Mayes (1989), Businesses are formed in order to create value for their owners. For corporations this value creation goal is transformed into stockholder wealth maximization. To fulfill this goal financial managers have certain responsibilities. One of them is to make wise capital budgeting decisions. Hilton (2002), managers in all organizations periodically faces major decisions that involve cash flows over several years. Decisions involving the acquisition of machinery, vehicles, buildings and other capital assets are examples of such decision.

2.2 Overview of capital budgeting decisions

Different scholars have defined the term capital budgeting decisions: Stephen, Ronal & Jaffrey (2002) defined capital budgeting decisions as it involves planning and managing expenditures for long lived assets. Mowen & Hasen (1995) defined capital budgeting as it refers to the process of making capital investment decisions. They said capital investment decisions are a process of planning, setting goals and priorities, arranging finance and using certain criterion to select long term assets. Ross, Westerfield & Jordan (1999) also defined capital budgeting as the process of planning and managing firms long term investment. Long term investment proposals is referred

to as (capital budgeting) Making optimum capital budgeting decisions (e.g. whether to accept or reject a proposed project), often requires recognizing and correctly accounting for flexibilities associated with the project Scott, Xie & Howard, (2008).

Blocher, Chen & Lilan (2002), the soundness of capital investment decisions are critical to the organizations. A good capital investment generates cash, decrease cash outlays, or both over its projects life to earn back capital committed to the projects and desirable profits. The lack or poorly executed capital investment decisions can lead to financial hardship, ties up resources for external periods, curtail opportunities available to the firm, demoralize employees and vex suppliers and customers.

Similarly, Schonberger (1981) argued that proposals to acquire or upgrade facilities are particularly important in capital intensive organizations. In manufacturing firms, both building and equipment planning are critical to the success of the firm. It is in manufacturing that planning for facilities tends to be done most carefully. Schroeder (1993), these decisions place physical constraints on the amount that can be produced and they require investments of scarce capital.

Wakuru (2007), capital budgeting decisions are important as it requires to be handled with at most care in the firm. The first importance is, it determines which permanent assets the firm will hold. Secondly, initial outlays in investment in long term assets are usually very substantial. Normally, thirdly, capital budgeting are very difficult to reverse or are usually reversed at a high cost. Finally, constant and up to date capital budgeting decisions is essential for acquiring the relevant assets.

2.3 Replacement of Assets

Lanbouchere (2001) argued that one of the biggest problems facing the industrial management is the replacement of production assets. The majority of such decisions are made on basis of some limited calculation, large amount of conscientious assessments. Few companies would wish to claim that they have rigorous means of assessing the optimum time at which to make such a replacement and reluctant to commit such expenditure, whilst absolutely valid and major factor in the assessment, often results in assets not being replaced until long after optimum point.

Louderback & Hirsch (1982), replacement decisions involve an investigation of new methods of production compared to existing machinery and technology. Managers of offices can choose to restrain current equipment (status quo) or they can opt for new equipment. Of course, if the status quo is to be a viable option, existing equipment must be serviceable. Chasteen, Flaherty & Connor (1998), replacement decisions occur when a firm purchases new equipment that has virtually the same operating capabilities as its predecessor. For example, if the substitution of new machinery for old one with essentially the same characteristics, it is replacement.

3.1 Significance of Replacing of Assets.

Hartman and Scarf (2008), argued that business required equipment in order to function and deliver their output. In the global competitive environment, this equipment is critical to deliver success. However, equipment generally degrades with age and usage, and investment is required to maintain functional performance of equipment. Capital equipment investment projects are typically driven by operating cost control, technical obsolescence, requirements for performance and functionality improvements and safety. That is rational decision making about capital equipment replacement will take account of engineering, economic and safety requirements.

Peter & Timmerhaus (1991) argued that reasons for making replacement decisions can be divided into general classes. First an existing property must be replaced in order to continue operations and meet required demands for production. Examples of this necessary types of equipments include the property is worn out, the property does not have sufficient capacity to meet demand and the property is no longer economically feasible. Second, an existing property is capable of yielding the necessary product, but more efficient equipment is available which can operate with lower expenses.

Langemeier (1998), found that replacement of capital is influenced by many factors such as age, efficiency and reliability of present equipment, repair and timeline of present machines, depreciation allowances, technological advancement, salvage value and size consideration caused by expansion or contractions. Delmare (1985), with high technological equipments such as computers and others becoming more common, the importance of maintenance function has grown increasingly significant and costly.

Charnig (1981), argued that as equipment deteriorates with use or degrades relative to the performance of newer models or improvements in design, there comes a time for operating and maintenance engineer to make decisions regarding replacement or maintenance. When outlays for new equipment is made, financial loss due to the stoppage of operation and cost of teaching new skills should be compensated for in trade off by an increase in productivity and decrease in maintenance and operating costs.

Rown (2006), Replacement or worn out or damaged equipment is necessary if the firm is to continue in business. The only issues here are; (a) should this operation be continued and (b) should we continue to use the same production processes? These projects lower the costs of

labor, materials and other inputs such as electricity by replacing serviceable but less efficient equipment.

Edwards (2008) argued that the following are the reasons for replacing machinery. First, cost maximization. The standard rule for maximizing the long run cost of equipment is to make a change when the annualized total cost of owning and operating the machine begins to increase. Secondly, Reliability besides the standard machinery costs, most operators also consider timelines costs in their replacement decisions. If the machine breaks down at a critical time, timeline costs can be quite high. Timelines costs are very hard to measure. Third is pride of ownership. Many firms take pride in owning and operating new modern machinery. They may be willing to accept higher long run costs in return. Fourth is new technology. In some case a machine may be in perfectly good working order, but the introduction of new technology has made it absolute. Fifth, need for capacity. When the number of units being produced increases significantly, operators may need to replace machinery with models that have high capacity to complete planning. Sixth, the farm machinery markets, The market for farm machinery is subject to changes in supply and demand, just as for any other product. In particular, the demand for both new and used machinery is strongly affected by ups and downs in the farm economy.

.3.2 Asset replacement analysis

Malisky, Guzman & Insulin (2008) at Mining (2008) III international conferences on mining innovation argued that the need to evaluate equipment replacement standards comes from differing and continuously evolving nature of operating environment. For example, it is usually the case that capacity and life span of equipment which is applied in the mine differ significantly

with those suggested by the supplier. The four principle factors affecting equipment replacement standards are as follows:

First is wear and tear. This refers to changes in physical conditions. With the time equipment gets older and it is reasonable to assume that operational efficiency declines as a result of increased routine maintenance and repair costs. In addition fuel often rises as equipment gets older.

Second is changing operational environment. Different types of vehicles are likely to be applied in different segments of the life of a mine. For example, a new high capacity shovel might be required which can only be efficient with subsequent purchase with larger haulage trucks.

Third is Technology. Technological changes may render some older equipment obsolete as well as lead to early replacement of existing machines due to capital cost reduction or revenue increments with new equipment might generate.

Fourth is Finance. Financial factors are important because the purchase of new equipment entails opportunity costs which are separate from day to day operations of said equipment. For example, the purchase of machines has an impact on taxes and budgeting. As a result leasing equipment may be financially preferable to ownership.

Langemeier (1998) proposes three periods of analyzing an asset replacement. First is payback period. It is the required to required to repay the cost of the machine through future or increased earnings directly related to specific machine. It can be calculated by using the formula below,

$$P=O/I$$

Where P equals the payback period in years, O equals the origin investment to acquire the asset, and I equals average annual income after tax.

Second simple rate of return, this done by using the formula below:

$$R = \frac{I - D}{O}$$

Where R equals annual rate of return, I is average annual income after tax before depreciation from investment, D is average annual depreciation for investment and O is the original purchase price.

Despite the vast amount of research in replacement analysis, the explicit consideration of asset utilization is assumed to be constant or predetermined over the life of the asset. Utilization is not a comfortable decision variable in the single asset case as the operating environment defines the periodic utilization levels. For instance, if a single machine is used to meet some service or demand requirement, then the asset operates at the level needed to meet demand in each period. But if multiple assets are used to meet the service or demand requirements, the decision makers has more control, may allocate the workload among the assets and thus determine their respective utilization schedules.

Since the residual value and useful lives of the plant assets are only estimates, it is common for the plant assets to be sold at good prices that differ from their book value at a date. When the plant assets are sold, any gain is computed by comparing the book value with the amount received from the sale. A sales price in excess of book value produces gain, a sales price below the book value produces loss (William et al, 2002)

2.3.3 Replacement planning

Riggs (1970), it is generally valid observation that machine lose value with age. Occasionally, a machine of outstanding craft man ship or one with antiques value becomes more valuable as it gets older ,but most of the tools of production depreciate in value over time.

Depreciation in accounting is an estimate, usually expressed in terms of costs of the amount of services potential of a a depreciable assets which expired in a a given period (Hermanson, Edwards & Salmonson, 1980). It is caused by factors such as physical deterioration, inadequacy for future needs and obsolesces

Physical deterioration results from use, wear, tear and action of elements. Even if a good maintenance and repair policy is in effect, a plant asset will eventually be discarded. If the company grows more rapidly than anticipated, the existing plant assets may become inadequate. In such a case, the company will not be able to meet the demands of its products and services. Obsolesences refers to the process of becoming out of date or absolute. (Riggs, 1970) argued that the development of new and better methods of performing function suddenly makes previous machine design uneconomical. A “breakthrough” in technology is now such a nature happening that obsolesences is major concern with any purchased machine.

Under the influence of these large unpredictable causes of depreciation, it is indeed difficult to estimate machine’s life. Life estimates are needed to evaluate relative attractiveness of new machines alternatively and to plan replacement schedule and taxes (Riggs , 1970)

2.3.4 Choice of investment appraisal techniques

According to the research done by Andrews and Butler (1986), the most popular methods in use in 1982 were the IRR (45.3%), the payback period method (26.5%) and the accounting rate of return (15.4%). The NPV method was only used as a primary evaluation technique by 7.7% of the respondents in that study. Parry and Firer (1990) reported that 43% of their respondents used the IRR as their primary technique. This was followed by return on investment, with a 32% usage. The NPV was only used by 10% of the respondents as their primary method. Recent Research conducted by Hall (2000) found that return on investment was the most popular primary evaluation method used by his respondents, with a 33.8% usage, followed by the IRR and NPV with a 32.3% and 16.9% usage respectively. These findings indicate that, in the past, the methods used in the practice stood in contrast to the generally accepted view that the NPV technique is superior to other capital budgeting methods (Clark, Hindelang & Pritchard 1984:57-72) as cited in Toit and Pienar (2005)

Generally speaking, there are four main capital budgeting techniques the manager may use when valuating an investment project. The Net Present Value (NPV) and Internal Rate of Return (IRR) methods are considered to be discounted cash flow (DCF) methods.

The Payback Period (PB), Average Accounting Rate of Return (AAR) and profitability index methods are so-called non-DCF methods.

Lee (1999), Net Present Value (NPV) method “mgt sets a minimum required rate of return (also called cut off, hurdle rate, or discounted rate), which is used to compute the present value of the cash flows from the proposed project”. Similarly, Horngren, Sundem and Stratton (2002) defined NPV “as discounted cash flow approach to capital budgeting that computes the present

value of all expected future cash flows using a minimum desired rate of return". If the present value is greater than the present value of cash flows, the NPV will be positive and the project will be accepted. If the present value of cash inflows is less than the present value of cash outflows, the NPV will be negative and the project will be rejected.

Awmewe & Ogundele (2008) argued that NPV is used in capital budgeting to analyze the profitability of an investment or project and its sensitive to the reliability of future cash flows that the investment or project will yield. For instance, the NPV compares the value of the dollar today to the value of that same dollar in the future taking inflation and returns into account. The NPV is computed as follows:

T

$$NPV = \sum_{t=1}^T \frac{C_t}{(1+r)^t}$$

Dascher & Strawser (2004), there are some limitations and unstated assumption which in here in the use of net present value. First, it assumes that the cash inflows and cash outflows are known with certainty. Second, there is an implicit assumption that the cost of capital considered at the beginning of the analysis remains constant throughout the life of the project. Thirdly cash flows occurs at equal intervals usually at the end of the year.

The primary advantage of NPV its focus on the timing of the expected future cash flows. Neither the payback period nor the average accounting rate of return distinguished between capital projects based upon the expected timing of the future cash flows.

Internal Rate of Return (IRR), also time adjusted rate of return, is the rate of return that will produce an NPV of zero. It is the discount rate that makes the present value of cash outflows. On the other hand, Ingram, Albright and Hill (2003,P.M388) defined IRR as "the interest rate that results the present value of cash outflows being equal to the present value of cash inflows from an investment.

Dascher & Strawser (2004) argued that the internal rate of return is calculated by determining the set of discount factors that will equate the future cash inflows associated with particular capital investment with future capital outflows associated with that investment. This process is often trial and error, since unequal are common once determined, the internal rate of return compared to a minimum desired rate of return. If the internal rate of return exceeds the desired rate of return, the organization would generally accept the proposed capital investment.

Awomewe & Ogundele (2008), Internal Rate of Return is used to rank several prospective projects a firm is considering .As such the internal rate of return provides a simple hurdle, whereby any project may be avoided if the cost of capital exceeds this rate.IRR is also referred to as economic rate of return (ERR). A simple decision making criteria can accept a project if its internal rate of return exceeds the cost of capital rejected if the IRR is less than the cost of capital. Edmonds, Edmonds and Tsay (2nd Ed), to be accepted, an investment proposal must provide an internal rate of return that is higher than the hurdle rate or desired rate of return.

. limitation of payback period is that this method does not consider cash inflows are actually received by the organization >cash flows are added together year after year as if the investor is indifferent to their timing .Comparing of future cash flows with initial cash flows without

discounting the future sums of their present worth is big weakness of which provides rough estimate of the time required for an organization to recover its capital investment.

Hilton (2001) argued that payback period method of evaluating investment proposals has two serious drawbacks .First the method fails to consider the time value of money. Second it does not consider cash flows beyond the payback period .On the other hand payback period has two advantages .First it is simple screening device for investment proposal .Second young firm may experience a shortage of cash For such a company it may be crucial to select investment projects that recoup their initial investment quickly.

It should be noted that required payback period sets the threshold barrier (hurdle rate) for the project acceptance .it often appears that in many cases that the determination of the required payback period is based on subjective assessments taking into account past experiences and perceived level of project risk. The payback period has shown to be an important, popular, primary and traditional method in the developed nations like the UK and the USA (pike 1985 as cited in Awomewe & Ogundele (2008).

Lakulu (2007), accounting rate of return is an accounting measure representing the ratio of average annual profits after taxes to the average outlay of the investment. Pandey (2004, p.148) defined accounting rate of return method the ratio of the average investment. Hilton (2004,p.755) defined accounting rate of return (ARR) as “average formed by taking a project’s average incremental revenue minus its average incremental expense including depreciation and income tax dividing by the project’s initial investment.”Needless and Crosson (2002), this method measures expected performances using two variables: (1) estimated annual net income from the project (2) average investment cost.

The basic question is:

$$\text{Accounting rate of return} = \frac{\text{Project's average annual net income}}{\text{Average investment cost}}$$

It is widely used because it is easy to understand and apply. It does have several disadvantages.

First because net income is averaged over the life of the investment, it's not a reliable figure. Net annual income may vary considerably from the estimates.

Second, the method is unreliable if estimated annual net income is different from year to year.

Third, cash flows are ignored. Fourth, the value of money is not considered.

Hansen & Mowen (2002) argued that ARR consider the project's profitability; like the payback period, it ignores the time value of money. Ignoring the time value of money is crucial deficiency in this method as well; it can lead a manager to choose investments that do not maximize profit.

Handey (2004, p.148) defined profitability index as "the ratio of the present value of cash inflows, at the required rate of return, to the initial cash outflows of the investment.

Hilton (2004, p.755) defined profitability index as "the ratio that compares the present value of net cash inflows with the present value of net investments." Profitability index is the ratio of the present value of cash inflows to the present value of cash outflows. PI can be computed using the following formula:

$$\text{PI} = \frac{\text{PV of cash inflows}}{\text{Initial cash outlay}}$$

Kakulu (2007,39) argued that "PI gives a quick view of the investment suitability (i.e, is it below or above one), but it may also obscure the information relating to the absolute value of the investment. It may not necessarily be true that PI higher, then the investment is more preferable to the one whose PI lower." Pandey (2004) argued that PI recognizes the time value of money, consistent with the shareholder maximization principles. A project with PI greater than one will have positive NPV and if accepted will increase shareholder's wealth. Finally, since the present value of cash inflows is divided by the initial cash outflow, it is relative measure of project's profitability.

2.4 Critical review

Capital budgeting decisions are essential for two reasons. First assets acquired under capital budgeting decision are used to generate enough profit for the firm. For instance generators are bought to give power to manufacturing equipments which in turns helps the firm meet the demand and order of its customers. Second, capital budgeting decisions would make the firm suffer and vice –versa.

It is common behaviors by the department' in organizations to come up with proposals regarding investments such as acquiring of long term assets and others that may not contribute to the profitability of their respective firms. Also they campaign for their proposals to be approved at any costs. Such behavior can be regarded as self interest and lead the firm to take decisions that do not contribute to the attainment of organizational goals and objectives.

From the researcher point of view, such behaviors can be eliminated by ignoring the degree of the pressures of the campaigner. Simply is to compare the costs associated with the project and the benefits (both financial and non financial) from that project. It is common for the organizations

to consider only financial issues such cost and revenue. Projects with highest benefits relative to the costs are accepted. In some cases, it is found that top managers may approve a project that can cause harm to the lives of workers or any other problems.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

The purpose of this chapter was to present the methodological process of the study. It outlined research design, target population and sample size, research instruments used in data collection, research procedures and ethical considerations in the research process.

3.2 Research Design

The study was conducted through cross-sectional survey design. Cross sectional survey design examines several groups of people at one time (Salkind, 2000). Cross sectional survey was particularly chosen because it enabled the researcher to study the experience of different manufacturing firms on assessing the effect of capital budgeting decisions which are common in all manufacturing firms because they heavily rely on property, plant and equipment in the production and delivery of goods to its customers.

3.3 Target Population

The study primarily focused on manufacturing firms in Hargeisa, Somalia. The fact is that manufacturing firms are more likely to invest in property, plant and equipment compared to those in service industries. Data was acquired from eight selected companies within manufacturing industries as shown in the table below.

Table 3.1: Targeted companies

No.	Company name	Number of workers in each company
1	Aafi Bottling co.	20
2	Dalsan	20
3	Zamzam water purification	20
4	Coca-cola company	20
5	Tango Bottling co	20
6	Jariiban sweet ltd	20
7	Ceegaag furniture co	20
8	Ali abokor group of industries	20
Total		160

Source: Primary data

3.4 Sampling Design and Procedure

The study employed purposive sampling technique. According to Amin (2005), “purposive sampling is the type of sampling where the researcher used her own judgment or common sense regarding participant from which the information was collected.” The researcher developed a list sample of eight manufacturing firms based on her own experience of knowledge of the group she sampled and had in mind that these respondents had the information she required. Then, the researcher distributed the questionnaire to finance managers of those companies on the list.

This method of sampling was chosen because it made the study convenient. The researcher selected companies that are known by the researcher and easy to reach. There are many manufacturing firms who operate in Hargeisa with differing operational and financial capacity.

Such differences bring difference on the level of investment in capital items and making capital budgeting decisions. Such methods helped the researcher select the manufacturing firms that the researcher thought they invested a lot in capital budgeting decisions to the profitability and capable of providing the needed information of the problem in question.

3.5 Sample Size:

The total population of this study was 160 and according to Sloven's formula, the sample size of this study was 114. In slovin's formula, $n = \frac{N}{1 + N(e)^2}$ where: n = number of samples, N = total population, and e = margin of error, 5% = 0.05 (Mugenda, 2003).

$$n = \frac{N}{1 + N(e)^2}$$

N= total population

n=number of samples.

e=margin of error.

$$n = \frac{160}{1 + 160(0.05)^2}$$

$$n = \frac{160}{1 + 160(0.0025)}$$

$$n = \frac{160}{1 + 0.4}$$

$$\frac{160}{1.4}$$

$$n = 114$$

3.5 Data Collection Instruments

A questionnaire was designed and administered to a sample of eight manufacturing companies in Hargeisa, Somalia. The instrument comprised of 12 questions that include both closed and open ended questions, replacement, profitability measures were used and the relationship between capital budgeting decisions and profitability in their respective firms.

This method was used because most managers were busy in their duties and the tool gave them ample time from them to fill the questionnaire at their free time and also allowed consistency and uniformity throughout the collection process. Mitchel and Jolley (2004), self administered questionnaire is easily distributed to large number of people. Second, self administered questionnaire often allows anonymity.

In addition to this, it also helped managers express their experience towards the relationship between capital budgeting decisions and profitability in their respective firms. It also helped the researcher to save his time in data collection.

3.5.1 Data Collection Procedure

After the research proposal was approved, the researcher passed administrative process to obtain introduction letter from academic authorities the permission to collect the research within the selected manufacturing companies. The researcher distributed the questionnaires with attached letter of introduction from the university to the selected manufacturing companies. After receiving the questionnaire back, the researcher analyzed the collected data by using SPSS package.

3.5.2 Validity and Reliability

The reliability of the research instruments was concerned with the extent to which the research instrument yields the same results. Questionnaire were pre-tested to two participants before being taken to the field to be field by different respondents. A structured and self administered questionnaire was used throughout the research and ensured that respondents fill the same questionnaire and the instrument provided the required information. Validity is the quality of the test doing what was designed to do (Salkind, 2000); where reliability consists of both true score and error score.

3.5.3 Ethical Consideration

The study was carried out with permission and the full knowledge of the managers of the selected manufacturing firms. No respondent's name is mentioned in this report. There was need for the researcher to use professional and ethical standards to plan, collect and process data. The researcher ensured that she uses the objective methods in data collection. The researcher made sure that any elements of individual bias are subdued in favor of well-systematic and objective measures.

The methodology chosen for the research was selected on the basis of research objectives and not for other reasons. The researcher ensured that she recognized the boundaries of her competence in selection of methodology and the researcher also made sure that she used only those techniques for which she is qualified by her education training and experience.

Finally, the researcher made sure that she collected data according to accepted research standards, ensuring that she did not mislead those who read the research report. The researcher kept all the information given to her very confidential and used only for academic purpose.

3.6 Data Analysis

After the questionnaires were filled by the respondents, the researcher used SPSS (Statistical Package for Social Science) to process and analyze data using descriptive statistics. The data was manually entered and stored in SPSS worksheet and by the advantage of statistical tests; information was generated through graphical presentations.

CHAPTER FOUR

PRESENTATION, INTERPRETATION AND ANALYSIS OF DATA

4.1 Introduction

The researcher used SPSS method of data analysis and presentations. The data was presented in tabular form. The data analysis and interpretation was based on the findings of the researcher which was also based on the research questions as well as research objectives. Below are the data presentations and analysis of research findings.

4.2 The gender of the respondents

Table 4.1 shows the gender characteristics of the respondents.

Response	Frequency	Percentage
<i>Male</i>	62	54
<i>Female</i>	52	46
Total	114	100

Source: field data.

From the findings shown in table 4.1 above clearly indicates the first demographic characteristic of the respondents' sex differences. It shows that the respondents were divided into 62(54%) male and 52(46%) female. There was a slight difference between the sex of the respondents imply because the researcher wanted to ensure gender balance.

4.3 The age of the respondents

Table 4.2 represents the age of the respondents

Age	Frequency	Percentage
25-30	55	48
31-45	42	37
46 and above	17	15
Total	114	100

From the above table 48% of the respondents are at the age of 25-30; 37 % of the respondents are at the age of 31-45 and the rest are more than 46. This indicates varying expertise and experience in working with organizations.

4.3 The marital status of the respondents

Table 4.4 represents the marital status of the respondents

Response	Frequency	Percentage
Single	65	57
Married	35	31
Others	14	12
Total	114	100

Based on the above table, it is evident that 57% of the respondents are single, 31 are married and 12% are not defined. This implies that companies employ individuals of different marital statuses including the single, married, widowed and divorced among others.

4.4 The education qualification of the respondents

4.5 Represent the Education qualification of the respondents

Response	Frequency	Percentage
Secondary	45	39
Bachelors	65	57
Masters	4	4
Total	114	100

Source: Field Data

From the above table, 39 % of the respondents are from secondary schools, 57% have bachelor's degree and 4 % have master's degrees. These individuals with different levels of education operate at different levels in the respective companies.

4.5 Capital equipment acquisition decisions have a relation to the firm's profitability?

Table 4.6 Responses on whether acquisition decisions effects the profitability of the firm

Response	Frequency	Percentage
Yes	76	67
No	38	33
Total	114	100

Source: field data

Based on the above table it is shown that acquisition of long term assets affect the profitability of the firm. Sixty seven percent (67%) of the respondents indicated that acquiring of long term assets effect the profitability of the firm while 33% of the respondents have shown that acquiring of long term assets have no effect on the profitability of the firm.

4.6 If your answer is yes, what effect(s) do these acquisition decisions have in the firm' profitability

Table 4.7. Responses on the effect of acquisition decisions on the profitability.

Responses	Frequency	Percentage
Effect of increased acquiring	69	61
Effect Decreased	45	39
Total	114	100

From the above table, 61% of the Respondents have shown that decisions such as acquisitions of new capital equipment effect on the firm's profitability by increasing operating profits, sales and earnings per share. Thirty nine percent (39%) of the Respondents showed that such decisions have no effect on the profitability of the firm. Eighteen point eight percent indicated that through decreasing production costs. The new machine increases the sales through increasing production capacity of the firm which helps the firm to meet demand. Therefore, as far as the firm reduces production costs and increases capacity, the firm would generate profits .It is common that the new machine may consume less fuel and can produce less wastage material compared to old one.

Based on the findings, it is evident that firms purchase new capital equipments to reduce production costs such as material costs, wages and machine overhead costs. Finns usually experience this for new machines. They use the material economically to reduce wastage

compared to the old one. New machines also reduce repair and maintenance costs incurred when the machines breakdown.

4.7 Capital equipment acquisition has enhanced the capacity of the firm to meet the demand which in turns helps the firm generate a maximum profit.

Table 4.8 responses on whether a capital acquisition decision enhances capacity.

Response	Frequency	Percentage
Agree	44	39
Strongly agree	26	23
Disagree	24	21
Strongly disagree	20	17
Total	114	100

From the above table, 39% of the Respondents have strongly agreed that capital equipment acquisitions enhance the capacity of the firm to meet order in the market. This is often why a firm purchases new machines because the new ones would be able to produce more outputs than the current machines. On the other hand, the firm may purchase extra machines to meet the demand. Most of the acquisition decisions concern about capacity expansion. When the company is able to meet demand it is able to generate maximum profits through the sale of the goods to the customers.

4.8 Have you ever had minimum standards of profitability or returns on investment for capital budgeting decisions in your firm?

Table 4. 9 responses on whether respondents have minimum standards of returns for capital budgeting decisions

Response	Frequency	Percentage
Yes	40	35
No	74	65
Total	114	100

Source: field data

From the above table 35% of the respondents have shown that they had minimum standards of profitability that capital project must meet before taking the decisions. They are determined by required rate of return. These or standards of returns profitability are set before the decisions are made and used as a basis on evaluating and selecting one project among different competing projects. Such standards are the targeted profit that the firm must achieve from that investment in capital items such as the acquisitions or replacement decisions.

4.9 If your answer is yes, have you been able to realize or meet these minimum standards of profitability?

Table 4.10 responses on whether the respondents realized these minimum standards of profitability

Response	Frequency	Percentage
Yes	36	32
No	78	68
Total	114	100

Source: field data

From the above table, 32% of the respondents have shown that they realize the minimum standard of profitability set before the project is approved. 68% of the respondents have shown that they did not realize the minimum standards of profitability set before the project. This indicates that after project is implemented, the rate of returns may exceed or less than the required rate of return.

4.10 Replacement decisions of capital equipment have effect on the profitability of the firm?

Table 4.11 responses on whether replacement decisions have effect on the profitability

Response	Frequency	Percentage
Yes	40	35
No	74	65
Total	114	100

Source: field data

Based on the findings obtained, 35 % of the respondents have shown that replacement decisions have effect on the profitability of the firm. Sixty five percent (65 %) of the respondent demonstrated that replacing of long term assets has no effect on the profitability of the firm.

4.11 Effect of replacement on the profitability of the firm

Table 4.12 responses on the effect of replacing on the profitability

Responses	Frequency	Percentage
Effect of Increased replacing	66	58
No effect Decreased	48	42
Total	114	100

Based on the above table, 58 % of the respondents have shown that replacement decisions have effects on the firm’s profitability by decreasing material costs, wage costs, machine overheads and wastage or scrap units. In other words, it reduces material cost, labor costs, and machine overhead and wastage products.

It reduces the wastage units, scrap materials and fuel consumption. It is a common phenomenon that when machines get older they are likely to produce scrap finished goods, waste a lot of material during the production and impose additional costs on repair and maintenance. Old machines take long term hours to produce a predetermined output and process becomes very slow.

They consume more fuel and require constant maintenance services. Therefore, at this time, production employees devote extra hours on dealing with breakdown and maintenance activities.

Forty two of the respondents have shown that replacing of long term assets can increase capacity. This implies that if an old machine is replaced by a new one that is technologically more advanced

one, the new one can produce more output units compared to the old one. This involves capacity enhancement.

4.12 Which of the following reasons does you replaces machinery

Table 4.13 responses on reasons for replacing long term assets

	Frequency	Percentage
Cost minimization	38	33
Need for capacity	35	31
New technology	24	21
Others	17	15
Total	114	100

From the above table, 33% of the respondent have shown that they replace the long term assets to minimize costs; 31% of the respondents have shown that reasons behind replacing of long term assets is due to technological changes and 21% of them they replace machine for the purpose of increasing capacity of the firm to produce more output compared to the replaced machinery while 15% had divergent views.

4.13 Do investment appraisal techniques have effect on the profitability?

Table 4.14 Responses on whether investment appraisal techniques have effect on the profitability

Response	Frequency	Percentage
Yes	81	71
NO	33	29
Total	114	100

Source: field data

From the above table, it indicates that 71 % of the respondents demonstrated that choice of investment appraisal techniques have no effect on the profitability of the firm. Twenty nine percent (29 %) of the respondents have shown investment appraisal techniques affect the profitability of the firms.

4.14 Which of the following techniques do you use in selecting different projects?

Table 4.15 shows responses on different investment appraisal techniques

Response	Frequency	Percentage
Payback period	77	68
Net present value	37	32
Total	114	100

Source field data

From the above table, 68 % of the respondents reported that they use payback period method in evaluating competing investment alternatives. Twenty five percent (32%) have shown that they use net present value (NPV) to evaluate and rank different competing investment alternatives.

4.15 Refer to question (15), state the reasons for selecting a particular techniques.

Table 4.17 shows responses on reasons for selecting an investment appraisal techniques

Responses	Frequency	Percentage
Valid Simplicity	54	47
Recovery of original Investment	60	53
Total	9	100

Source: field data

From the above table, 47% of the respondents reasoned out the use of payback period method because of its simplicity. Simplicity is the one of the advantages of payback period method because it does not involve much complex calculations. Fifty three percent (53%) of the respondents have shown that they use payback period for its consideration of the recovery of the original (initial investment). The major reason supporting this idea can be traced to the fact that the payback period is simple and has effective communication. Small companies are also more interested in the immediate cash flow because they often lack the requirements to be able to source for funds.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the discussion of the findings, conclusions and recommendations for further studies in the future.

5.2. Summary of the findings

5.2. 1 Effect of acquiring long term assets on profitability

Based on the analysis of the findings, majority of the respondents reported that acquiring of long term assets affects the profitability of the firm. Therefore, the finding is in line with Halpin and Woodhead (1980) conclusions that decisions regarding equipment type and combination can have a major impact on the profitability of a job.

In this respect, the manager's object is to select the equipment combination that yields maximum production at the best or most reasonable price. Managers must be able to understand costs associated with a particular piece of equipment. Edwards (2008), Costs related to the machinery line clearly had a large effect on whether farms were high or low profit procedures.

The fact is that a firm purchases a new machine that is able to produce more goods. This helps a firm to meet its demand which causes an increase of sales of the firm. On the other hand, it reduces production costs such as direct material, direct labor and factory overhead (machine costs). New long term assets often reduce wastage of material that would be part of costs if they are committed. Also new machines are likely to reduce time of employee's productions during breakdown and maintenance of production facilities.

5.2 .2 Effect of replacing of long term assets on profitability

Based on the analysis of the findings, most of the respondents reported that replacing of long term assets affects the profitability of their respective firms by describing that replacements of

assets lowers labor costs, material and machine overhead. The finding is in line with Brown (2006); these projects lower the costs of labor, materials, and other inputs such as electricity by replacing serviceable but less efficient equipment. Norgaard (1985) argued that replacement decisions effects the net income of the firm. He illustrated the example by using accounting rate of return and accounting number to calculate the effect of replacement decisions on the net income. He concluded by saying replacement decisions would cause an increase in the net income in all six years.

Kakuru (2007) argued that if an old production facility is not replaced, it causes production costs to increase. Idle time has to be paid for when the assets breaks down. When scrap is produced owing to malfunction assets, losses are made. These costs greatly increase the total cost of production.

5.2.3 Effect of choice of investment appraisal techniques on profitability

In the survey carried out in the study showed that majority of respondent firms that they use payback period (PB). In addition to this, majority of the respondents have shown that the choice of specific investment appraisal techniques have no effect on the profitability of the firm. The finding conforms to other studies.

Other studies examine the effect of the decision rule used on firm performance, for example, Clammer (1973) found no significant association between capital budgeting techniques and performance.

Similarly, Mooi and Mustapha (2001) found that the results of the regression analysis and t-test show that DOSCB (degree of sophistication of capital budgeting practices) does not significantly affect firm performance, measured by ROA and BPS. Theoretically, the use of sophisticated capital budgeting process should increase the effectiveness of the firms' investments decision making.

Although academic literature has long argued that discounted cash flows methods are superior to other capital budgeting rules, these methods have only fairly recently come into widespread use. So a number of researchers in finance and accounting have examined corporate budgeting practices. Many of these articles survey corporate managers and report frequency with which

various evaluation methods , such as payback period, internal rate of return(IRR), net present value (NPV), discounted payback, profitability index and average rate of return.

5.3 Conclusion

In this study, majority of the respondents have that they use payback period in evaluation capital projects. In spite of its critics; it is commonly used for appraisals of capital investments. The simplicity of the payback period outweighs this method to other methods and it is often used as a screening device in which the obvious cases of profitable and unprofitable investments are sorted out. The study explored the aim of collecting data on the relationship between capital budgeting decisions and profitability in manufacturing firms in Hargeisa, Somalia by using self administered questionnaire. Managers usually involve making capital budgeting decisions such as acquisition of new capital equipment and replacement of an old machine with one that operates more efficient to produce. The researcher had asked about the relation of such capital budgeting decisions (acquisitions and replacement) to the profitability in a manufacturing firm. This can be drawn based on the finding which is in conformity with research objectives and questions. Despite any other factors, the results obtained in this study showed that capital budgeting decisions affects profitability in manufacturing firms as also literature suggested that effect. According to Pandey (2004) and Lesile (1977), capital budgeting decisions are of considerable importance to the firm since they tend to determine its value by influencing its growth, profitability, risk and its survival. Edmonds, et al (2003) states capital expenditures have long term effect on the profitability, they usually involve major cash outflows that are recovered through cash inflows. Capital budgeting decisions are among the most important made. Upon them rest the firm's long term profitability, and even its survival.

5.4 Recommendation

- 1. Manufacturing firms should acquire long term assets as it was found that they help improve on firm’s profitability in both short and long term.
- 2. Firms should replace assets which will acquire profits to the business without encroach on the initial investment of the firm.
- 3. Manufacturing firms should always encourage employee appraisal using both non pecuniary and pecuniary advantages to help motivate their workers, as this will figure firms profitability.
- 4. Business firms should always refer to the decision techniques such as Net present value, internal rate of return, payback period and accounting rate of return among others in order to stay long in operation.

5.5 Suggestions for further Studies

On the basis of the knowledge that I gained during the research period, I would suggest the following further studies to be conducted which seem very important in the field of capital budgeting decisions and it may help users enhance the performance of their respective firms;

- 1. The impact of the challenges of capital decisions on financial performance in manufacturing firms
- 2. The significance of budgeting in the resources allocation of the firms.

5.6 Limitations of the study

Because of the sensitivity off the topic of the study to the respondent, it took time for the researcher to convince every single respondent to fill the questionnaire and to provide valuable comments on the open ended questions. In addition to this, respondents (finance managers) are so busy on handling financial issues.

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APPENDIX A: RESEARCH INSTRUMENTS

i. Questionnaire

Instructions:

Please use check mark to answer the following questions about your firm's capital budgeting decisions. It is recognized that this means providing simple answers to complex questions. Please base your answers on the capital budgeting decisions taken in the firm. Please feel free to make additional comments on your answer to any or all questions. The information collected will be used only for academic purpose.

Section one introductory questions

Name:

Position:

Company name:

Age:

A) 25-35 ☐ b) 35-45 ☐ c) more than 45 ☐

Marital status

a) Single ☐ b) married ☐ C) others ☐

Educational level

a) Secondary ☐ b) bachelor ☐ c) masters ☐

Section two acquiring of long term assets

1. Capital equipment acquisition decisions have a relation to the firm’s profitability?

Yes ☐

No ☐

2. To your answer is yes, what effect(s) do these acquisition decisions have on the firm’

Profitability:

	Increased	No effect	Decreased
Operating profit			
Production costs			
Sales			
Earning per share			

3. Capital equipment acquisition has enhanced the capacity of the firm to meet the demand which
n turns helps the firm generate a maximum profit

Agree ☐ Strongly agree ☐

Disagree ☐ Strongly disagree ☐

4. Have you ever had minimum standards of profitability or returns on investment for capital budgeting decisions in your firm? (e.g. Did you require that expected profit or cash flow from the investment equal or exceed some standards of profitability before the capital budgeting decision is taken)

a. Yes ☐

b. No ☐

5. If your answer is yes, have you been able to realize or meet these minimum standards of profitability? State how often have you been able to realize this standards

6. Refer to question five, what was the percentage of return on investment realized from these capital budgeting decisions? Please state in percentage

7. Replacement decisions of capital equipment have effect on the profitability of the firm?

Yes ☐

No ☐

8. If your answer to (4) is yes, in subsequent years, what effect(s) did the replacement decisions had on the firm? For further comments you can write under the table

Material costs ☐

Wages costs ☐

Machine overhead ☐

Capacity ☐

Wastage or scrap units ☐

9. Which of the following reasons do you replace machinery

a. Cost minimization ☐

b. Need for capacity ☐

c. New technology ☐

d. Others, specify ☐

Increased No effect Decreased ☐

Section three: choice of investment appraisal techniques

10. Do investment appraisal techniques have effect on the profitability?

i) Yes ☐ No ☐

11. Which of the following techniques do you use in selecting different projects?

i. Net present value ☐

ii. Internal rate of return ☐

- c. Payback period ☐
- d. Accounting rate of return ☐
- e. Profitability index ☐

12. Refer to question (15), state the reasons for selecting a particular technique

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ii. INTERVIEW GUIDE

- 1. Have you ever had minimum standards of profitability or returns on investment for capital budgeting decisions in your firm?
- 2. Have you been able to realize or meet these minimum standards of profitability?
- 3. Do investment appraisal techniques have effect on the profitability?
- 4. Which of the following techniques do you use in selecting different projects?
- 5. Which of the following reasons does you replaces machinery
- 6. Effect of replacement on the profitability of the firm

APPENDIX B: TIME FRAME

TIME FRAME	
Period	Activity
October to November	Proposal writing
November to December	Data allocation and compilation
December	Handing of the Dissertation

APPENDIX C: BUDGET

BUDGET FRAME WORK	
Activity	Amount(Ush)
Stationery	60,000
Questionnaire administration	400,000
Transport	800,000
Typing and printing	70,000
Miscellaneous	60,000
Total	1,390,000