



The Relationship Between Financial Goals of SMES and Investment Decisions

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Abstract

There are a number of reasons which can guide Small and Medium Enterprises (SMEs) in making investment decisions. The aim of this paper is to contribute to the understanding of the relationship between financial goals of SMEs and investment decisions in Tanzania. This study used a cross-sectional design and the method of the study was the survey. Purposive sampling was used to collect data to a sample of 301 SMEs drawn from SIDO in Dar es Salaam and Dodoma regions. Questionnaires and personal interviews were used to collect data. Multiple regression analysis was used to investigate the relationship between investment decisions is simultaneously influenced by the financial goals of SMEs and who makes investment decisions. The findings suggest that the financial goals of SMEs do influence investment decisions. However, who makes investment decisions do not have influence on investment decisions of the SMEs.

Keywords: Relationship, Financial Goals, SMEs, Investment Decisions

Introduction

It is known all over the world that the SMEs play a major role in social economy development (URT, 2003). In Tanzania, the SMEs nomenclature is used to mean micro, small and medium enterprises in non-farming activities, which include manufacturing, mining, commerce and services (URT, 2003). These SMEs contribute significantly to employment creation, income generation and stimulation of growth in both urban and rural areas. It is estimated that about a third of the GDP in Tanzania originates from the SME sector (URT, 2003). According to the ten years implementation review of the Small and Medium Enterprises Development Policy-SMEDP (UNDP, 2012), it is estimated that there are 3 million SMEs employing 5.2 million people of which 45% of SMEs are located in urban and the remainder in rural areas.

Despite their importance in the economy of the country, these SMEs face problems which inhibit their growth and success. For example studies conducted by Omar (2008); Isaga (2012); Maziku (2012) indicated that access to finance is a major problem for SMEs in Tanzania. The SMEDP revealed that among the unique problems facing SMEs is limited access to finance (URT, 2003). Also it might be possible that if owners do not know how to make investment decisions and the link thereof between the financial goals and investment decisions, even if they are given sufficient capital, businesses may continue having problems. So, besides the problems of SMEs as highlighted above, there might be other problems including variability of the financial goal of investment decisions from shareholder wealth maximization to other goals when making investment decisions.

Investment decisions is the firm's decision to invest its current funds most efficiently in the long-term assets in anticipation of an expected flow of benefits over a series of years (Pandey, 1976). In other words investment decisions can be described as a process by which the businesses determine how to invest their capital (Srivastava & Misra, 2008). This process can include decisions to invest in new projects, expand a business, modernization or replacement of long-term assets.

It is generally agreed that the financial goal of the business should be wealth maximization (Pandey, 1979; Pinches, 1987; Oladipupo & Okafor, 2011). The investment decision theory prescribes rules in keeping with this objective of shareholder wealth maximization (Mao, 1970; Mukherjee & Henderson, 1987). Therefore, it is expected that all businesses activities are geared towards achieving this objective and apply this theory on evaluation of investments which are compatible with the objective to maximize the wealth of its shareholders.

However, several previous studies on investment decisions indicated a gap between theory and practice. For example, Danielson and Scott (2006); Uddin and Chowdhury (2009) observed that small businesses operate in environments that do not satisfy the assumptions underlying the theory of investment decisions, that is, many investments cannot easily be evaluated using discounted cash flow methods due to difficulty to estimate future cash flows and market determined discount rate. On the other hand, Vos and Vos (2000) argued that, the small businesses may have varied objectives which may not be wealth maximization. This variation has implications to the rest of criteria for evaluation of investments. McLaney(1991) observed that the choice of investment appraisal methods can quite logically be seen as evidence of financial objective which firms are following. This is because, when making investment decisions, firms are frequently making judgments which will have the most profound effects on their future welfare and success (McLaney, 1991)

The above studies have emphasized much on the quantitative criteria in evaluating investments. Although this is important, these studies have overlooked an important aspect in the investment decision process that is, consideration of other financial goals of SMEs. This study aims to add value to the earlier studies by extending the scope of the investment decision process beyond the quantitative evaluation techniques only, by incorporation of the real financial goals of SMEs when making investment decisions.

Financial Goals of SMEs

When owners want to invest, they are supposed to select investments that maximize the net worth of the business. Mao (1970) pointed out that the theory of optimal investment decisions is premised on the existence of an objective function which the firm maximizes. Also

Mukherjee and Henderson (1987) concurred with Mao (1970) on the theory of capital budgeting, that it is assumed that the management's primary goal is to maximize the wealth of the firm's shareholders. Capital budgeting theory prescribes the rules in order to be consistent with the objective. However, Vos and Vos (2000) argued that, the method for evaluating investment opportunities employed by a firm should be a direct reflection of the goals of decision maker such as maximization of shareholders wealth.

However, it has been observed that, the shareholder wealth maximization cannot be the only goal pursued by businesses (Findlay and Whitmore, 1974; Keasey & Watson, 1993; Oladipupo and Okafor, 2011). The above observation is in line with what has been pointed out by MacMahon *et al* (1993) in Vos & Vos (2000), that there are three important things regarding the objective function of the small business: (i) owner-managers of small enterprises are unlikely to have a single overriding aim in establishing and running their own businesses. Their intentions are numerous and complex. (ii) Many of the motives owner-managers have for being in small business and also the satisfaction they derive from this occupation, are unequivocally non-financial. (iii) Owners managers of small firms have considerable freedom to indulge their many and varied objectives, be financially or otherwise. Hence, the variation from the shareholder wealth maximization has implications for the rest of the criteria of maximizing shareholders wealth including the methods used to evaluate investment decisions.

It is argued that, although the goal of the business is supposed to be shareholders wealth maximization, the agents with effective control over investment decisions may not perceive it to be in their interests to use the DCF approaches to investment decisions (Keasey & Watson, 1993). Instead the objectives of the managers may lead the investment decisions of the firm (McLaney, 1991; Danielson & Scott 2007).

Theory of Investment Decisions

The theory of investment could be based on the neoclassical theory of optimal capital accumulation (Jorgenson, 1967). The neoclassical theory is based on the assumption of profit-maximizing behavior by firms (Samuel, 1996). The neoclassical theory is based on the assumption that the management seeks to maximize the present net worth of the firm. Hence, an investment project should be undertaken if and only if it increased the value of the shares (Tobin and Brainard, 1968 as quoted by Yoshikawa, 1980). Danielson and Scott (2006) put it clear that, the firms will make set of investments decisions that will maximize shareholders wealth. Hence, the rule is invest in all positive net present value projects and reject those with a negative net present value.

The neoclassical model of optimal capital accumulation may be derived by maximizing present value of the firm, by maximizing the integral of discounted profits of the firm, or simply by maximizing profit at each point of time (Jorgenson, 1967; Eklund, 2013). There are two assumptions regarding the theory of investment decisions as highlighted by Danielson and Scott (2006): first, the primary goal of a firm's shareholder is to maximize firm value; second, a firm has access to perfect financial markets allowing it to finance all value enhancing projects.

A number of investment criteria can be used by businesses when making investment decisions. These criteria may be grouped into two; Discounted cash flow criteria and Non-discounted cash flow criteria (Pandey, 1976). Under the discounted cash flow criteria there are three methods: Net Present Value (NPV), Internal Rate of Return (IRR), Modified Internal Rate of Return (MIRR), and Profitability Index. While under the discounted cash flow methods there

are three methods as follows; Pay Back (PB), Discounted Payback, and Accounting Rate of Return (ARR).

Agency Theory

This theory discusses the agency relationships in a firm. Jensen and Meckling (1976) define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. It is further argued by Jensen and Meckling (1976) that if both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. This idea is supported by Kalyebara and Islam (2014) who observed that Agency theory is brought about by managers maximizing their own wealth at the expense of shareholders' wealth through excessive self remuneration: making decisions that focus on short-term performance rather than long-term growth (capital budgeting), and avoiding long-term risky projects, thus increasing agency costs and impacting on investment appraisal decisions.

Small Business and Investment Evaluation Techniques

There are various techniques which can be used to evaluate investments as indicated in the finance literature. The methods are grouped into two: discounted cash flow methods and non-discounted cash flow methods (Pandey, 1979). In order to maximize wealth of shareholders businesses are required to use discounted cash flow methods (Mukherjee & Henderson, 1987). However, several studies indicated wide use of non-discounted cash flow methods, naming few of them: ((Mukherjee & Henderson, 1987; Graham & Harvey, 2001; Vos and Vos, 2000; Danielson & Scott, 2006; Khakasa, 2009; John, 2007; Kipesha, 2009; Olawale et al, 2008; Brijal & Quesada, 2009; Awomewe, 2008).

Several reasons have been pointed out as to why businesses continue to use the non-recommended investment evaluation techniques to be: difficulty to estimate future cash flows and market determined discount rate (Danielson and Scott, 2006; Kaijage, 1992), variation of goals from shareholder wealth maximization (Vos & Vos, 2000), assumptions of the theory that investment decisions are solely on economic analysis (Mukherjee and Henderson, 1987), lack of business experience and training (Vos & Vos, 2000), size, availability of capital, and nature of decision makers (Uddin & Chowdhury, 2009).

From the literature review, it is clear that the financial goal of SMEs should be maximization of shareholders wealth. It has been also revealed that the method for evaluating investment opportunities should be a direct reflection of the goals of owners of small SMEs. However, owners may pursue different goals from shareholders wealth maximization, and there can be agency conflicts arising from managers pursuing different goals from shareholders wealth maximization. Therefore this study aimed to test the influence of financial goals of SMEs and who make investment decisions to investment decisions.

Methodology and Results

This study was conducted in Tanzania, and two regions Dar es Salaam and Dodoma, were chosen having high population of SMEs as indicated from SIDO Directory. A non- probability

sampling method known as purposive sampling was used to get a sample of 301 respondents which met the following criteria: the SMEs employing from 5 up to 99 people or capital investment of from 5 up to 800 million shillings, the SMEs which is in the manufacturing, service and distribution sectors of business, and involved in local business, the contact respondent be limited to- the owner, manager, or finance manager. In this study, the term SMEs is used interchangeably with small business to describe small and medium-sized enterprises. In Tanzania, a micro enterprise is defined as a firm with fewer than five employees, whereas a small firm is a firm with 5 to 49 employees and a medium-sized enterprise is a firm with 50 to 99 employees (see table 1).

Table 1: Categories of SMEs in Tanzania

Category	Employees	Capital investment in machinery (Tsh)
Micro	1 - 4	Up to 5 million.
Small enterprise	5 - 49	Above 5 million to 200 million
Medium enterprise	50 - 99	Above 200 million to 800 million

Data for this study were collected using the questionnaire and personal interviews: A developed questionnaire was pre- tested to 15 SMEs in Dar es Salaam selected from the targeted sampled frame. Based on the results from the pre- tested small businesses, the questionnaires was modified and rectified to validate the proposed questions and study. Respondents were supplied with written questionnaire to fill in data and necessary information regarding the study. The personal interview method was appropriate for collecting data from SMEs owners. This method was useful for questions that required probing to obtain adequate information (Walliman, 2011).

Data analysis involved two phases namely; descriptive analysis and inferential analysis. Descriptive analysis involved construction of statistical distribution and calculation of simple measures like averages and percentages for describing the features of the research aggregate. Inferential analysis on the other hand was concerned with drawing inferences and conclusions from the findings of the study. The categorized, tabulated data and evidence from the study were combined to address the research problem and then interpretation was done to analyse the data.

This study used purposive sampling technique to select a sample of SMEs from SIDO in DSM and Dodoma regions. A sample of 301 SMEs was used, and detailed descriptions of this sample are as explained below:-

The following is a summary of the characteristics of SMEs in this study which includes: type of the industry of the business, business sales growth, establishment of the business, and the number of employees in the business. It is indicated that most small businesses are in manufacturing activities (44.5%), and are sole proprietors (60.5%), and reports a higher sales growth (48.2%) in the past two years. However, these SMEs are young in terms of age, from one to five years (45.8%), and number of employees from one to five employees (64.5%).

Characteristics of SMEs owners which include: gender, marital status, position in the business, level of education, level of finance education, and age are summarized as follows: it is indicated that most SMEs are dominated by female (51.8%), and most respondents are owners of the business (75.1%). As far as formal and finance education is concerned, most SMEs owners

do not have degrees (39.9%). These SMEs most of them are run by owners who are less than 54 years of age (84.6%).

In summary, after conducting the survey and data analysis, this study has provided an insight into the financial goals of SMEs with empirical evidence. Descriptive findings of financial goals of SMEs are summarized as follows: - first, to most SMEs, the financial goal is maximization of growth in sales (31.6%). Second, to majority of SMEs, investment decisions are done by owners (65.1%).

Table 2 reports the frequency of using investment evaluation techniques. Results show that the technique which is always been used by SMEs is gut feel (60.3%), the second used method is ARR (22.5%), followed by payback period (17.3%), and lastly is DCF (8.8%).

Table 2: Frequency of using investment evaluation techniques

Investment evaluation technique	Always	Often	Sometimes	Rarely	Never	Total
Payback period	41 (17.3%)	83(35.0%)	19(8.0%)	23(9.7%)	71(30.0%)	237(100%)
ARR	53(22.5%)	45(19.1%)	23(9.7%)	20(8.5%)	95(40.3%)	236(100%)
DCF	20(8.8%)	33(14.5%)	25(11.0%)	47(20.7%)	102(44.9%)	227(100%)
Gut feel	138(60.3%)	43(18.8%)	10(4.4%)	12(5.2%)	26(11.4%)	229(100%)

In this study, investment decisions was measured by the investment criteria used to decide an investment (as addressed by the frequency of using investment evaluation techniques) is associated with the financial goals of SMEs, In order to analyse how a dependent variable is related to each of the independent variable, multiple regression was used. Before carrying out the analysis, bivariate analysis was conducted to test the relationship between variables. In this study two methods were used to test this association: the Chi-square test of independence was used to test the association between the type of investment evaluation technique and objectives of SMEs, while correlation coefficients were determined to test association between frequency of using investment evaluation techniques and objectives of SMEs.

The Chi-square test of independence revealed a significant association between the financial goals of SMEs and the type of investment evaluation technique $\chi^2(15, n = 184) = 32.771, p = 0.005$. A significant association was revealed between the person who make investment decision and the type of investment evaluation technique $\chi^2(6, n = 163) = 11.4606, p = 0.075$.

The results of correlation analysis of the frequency of using investment evaluation techniques show that, there is a significant relationship between the frequency of using payback period and the frequency of using ARR, discounted cash flow method ($r = .597$ and $.336$) respectively; while there is no significant relationship with the frequency of using gut feel. There is also a significant relationship between the frequency of using discounted cash flow and ARR($r = .590$). Correlation analysis for the case of financial goals of SMEs, it was revealed that there is a significant negative relationship exists between capital availability and increased profits ($r = -.285$), maximizing shareholders wealth and increased profits and capital availability ($r = -.131, -$

.114) respectively, customer requirement and increased profits, capital availability (r = -.243,-.212) respectively. Correlation analysis of the person who make investment decisions revealed that, there is a significant relationship between frequency of using payback and chief finance officer(r = 0.129). A significant relationship exists between management and the frequency of using DCF (r = 0.135).

In this study the multiple regression analysis was used to determine whether the independent variables (financial goals of SMEs, who make investment decisions) simultaneously impact the dependent variable (frequency of using investment evaluation techniques).

Therefore, the regression model is as follows:-

$$DV = \alpha + \beta_1\chi_1 + \beta_2\chi_2 + \beta_3\chi_3 \dots \dots \dots + \beta_n\chi_n + \varepsilon$$

Where,

DV = Dependent Variable in the hypothesis.

i.e. investment decisions proxied by the frequency of using investment evaluation technique.

$\chi_1 \dots \dots \chi_n$ = Explanatory Variables in the hypothesis i.e. financial goals of SMEs, and who make investment decisions

$\alpha, \beta_1 \dots \dots \beta_n$ = Regression Coefficients

ε = Error variable

Estimation results of regression analysis which determines the relationship between the frequency of using investment evaluation techniques on one hand and financial goals of SMEs and who make investment decisions, on the other hand are presented below. Because the variables were categorical, hence dummy variables were created. Thus for each category, one category was omitted because it is the reference. Thus the coefficients should be interpreted as the increase (a positive coefficient) or the decrease (a negative coefficient) in the B coefficients between the specified category and the reference category.

The financial goal when making investment decisions (maximize growth in sales, increased profits, capital availability, maximize shareholders wealth, customer requirements, and combination of objectives) were used in a multiple regression analysis to predict the frequency of using payback period, ARR, DCF, and gut feel. The prediction models were all statistically significant which allowed us to proceed to another step of examining the contribution of each independent variable in the model. Results from the regression analysis in Table 3 revealed that in relation to maximization of growth in sales, increased profits, capital availability, maximization of shareholders wealth, and combination of objectives decreases the frequency of using payback period, ARR, DCF, and gut feel. Also it is indicated that there is no effect of customer requirement and combination on the frequency of using DCF, while there is no effect on increased profits, capital availability, and maximization of shareholders wealth with the frequency of using gut feel. Hence, it can be concluded that maximization of growth in sales, increases the frequency of using payback period, ARR, DCF, and gut feel.

Table 3: Estimation results for regression analysis on financial goals of SMEs

Financial goals of SMEs	Coefficients, t-values, sig.values	Payback period	Accounting rate of return	Discounted cash flow methods	Gut feel
• Maximize growth in sales					
• Increased profits versus maximize growth in sales	Coefficient t-value sig.value	-1.439607 - 6.87 0.000	- 1.695652 - 6.41 0.000	- 1.127473 - 5.04 0.000	0.3181818 1.36 0.174
• Capital availability versus maximize growth in sales	Coefficient t-value sig.value	- 0.9413691 -3.98 0.000	-0.9935245 - 3.43 0.001	- 0.553668 - 210 0.037	0.02941176 1.04 0.302
• Maximize shareholders wealth versus maximize growth in sales	Coefficient t-value sig.value	-1.61385 -4.22 0.000	- 1.495652 - 2.89 0.004	-1.242857 -3.06 0.002	- 0.4545455 - 0.103 0.303
• Customer requirements versus maximize growth in sales	Coefficient t-value sig.value	- 1.054326 - 4.17 0.000	- 1067081 -3.36 0.001	- 0.1252101 - 0.46 0.645	0.02051282 0.76 0.451
• Combination versus maximize growth in sales	Coefficient t-value sig.value	-1.897183 -4.58 0.000	- 1.395652 - 270 0.008	- 0.7428571 - 1.61 0.108	- 0.8 - 1.74 0.083

The one who makes investment decisions (owner, chief finance officer, management, and any other person) were used in a multiple regression analysis to predict the frequency of using payback period, ARR, DCF, and gut feel. The prediction models were all not significant; hence we could not proceed with another step of determining the contribution of each independent variable in the model. However, Table 4 shows the estimation results for the regression of who make investment decisions.

Table 4: Estimation results for regression analysis on who make investment decisions

Who make investment decisions	Coefficients, t-values, sig.values	Payback period	Accounting rate of return	Discounted cash flow methods	Gut feel
• Owner					
• Chief finance officer versus owner	Coefficient t-value sig.value	-1.897183 - 4.58 0.000	0.7402027 1.72 0.086	-0.0300802 - 0.09 0.931	0.4916444 1.42 0.157
• Management versus owner	Coefficient t-value sig.value	0.1042925 0.41 0.682	0.0674086 0.22 0.827	0.5189394 2.00 0.047	-0.0680195 -0.27 0.788
• Other versus owner	Coefficient t-value sig.value	-1.248649 -0.92 0.361	- 1.697297 - 1.03 0.306	- 1.147727 - 0.83 0.405	- 2.096591 - 1.53 0.127

Discussion

From the study, the investment evaluation techniques used by SMEs have been identified to be gut feel, payback period, DCF, and ARR. This study also tested the relationship between financial goals of SMEs, and who make investment decisions on one hand, and investment decisions on the other. It is evidenced from the results that the financial goals of SMEs have influence on their investment decisions, while the one who make investment decisions do not have influence on investment decisions of the SMEs.

On the financial goals of SMEs, the results are contrary to what we expected that there could be an increase on the use of DCF methods when maximizing the wealth of shareholders. However, these results show an increase on the use of the methods (payback period, ARR, and DCF) when the objective is maximization of growth in sales. These results are consistent with the results reported by Vos and Vos (2000), whereby owners were asked to indicate the importance of goals when making investment decisions: the most important goal was to maximize growth in sales (40%) while shareholders wealth maximization was ranked third. This indicated that shareholders wealth maximization was not on the whole at the fore front of the owner's minds when evaluating the investments. The descriptive statistics of this study indicated that maximization of growth in sales was the most important objective (31.6%), while maximization of shareholders wealth was ranked fifth (5.5%).

Investment decisions in the business can be made by the owner, chief finance officer, management, or any other responsible person. According to Keasey (1993), although the goal is supposed to be shareholders wealth maximization, the agents may not perceive it to be in their interest to use the DCF approaches to investment decisions. Instead the objectives of managers may lead the investment decisions of the firm. Danielson and Scott (2007) worked on the agency problems in small business investments; their results show that the agency conflicts affect the

business' investment decisions in different ways before and after the separation of ownership and control. Uddin and Chowdhury (2009), argue that NPV is the ultimately suggested method of investment decisions that involves estimation of cash flows and the discount rate. These two tasks need expertise and relevant knowledge. In small businesses, owners or decision makers may lack this knowledge, or may find it cost ineffective to hire that kind of expertise. Hence, the decision maker can influence the investment decision, especially on the use of investment evaluation techniques. Although in the descriptive statistics of who make investment decisions it is indicated that in most cases the owner is the one making investment decisions (76.6%). But it is very unfortunate that our results of the regression analysis indicated that there is no association between the one who make investment decisions and investment decisions which was measured by the frequency of using investment evaluation techniques.

Conclusions

This study used a cross-sectional design and the method of the study was the survey. Purposive sampling was used to collect data to a sample of 301 SMEs drawn from SIDO in Dar es Salaam and Dodoma regions. Questionnaires and personal interviews were used to collect data. Multiple regression analysis was used to investigate the relationship between investment decisions is simultaneously influenced by the financial goals of SMEs and who make investment decisions. Results from this study indicated that frequency of using investment evaluation techniques is simultaneously influenced by the goals of SMEs. Specifically, when the financial goal is maximizing growth in sales, there is an increase in the use of payback period, ARR, and DCF; and there is a decrease in the use of these methods when the goal is increased profits, capital availability, maximizing shareholders wealth, customer requirements, and combination of objectives.

The study as well provided both the theoretical and practical contribution on the influence of financial goals of SMEs to investment decisions (frequency of using investment evaluation techniques). The financial goals of SMEs differently affected the choice of investment evaluation techniques. The research findings were contrary to the theory for example the non-use of DCF methods when the goal is to maximize the wealth of shareholders.

It should be remembered that the main question addressed in this study was what is the relationship between financial goals of SMEs in Tanzania and investment decisions? In that we also considered the relationship between the one making investment decisions and investment decisions. The financial goals were: maximize growth in sales, increased profits, capital availability, maximize shareholders wealth, customer requirements, and combination of goals. Four categories of who make investment decisions were proposed which included: owner, chief finance officer, management, and any other person in the SME. Investment decision was measured by the frequency of using payback period, accounting rate of return, discounted cash flow methods, and gut feel. The theory of investment decisions requires that the financial goal of a business when making investment decisions to be maximization of the wealth of shareholders. Based on the findings of this study, it has been indicated that the main financial goal of SMEs is maximization of growth in sales. Regarding the one who makes investment decisions, it has been indicated that the owners are the ones making investment decisions; however, there was no influence between them and investment evaluation techniques they used to make investment decisions.

The financial goals and the one who makes investment decisions play a very great role in the investment decisions. Many researchers of investment decisions focused more on quantitative evaluation techniques only, hence requiring businesses to have in their minds on the issue of maximizing the wealth of shareholders and use discounted cash flow methods when making investment decisions. This study, in addition to the quantitative evaluation techniques of investments, it focused on the real financial goals and who make investment decision in SMEs in Tanzania. By developing and testing the model, this study contributes to a better understanding of the relationship between financial goals and investment decisions of SMEs in Tanzania.

The findings of this study suggest that due to the importance of investment to the economy of the country and SMEs themselves; the government and other service providers such as Small Industries Development Organisation (SIDO) to focus more on the issue of investment decisions for SMEs. In particular they should train SMEs on the investment evaluation techniques, their advantages and disadvantages in relation to their financial goals.

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