The Effect of Small Business Characteristics on the Choice of Investment Evaluation Techniques for SMEs in Tanzania

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Abstract: *This study investigated the effect of business characteristics on the choice of investment evaluation techniques of SMEs in Tanzania. The 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. Four hypotheses were proposed and tested using the multinomial logit regression. Descriptive data shows that SMEs in Tanzania tend to use the non-recommended investment evaluation techniques such as payback period, ARR, and gut feel. Other SMEs do not use any recommended or non-recommended investment evaluation techniques when making investment decisions. The Chi- square test for independence indicated a significant association between industry of business, sales growth, and age of business on one hand and choice of investment evaluation techniques on the other. Multinomial logistic regression model was used to investigate the relationship between the choice of investment evaluation techniques and business characteristics (sales growth, industry of business, number of employees, form of ownership, and age of business). Sales growth and industry of business were found to be significant factors to the choice of investment evaluation techniques. However, number of employees, age of business, and form of business are found not to be significant factors on the choice of investment evaluation techniques. The findings of this study suggest that business characteristics affect the choice of investment evaluation techniques.*

Keywords: *small business characteristics, investment evaluation techniques, choice, SMEs, Tanzania*

I. Introduction

Small businesses play a major role in the economy by providing both employment and goods and services (Kuratko, 1982). In the US, the Small Business Administration estimates that small businesses produce 50% of private GDP, and employ 60% of the private sector labour force (Danielson and Scott, 2006). Omar (2008) conducted a study and found that; in India, SMEs are referred to as small scale industries, and they contribute approximately 40% of the total production within the industry and over 34% of the national export, in Kenya, the small scale enterprise sector, play a crucial role in the Kenyan national economy.5.1 million people were engaged in this sector, representing 74% of the total National employment and contributed about 88% of the total job creation at any one time), in Uganda, the SMEs comprise over 90% of the private sector and are considered to be very important in stimulating the economic growth of the country.

Other studies indicate that formal SMEs contribute up to 45% of employment and up to 33% of GDP in developing countries (IFC, 2010). In Tanzania, SMEs contribute significantly to employment creation, income generation and stimulation of growth in both urban and rural areas. And it is estimated that about a third of the GDP in Tanzania originates from SME sector (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). According to the ten years implementation review of the SMEDP (2003), it is estimated that there are 3 million SMEs employing 5.2 million people of which 45% are located in urban and the remainder in rural areas.

Danielson and Scott, (2006) argued that, capital investments in the small business sector are important to both individual and overall economy. Also Uddin and Chowdhury (2009) pointed out that, although small businesses seem "small" collectively it is huge and significant for an economy. Many countries are becoming much more serious about developing small business sector. Therefore understanding the pattern of their investment decisions is important (Uddin and Chowdhury, 2009).

Besides the importance of SMEs 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. Also the SMEDP revealed that among the unique problems facing SMEs is limited access to finance (URT, 2003). However, it might be possible that if owners do not know how to select the right investment evaluation technique and the business characteristics which may influence their choice, 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 inability to identify business characteristics which influence the choice of investment evaluation techniques.

Investment decisions are among the most important decisions to be made by the business. There are several reasons which make investment decisions to be critical decisions as highlighted by Pandey (1976): they influence the firm's growth in the long run, they affect the risk of the firm, they involve commitment of large amount of funds, they are irreversible, or reversible at substantial loss, they are among the difficult decisions to make. Hence, businesses need to make sure that they are making the right decision on deciding about what investments to undertake. One of the tools which can assist owners or decision makers of SMEs to evaluate and select investment projects is the investment evaluation techniques. These techniques are grouped into two; discounted cash flow methods and non- discounted cash flow methods (Pandey, 1976). These methods have advantages and disadvantages which SMEs are supposed to be aware of.

Several studies have been conducted on investment decision practices, and on the use of investment evaluation techniques in different countries. These studies are : Danielson and Scott, (2006) in USA; Vos and Vos(2000) in New Zealand; Graham and Harvey (2001) in Canada; Brijlal and Quesada (2009) in South Africa; Olawale et al (2010) in South Africa; Mukherjee and Henderson (1987) in UK; Awomewe and Ogundele (2008) in European, American, and African companies; John (2007) in Tanzania; Kipesha (2009) in Tanzania. These studies in most cases indicated the most widely used investment technique. However, it is most important to know beyond the reasons given for the use of an investment evaluation technique by understanding the influence on the selection and adoption of a certain investment evaluation technique. Knowing these factors may assist SMEs in making better investment decisions on selecting the right investment evaluation techniques. To what extent do SMEs know the business characteristics affecting the selection of investment evaluation techniques for their businesses? Knowing the business characteristics, will assist them to understand which of them affects their investment decision practices. This study investigates the business characteristics which affect the choice of investment evaluation techniques of SMEs in Tanzania.

II. Literature Review

2.1 Small business characteristics

Entrepreneurial motivation can be defined an inner state that causes a person to act towards attainment of goals (Gupta and Khanka, 1996). It is further explained that, there are two theories of motivations which can be used to describe the process and determination of motivations. These theories are; (i) the Maslow's Needs Hierarchy Theory, and (ii) McClelland's Acquired Needs Theory. One of the types of needs as explained by McClelland is the need for achievement which refers to the desire to accomplish something with one's own effort (Gupta and Khanka, 1996). This need is a fundamental characteristic of most entrepreneurs.

According to Gupta and Khanka, (1996) there are two main motivations for establishing enterprise to be (i) internal factors which include; educational background, occupational experience, desire to do something pioneering and innovative, desire to be free and independent, family background. Internal factors constitute the personality of the entrepreneur and thereby generate an inclination to adopt entrepreneurial activity (Gupta and Khanka, 1996). (ii) External factors includes; assistance from government, financial assistance from institutions, availability of technology and/or raw materials, encouragement from business units and others.

There are studies which evidence the effect of business characteristics on the use or choice of investment evaluation techniques as indicated in the following discussion. Danielson and Scott (2006) in their study, revealed how the small business characteristics such as industry, sales growth, business age, employment, owner education, owner age can influence the type of the method to be used to evaluate investments. On the other hand, Daunfeldt and Hartwig (2012), in their study on what determines the choice of the use of capital budgeting methods, observed that the business characteristics such as size, form of ownership, industry of business influence the choice of investment evaluation technique. Graham and Harvey (2001) conducted a study on the theory and practice of corporate finance, it was also revealed that the size of the firm significantly affect the practice of corporate finance, especially on the use of investment evaluation techniques. Brijlal and Quesada (2009), when studying the use of capital budgeting techniques in businesses observed that size and sector of the business has impact on the use of capital budgeting methods. Kira and He (2012), identified the following business characteristics to have impact in the access of financing; business's location, industry, size, business information, age, incorporation, and collateral. This study is concerned with the characteristics of the business (i.e. industry of business, sales growth, business age, number of employees, form of ownership, and position in the business).

2.2. Investment criteria

Investments are to be evaluated using laid down criteria known as investment criteria. These criteria are supposed to be consistent with the goal of maximization of shareholder's wealth. There are a number of

investment criteria which are in use. These criteria may be grouped into two; Discounted cash flow criteria and Non- discounted cash flow criteria (Pandey, 1976), each having advantages and disadvantages.

There is an evidence of few studies conducted on the use of investment evaluation techniques: Daniel and Scott (2006) observed that small firms evaluate projects using payback period or owner's gut feel. Vos and Vos (2000) found that gut feel and accounting based methods were mostly used. Graham and Harvey (2001) observed that small businesses are significantly less likely to use NPV method but they frequently use the payback period method. Daunfeldt and Hartwig (2012) their results show that recommended and non-recommended methods were used with large companies using capital budgeting method more frequently than small firms. Brijlal and Quesada (2009), found that payback period, followed by NPV appeared to be the most used methods across the different sizes of businesses. Olawale et al (2010) observed that small manufacturing firms do not use sophisticated investment appraisal techniques when evaluating their proposed projects. Awomewe and Ogundele (2008) in their study observed that there is a trend that payback period method has been prevalent in appraising capital budgeting decisions in various organizations. Khakasa (2009), in his study observed that the usage of simple ratio- based techniques such as cost benefit analysis, payback period and return on investment is very high compared to the use of discounted cash flow techniques. John (2007) the results of his study showed that most small businesses do not use capital budgeting techniques when making investment decisions. Among the few firms which use these methods, payback period and accounting rate of return methods were the most used techniques. Kipesha (2009) observed that most of SMEs do not use the DCF methods; rather they select investments basing on their personal perception, market trends and external attractiveness of the investment.

The above studies indicated wide use of non-discounted cash flow methods. 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 and 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 and Vos, 2000), size, availability of capital, and nature of decision makers (Uddin and Chowdhury, 2009).

The literature review has revealed that investment decisions are very important to business for a number of reasons which include influencing growth and profitability of the business in the long run. Moreover, investments are to be evaluated using laid down criteria or investment evaluation techniques which are supposed to be consistent with the goal of maximizing shareholders wealth. However, the choice of investment evaluation technique can be influenced by the characteristics of the business such as; industry of business, sales growth, age of business, number of employees, and form of ownership. The aim of this study is therefore to test how business characteristics influence the choice of investment evaluation techniques. The hypotheses to test this relationship are as stated below:-

$H_{1.1}$ *industry of business positively influence the choice of investment evaluation techniques*

$H_{1.2}$ *sales growth positively influence the choice of investment evaluation techniques*

$H_{1.3}$ *age of business positively influence the choice of investment evaluation techniques*

$H_{1.4}$ *number of employees influences the choice of investment evaluation techniques*

$H_{1.5}$ *form of ownership positively influence the choice of investment evaluation techniques*

III. Methodology

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 mil.
Small enterprise	5 - 49	Above 5 mil to 200 mil
Medium enterprise	50 - 99	Above 200 mil to 800 mil

Source: URT, 2003

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. The 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 after analysis of the data.

IV.   Empirical Results

This section presents the results of a survey conducted in Dar es Salaam and Dodoma regions in relation to the effect of small business characteristics on the choice of investment evaluation techniques.

4.1 Sample description

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 summary descriptions of this sample are as explained below:-

4.1.1   SMEs characteristics

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%).

4.1.2 Characteristics of SME owners

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%).

4.3 Descriptive statistics for investment decisions evaluation techniques

The investment evaluation methods used to assess the financial viability of a major investment in the business are presented in Table 2. The results indicate the first used method is gut feel (20.9%), second used method is the payback period (19.6%), and this is followed by discounted cash flow methods (12.3%). Accounting rate of return scored 8.0%, while 0.7% used combined methods. Reasons for using the particular investment evaluation method were given by respondents. However, the major reason was that the method is easy to calculate and explain to others. Also reasons for not using a particular method were given, but the major reason was that respondents were not familiar with the methods.

Table 2: Investment Evaluation Techniques

Investment evaluation technique	Number of observations	percent
Payback period	59	19.6
Accounting rate of return	24	8.0
Discounted cash flow methods	37	12.3
Gut feel or intuition	63	20.9
Combination	2	0.7
No answer	116	38.5
Total	**301**	**100.0**

Source: Survey data

4.4 Hypothesis testing

The objective of this study was to investigate on the factors affecting the choice of investment evaluation technique for SMEs in Tanzania. The dependent variable in this study was the type of investment evaluation techniques, and the independent variables were the small business characteristics. Multinomial logistic regression was used to test the simultaneous influence of independent variables on the dependent variable. But before carrying out the analysis, the Chi- square test of independence was used to find out the association between the factors affecting the choice of investment evaluation techniques and the type of investment evaluation techniques. The results from the test show that there is significant association between variables (industry of business, sales growth, establishment of business,). There was no significant association between the following variables; number of employees, and form of ownership. These results for the Chi-square test of independence are summarized in the table below:-

Table 3:Results for the Chi- Square Test of Independence

S/N	Variable	Pearson Chi-square (χ^2)	df	Sig. value
1	Industry of business	14.591	6	0.024
2	Sales growth	31.784	6	0.000
3	Establishment of business	20.154	9	0.017
4	Number of employees	11.257	9	0.259
5	Form of ownership	6.626	6	0.357

Source: Survey data

4.4.1 Multinomial logistic regression

Multinomial Logistic Regression was performed to analyse the factors influencing the choice of an investment evaluation technique made by SMEs. The model contained five independent variables (form of ownership, sales growth, industry of business, number of employees in the business, and age of the business). The following multinomial logit model is estimated using maximum likelihood function:

$$\mathrm{p}_{ij} = \frac{\exp(X_i \beta_j)}{\sum_{k=1}^{J} \exp(X_i \beta_k)}$$

$$\mathrm{p}_{ij} = \frac{1}{\sum_{k=1}^{J} \exp[X_i(\beta_k - \beta_i)]}$$

Where;

J= alternatives to choose (i.e. evaluation methods)

p_{ij} = probability that a business *i* chooses evaluation method *j*

X_i = the characteristics of the business e.g. age of business

β = parameter vectors

This model can be estimated by the likelihood function

$$\mathrm{Log\ L} = \sum_{i} \sum_{j} \mathrm{y}_{ij} \mathrm{p}_{ij}$$

Where y_{ij} is equal to 1 if a business chooses alternative *j* and y_{ij} equal to 0 otherwise.

4.4.2 Results from the Multinomial logistic regression

The full model containing all predictors was statistically significant $\chi^2(18) = 52.15$, $p < 0.0001$, indicating that the model was able to explain how respondents chose the investment evaluation techniques. The model as a whole explained the pseudo - R^2 metric (10.69%). This metric shows variance in the choice of investment evaluation techniques. From the findings of this study it is shown that the intercept of the model had -2Log likelihood of 243.97869 and a model with all variables has a -2Log likelihood of 217.90268. This shows an improvement of the model from the intercept model.

The multicollinearity in the multinomial logistic regression is detected by examining the standard errors of the **b** coefficients. A standard error larger than 2.0 indicates numerical problems such as multicollinearity among the independent variables, zero cells, etc. in this analysis, two variables (age of the

business, and form of ownership) had numerical problems having a standard error larger than 2.0, hence, they are not interpreted.

The relationship of individual independent variables and the dependent variable is shown in Table 4. In this analysis the reference category is payback period.

Table 4: Results from multinomial logistic regression
mlogit invtechs Dindust1 Dindust2 Dsgrowt1 Dsgrowt2 Destab1 Destab2

Iteration 0: log likelihood = -243.97869
Iteration 1: log likelihood = -218.32428
Iteration 2: log likelihood = -217.90294
Iteration 3: log likelihood = -217.90268

Multinomial logistic regression   Number of obs   =   185
                                                                  LR chi2(18)   =   52.15
                                                                  Prob > chi2   =   0.0000
Log likelihood = -217.90268   Pseudo R2   =   0.1069

invtechs	Coef.	Std. Err.	z	P>z	[95% Conf. Interval]	
Accounting rate of return						
Dindust1	-.3134295	.5729717	-0.55	0.584	-1.436433	.8095744
Dindust2	-1.159493	.5747531	-2.02	**0.044**	-2.285988	-.0329976
Dsgrowt1	2.142997	.6157959	3.48	**0.001**	.9360594	3.349935
Dsgrowt2	1.283637	.5827243	2.20	**0.028**	.1415182	2.425756
Destab1	-.5454945	.4492473	-1.21	0.225	-1.426003	.335014
Destab2	-.2529331	.6596876	-0.38	0.701	-1.545897	1.040031
_cons	-.5868291	.7010193	-0.84	0.403	-1.960802	.7871435
Discounted cash flow						
Dindust1	-.764977	.7719236	-0.99	0.322	-2.277919	.7479655
Dindust2	-.4364021	.6874776	-0.63	0.526	-1.783833	.9110292
Dsgrowt1	1.116552	.8411986	1.33	0.184	-.5321667	2.765271
Dsgrowt2	.8240299	.7424422	1.11	0.267	-.6311301	2.27919
Destab1	.5762163	.5502636	1.05	0.295	-.5022806	1.654713
Destab2	.0114595	.8992674	0.01	0.990	-1.751072	1.773991
_cons	-1.491384	.9132777	-1.63	0.102	-3.281376	.2986073
Gut feel or intuition						
Dindust1	.7906485	.8034189	0.98	0.325	-.7840236	2.365321
Dindust2	.6060675	.7935625	0.76	0.445	-.9492866	2.161421
Dsgrowt1	2.79764	.7367654	3.80	**0.000**	1.353607	4.241674
Dsgrowt2	.8473913	.7417257	1.14	0.253	-.6063644	2.301147
Destab1	.5464991	.5059744	1.08	0.280	-.4451925	1.538191
Destab2	.349083	.7276107	0.48	0.631	-1.077008	1.775174
_cons	-2.828482	.977502	-2.89	0.004	-4.74435	-.9126129

(invtechs==payback period is the base outcome
Accounting Rate of Return relative to Payback period: as shown in Table 4, only three of the independent variables made a unique contribution to the model (sales growth, and industry of business). The strongest predictor for making choice of ARR as the investment evaluation techniques is the sales growth of 10% to 19%, with coefficient of 2.142997. This indicated that businesses whose sales growth is 10% to 19% were two times more likely to select ARR than businesses whose sales growth is less than 10%, controlling for other factors in the model.

The least of the predictors was the industry of business (manufacturing) with coefficient of -1.159493. This indicated that respondents who are in manufacturing industry were over 1 times more likely to select ARR than businesses which are in distribution industry controlling for other factors in the model.
Interpretation of the variables which made unique contribution to the model is presented below.

(a) Sales growth

Results indicated that sales growth from 10% to 19% and more than 20% is significant at 1% and 5% respectively. Coefficients are 2.142997 and 1.283637 respectively. This means that businesses with sales growth from 10% to 19% and more than 20% increase the likelihood of choosing ARR compared to businesses with sales growth less than 10% controlling for other factors in the model.

According to the study conducted by Danielson and Scott (2006), it was indicated that ARR was the frequency choice for businesses pursuing growth strategy. The ARR is valuable because it provides information about how a project will affect businesses' financial statements and its ability to meet accounting – based loan covenants.

(b) Industry of business

Results indicated that industry of business which is manufacturing is significant at 5%. Coefficient is 1.159493. This means that businesses in manufacturing industry increase the likelihood of choosing ARR compared to businesses in distribution industry controlling for other factors in the model.
Discounted cash flow relative to payback period: as shown in Table 4 none of the independent variables made a unique contribution to the model.

Gut feel relative to payback period: as shown in Table 4 (Appendix 1), only one of the independent variables made a unique contribution to the model, this is sales growth of 10% to 19%, with coefficient of 2.79764 and is significant at 1%. This indicated that businesses whose sales growth is from 10% to 19% were two times more likely to select gut feel than businesses whose sales growth is less than 10%, controlling for other factors in the model.

V. Discussion

The study investigated the effect of business characteristics on the choice of investment evaluation techniques of SMEs. The study identified the following investment evaluation techniques to be used by SMEs in Tanzania: payback period, accounting rate of return, DCF, gut feel or intuition, and combination of methods. However, about 38.5% of SMEs do not use any of the methods mentioned above, this is a very serious issue to the SMEs if at all they want to enhance growth, performance, and profitability. These findings are consistent with the results of John (2007) and Kipesha (1009), who observed that most SMEs in Tanzania do not use investment evaluation techniques when making investment decisions.

There is evidence from the study that business characteristics affect the choice of investment evaluation techniques. A positive relationship was observed between the choice of ARR, gut feel and sales growth. These results partly confirmed our expectations, whereby we expected that businesses with greater sales growth it will have to expand or replace equipments. Hence, it may need to use the recommended methods (DCF methods) and ARR. This is because on expansion or replacing of long term assets, the business may need to raise a new capital, either by obtaining a bank loan or by attracting new investors. In either case, the business' historical and projected financial statements will be used to communicate information about the firm investors (Danielson and Scott, 2006).

There was also a negative relationship between the choice of ARR and industry of business which is manufacturing. These results are contrary to our expectations; we expected businesses in the manufacturing industry to select the recommended methods. i.e. DCF methods. This is because businesses in the manufacturing industry they often use large amount of capital with higher sunk costs, so they are supposed to select investments carefully using the recommended methods. However, for businesses in service industry, we expected them to use more gut feel. This is because the investment of many service businesses might be limited to businesses vehicles, or office equipments (Danielson and Scott, 2006). Because the businesses' primary consideration when evaluating this type of purchase decision may be cost, reliability, and product features, structuring a DCF analysis of the investment can be difficult (Danielson and Scott, 2006).

No relationship existed between the choice of DCF and business characteristics. This means that businesses do not select DCF methods instead they rely on payback period method to evaluate their investments. The extensive use of payback period is supported by many studies such as Graham and Harvey (2001), Awomewe and Ogundele (2008), Danielson and Scott (2006), and Brijlal and Quesada (2009).

VI. Summary And Conclusions

Sales growth and industry of business have been identified as the main business characteristics that influence the choice of investment evaluation techniques for SMEs in Tanzania. Hence, based on these findings, the study recommends that business service providers in Tanzania conduct trainings to SMEs owners on different types of investment evaluation techniques their advantages, disadvantages and the factors thereof

which influence their selection. Knowing these factors of influence will enable SMEs to make better investment decisions by selecting the right investment evaluation technique.

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