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## The Impact of Capital Budgeting on the Innovation Capability of Small and Medium Enterprises in Nakawa Division, Kampala Capital City Authority, Uganda

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### **Abstract:**

*The study examined the impact of capital budgeting on the innovation capability of Small and Medium Enterprises in Nakawa Division, Kampala Capital City Authority. The study was premised on the following research objective: to find out the impact of capital budgeting on the innovation capability of SMEs in Nakawa Division. The study adopted a descriptive cross-sectional survey design using both quantitative and qualitative approaches. In this study, data was collected from a sample of 437 respondents. The data was collected using questionnaires and a key informant interview guide. Analysis was done using Pearson correlation coefficients and simple regression analysis. Qualitative analysis was done using thematic analysis. Findings revealed a strong positive impact of capital budgeting on the innovation capability of SMEs in Nakawa Division; the coefficient is 0.911\*\* and p-value = 0.000. It was concluded that proprietors of SMEs still struggle to remain operating beyond one year and need training in financial management practices to gain the capability to innovate and thus address the challenge of quick collapse. It was recommended that SMEs' owners in Nakawa Division should be well versed and acquainted with capital budgeting tactics to shield their enterprises from financial challenges.*

**Keywords:** Small and medium enterprises, capital budgeting and innovation capability

### **1. Introduction**

This study focused on examining the impact of Capital budgeting on the innovation capability of Small and Medium Enterprises in Nakawa Division, Kampala Capital City Authority. The role of SMEs in the economic activity of Uganda is significant. These enterprises account for approximately 90% of the private sector industry, and they occupy a significant position in the country's industrial structure (UIA, 2016). The SMEs in Uganda create jobs and serve as a good mechanism to address unemployment in the country. There is a common belief among economists that businesses with the innovation capability can incorporate their organizations' key abilities and assets to effectively empower advancement and expand on their production and market share. Innovation capabilities have enabled large firms to achieve desired outcomes by acquiring new technologies and knowledge that help them to effectively compete in the market, the favor obtained through establishing an efficient and effective financial management system. Thus, more financially literate and informed entrepreneurs in the SMEs sector would probably benefit from the practice of capital budgeting.

Consequently, capital budgeting would positively connect with SMEs' innovation capabilities. Based on their crucial role in creating new jobs, rise in GDP, entrepreneurship, and innovation, Small and Medium Enterprises (SMEs) are recognized as the drivers of socio-economic growth in developed and developing countries. Historically, SMEs are traced back to the time of the industrial revolution in the 1850s, and most of them were initiated as small factory workshops (Ruthrock, 2013). These enterprises were associated with different challenges, such as limited capital to buy the stock and equipment to most of these enterprises. In the United States of America (USA), SMEs emerged rampant by 1782, with less than 500 workers for manufacturing business enterprises and less than \$7,000,000 in annual receipts for most non-manufacturing businesses (Lepoutre & Aime, 2006). In India, by 1920, SMEs got classified into two categories: those that used power with less than 50 employees and those that did not use power with the employee strength being more than 50 but less than 100 (National Research Development Corporation, 2008).

#### *1.1. Background Information*

In East Africa, SMEs started in 1930s with the introduction of Rupees. At the time of independence in the 1960s, industries were playing the most crucial role in the economic development of the whole region, although they had challenges with management functions (Musiiitwa, 2015). Nowadays, the nature and features of SMEs in the region differ from country to country and from industry to industry, as well as the legal definition. Each SME needs a business plan;

however, due to limited entrepreneurship skills, most SMEs in East Africa do not make business plans as proprietors feel that their businesses can progress even without business plans (Rumumba, 2015).

In Uganda, SMEs resulted from the initiation of cooperative societies in 1940s, 1950s, and 1960s. During this period, there were no straightforward national policies for SMEs' industrial development (Tulip & Bitekerezo, 2003). However, as of today, the development of these enterprises has been facilitated in the country, and they account for approximately 90% of the private sector industry. As a result, they occupy a highly important position in the country's industrial structure (UIA, 2016). The Global Entrepreneurship Monitor (2015) ranked Uganda as one of the most entrepreneurial countries in the world, with the highest proportion globally of youth involved in nascent, new, or established SMEs. These businesses are reported to contribute employment of over 2.5 million people in Uganda (UIA, 2016). Because of the contributions made by SMEs in Uganda, such as the creation of employment opportunities and government revenue, they need to be supported to be innovative so that they continuously develop the country's economy. However, these enterprises in Uganda are typically characterized as capital-constrained, operating in highly competitive markets, dealing predominantly in cash, and able to evade the authorities (International Labour Organization, 2016). Therefore, financial management analysis is an area of concern to the owners of SMEs, especially if the attainment of business goals is constrained (Nuwatuhaire & Ainomugisha, 2019).

The study was informed by the Modern Portfolio Theory. Harry Markowitz initiated this theory to explain the uncertain future. The theory differentiates the risk of an asset's portfolio against the entire portfolio's risk (Amenc & LeSourd, 2003). As such, the portfolio's efficiency is wholly determined by the set of assets that either returns highly on a particular risk or lowers risks for a certain level of return. Therefore, the investor may opt to reduce the risk of accruing negative returns by holding the portfolio of different assets to avoid the risk of higher loss. Hence, there is a strong need to measure and integrate the risks involved in business entities, mainly those that invest heavily in financial instruments.

Furthermore, the theory proposes that financial management strategies should act to ensure that risk is managed by diversifying their asset investments in case one of them fails. The theory also provides a guideline on how SMEs should undertake investments to ensure maximal gains, especially in terms of innovation capabilities. According to this theory, all the financial management practices, including financial budgeting, financial reporting, financial recording, and inventory management (Anoos et al., 2020), should all be complementary to each other in fostering financial security and stability in the SMEs which is theorized to translate to innovation capability.

### 1.2. Statement of the Problem

Nakawa is one of the five divisions in Kampala District with many well-established Small-Medium Enterprises (SMEs) that employ most of the city's urban dwellers from all over Uganda. However, these SMEs are characterized by poor innovation capability, which usually makes many of them collapse even before completing one year of operation. The challenging environment in which SMEs operate in Nakawa Division presents a crucial need for developing innovation capability. Innovation means the adoption of new ideas or behavior, and firms with high innovation orientations engage in value creation strategies, such as developing new products or services (Dobni, 2010). In order to sustain competitiveness in the market, the firms must continuously innovate their business processes, which require the firms to manage sustained investment in both the tangible and intangible aspects of business innovations (Fang et al., 2014). Even though many SMEs have recognized the importance of developing innovation capability, they lack an understanding of the impact of capital budgeting on innovation capability. As a result, SMEs have inadequately practiced capital budgeting to ensure effective innovation and beat their competition with large-scale enterprises. In addition, since many SMEs have a challenge of innovating their business, it indicates a need to introduce the function of capital budgeting and its practices along with innovation capability. Furthermore, no research was there that had been conducted to examine the impact of capital budgeting on the innovation capability of SMEs; instead, most of the researchers have concentrated barely on financial management practices among SMEs. Therefore, this study was intended to close the gaps by examining the impact of capital budgeting on the innovation capability of Small and Medium Enterprises in Nakawa Division, Kampala Capital City Authority.

### 1.3. Review of Literature

According to Menya and Gichinga (2013), capital budgeting is the process through which firms decide which long-term investments are expected to generate cash flows over several years. The decision to accept or reject a capital budgeting decision depends on an analysis of cash flows generated by the project and its costs. The decision rules in capital budgeting decisions are Payback Period, Net Present Values, Internal Rates of Returns, Accounting Rates of Returns, and Profitability Index. However, the existing literature based on the researcher's review is not directly reflected in the sense of the impact of capital budgeting on the innovation capability of SMEs. It instead gives a broader picture of the relationship between capital budgeting and general performance, including capability innovation of SMEs. This implies that there is a need for the researcher to carry out the study and bring out the real impact of capital budgeting on the innovation capabilities of SMEs. Previous researchers have investigated the concepts as follows.

Cheruyot (2019) studied the effect of capital budgeting on the organizational performance of manufacturing SMEs in Kericho County. The correlation analysis showed that incorporation of capital budgeting in the firms resulted in increased returns, with a Pearson Correlation of 0.372. This is because the cash budget aids in ensuring that there are sufficient funds to meet the operational levels that are required by the budget.

Wembe (2015) suggested that firm performance gets affected by working capital management. According to Semasinghe et al. (2017), there is a strong significant relationship between working capital management and profitability, liquidity, solvency, and financial health. Rahman et al. (2015) examined the relationship between working capital

management and profitability of 10 sample companies listed on Bangladesh's Chittagong Stock Exchange (CSE). They revealed that company operating profit was positively correlated with efficient working capital management.

A research study was conducted by Hamza et al. (2015) on the cash management practices and performance of SMEs in the Northern Region of Ghana. The study adopted a descriptive cross-sectional survey allowing primary quantitative data collection using structured questionnaires. The study revealed that cash management efficiency positively impacted ensuring that the SMEs were successful. The study was, however, compared in an international setting and thus cannot be compared locally. The current study addressed this by providing local empirical evidence from Nakawa Division, Kampala Capital City Authority.

Nyakundi et al. (2016) revealed that SMEs' performance was positively related to efficient cash management, receivable management, and inventory management. Further, it concluded that working capital management practices influence the firm performance of SMEs. Therefore, there is a need for SMEs owners/ managers to embrace efficient working capital management practices as a strategy to improve their performance in order to survive in the turbulent business environment.

A study by Cheruyot (2019) sought to evaluate the effect of working capital management on the organizational performance of manufacturing SMEs in Kericho County. A correlation analysis indicated that the working capital management practices positively affected the performance, whereby it had a Pearson Correlation of 0.716. This was attributed to the fact that efficient working capital management is essential in managing corporate funds to increase interest income earned by maximizing investments and reducing interest paid by minimizing borrowings.

A positive relationship between firm performance and the budgeting process was found in a study by Mulani, Chi, and Yang (2015) to determine the impact of budgeting on the performance of small and medium enterprises in India. The results added that higher performance could be achieved through more precise goals. Astonishingly budget goals that are difficult but achievable motivate employees to achieve budget goals. Moreover, tight, achievable goals also increased employees' motivation in achieving budget objectives, improving the performance of Small and Medium Enterprises in India. Another significant result was that formal and tight control mechanism of control for the budgetary process also tends to increase firm performance in the SME sector of India.

According to Mun (2020), the concept of capital budgeting and portfolio optimization has far-reaching consequences beyond the DoD. These optimized portfolios are, by definition, the best and most efficient usage of a firm's capital to generate the greatest amount of value while mitigating risks for the organization and keeping limited budgetary and human resource constraints in check. More technically savvy individuals can apply the same methodologies in their retirement and investment portfolios, and portfolio managers can leverage the knowledge and insights from the research to apply efficient frontier analyses for their clients' invested portfolios. A portfolio, by definition, is any combination of two or more assets, projects, capabilities, or options. The whole portfolio is usually assumed to be greater than the sum of its parts, based on outcome performance measures, expected return on investment (ROI), capabilities, and other metrics (Mun, 2015).

Innovation capability can be conceptualized as the potential to create novel and valuable products or knowledge. Lawson & Samson (2001) defined innovation capability as 'the ability to continuously transform knowledge and ideas into new products, processes, and systems for the benefit of the firm and its stakeholders.

In addition, innovation capability is defined as a firm's continuous improvement of its capabilities and resources to explore and exploit new product development opportunities to meet market expectations (Boly et al., 2014). It represents a firm's ability to innovate continuously ahead of its competitors. The innovation capabilities should enable a firm to enter a new market rapidly, ascend to a new level of quality earlier than its competitors or force a firm to imitate and improve product quality faster than its competitors to gain a competitive advantage (Boly et al., 2014).

Based on the literature review, the level of innovation capability is determined by multiple aspects. These determinants include top management leadership, knowledge development, entrepreneurial orientation, and external networks (Saunila, 2019). Considering external networks, Liu et al. (2013) suggest that intermediary organizations can further the innovation resources obtainable for small and medium enterprises, especially relations established within the earliest phases of the firm's lifecycle are crucial in innovation capability development. In turn, organizational rigidity and insufficient resources can hamper innovation capability (Kim et al., 2018). Therefore, innovation capability is central to SMEs aiming to compete with their larger and more resource-possessing competitors.

## 2. Methodology

A cross-sectional survey research design was adopted for this study. This is where data is gathered from a cross-section of firms at one point in time (Zangirolami-Raimundo et al., 2018). Data were gathered from small and medium enterprises of Nakawa Division in Kampala Capital City Authority. A cross-sectional survey research design was used because it allowed the researcher to directly observe the impact of capital budgeting on SMEs' innovation capability while collecting data in a short time without the need for follow-up on the respondents. It also allowed her to produce faster results at a lower cost. Both quantitative and qualitative approaches to data collection were used for the study.

The study population comprised the owners and employees of Small and Medium Enterprises operating in Nakawa Division in Kampala Capital City Authority and the chairpersons of these businessmen and women in their respective traders' associations. The Uganda Small Scale Industries Association (2016) and Uganda Bureau of Statistics Report of 2017 indicated that 1525 SMEs operated in Nakawa Division. However, 649 SMEs out of 1525 were fully categorized as metal fabricators, Hair Salons, Bars and Restaurants, Motor Garages, Carpentry Workshops, and Shops, with the remaining 876 simply categorized as others (UBOS, 2017). Hence, for convenience in the data collection process, the study population only comprised 649 currently categorized SMEs.

## 2.1. Sample Size

Category of Respondents	Population	Sample	Data Collection Tools
Metal Fabricators	86	66	Survey questionnaire
Hair Salons	83	66	
Bars and Restaurants	57	48	
Motor Garages	42	36	
Carpentry Workshops	35	32	
Shops	346	181	
Chairpersons of SMEs	12	8	Key Informant interview guide
Total	661	437	-

Table 1: Sample Size  
Source: Krejcie & Morgan (1970)

## 2.2. Sampling Techniques

The study adopted simple random and purposive sampling techniques to select and obtain the respondents.

### 2.3. Simple Random Sampling

The researcher adopted a simple random sampling technique to select the SMEs owners and operators in Nakawa Division who participated in the study. Simple random sampling refers to the technique of sample selection where all the population members have equal chances to participate in the study (McCombes, 2019). The researcher used this sampling technique because each member of the population would have an equal chance of being included in the sample.

### 2.4. Purposive Sampling

Purposive sampling was used to select Chairpersons of different SMEs in Nakawa Division who were interviewed. Purposive sampling involves identifying and selecting individuals or groups of individuals that are knowledgeable about or experienced with a phenomenon of interest (Cresswell & Plano-Clark, 2011). The researcher used this technique because the respondents (Chairpersons) were knowledgeable and had a long experience in management matters.

### 2.5. Data Collection Methods

The researcher employed both a structured questionnaire and a Key Informant Interview to collect data from the respondents.

### 2.6. Questionnaire

The researcher used the questionnaire to collect quantitative data from the staff of SMEs in Nakawa Division. A questionnaire is a method for collecting and recording information about a particular issue of interest. As an instrument, a questionnaire is mainly made up of a list of questions and clear instructions, and space for answers or administrative details (Krosnick, 2018). This data collection method was used because it allowed a wider range and distribution of samples, provided an opportunity for respondents to give frank answers, and allowed greater economy of effort. In addition, questionnaires were distributed and completed at the respondents' leisure. Thus, this helped to eliminate the variation in the questioning process due to its fixed format.

### 2.7. Key Informant Interview

Key informant interviews were used to collect data from the chairpersons of different SMEs in Nakawa Division. Key informant interviews are described as qualitative in-depth interviews that collect information from a wide range of people who have firsthand information about the community of choice (UCLA Centre for Health Policy Research, 2006). Therefore, this method helped the researcher to get insights into the problem that supplemented the quantitative data, thereby strengthening the study.

## 2.8. Data Collection Tools

### 2.8.1. Survey Questionnaire

A well-designed structured and self-administered survey questionnaire was used to collect quantitative data from the staff of SMEs. This was intended to allow the respondents adequate and convenient time to answer the questions, which helped the researcher to maintain a complete response rate.

### 2.9. Data Analysis

Data analysis is defined by Colorafi & Evans (2016) as the whole process, which starts immediately after data collection and ends at the interpretation of the processed results. First, quantitative data were analyzed using descriptive and correlation analyses. Then, qualitative data were analyzed using thematic analysis as described below.

### 2.9.1. Quantitative Data Analysis

The quantitative approach to data analysis involved the presentation of the findings descriptively in the form of frequency tables with varying percentages. Descriptive statistics were used to describe the data on the socio-demographic characteristics of respondents and present quantitative descriptions in a manageable form. SPSS software version 22.0 was used to obtain inferential statistics, reach conclusions beyond the immediate data alone, and make inferences from the data to more general conditions. The following analyses were used:

- Pearson's Product Moment,
- Linear Regression.

Pearson's Product Moment Coefficient was used to determine how strongly the scores of two variables were associated with each other in the following objectives:

Pearson's Correlation Coefficient was used to test and establish the impact of each independent variable on the variable.

A simple linear regression was used to determine the overall impact of financial management on the innovation capability of Small and Medium Enterprises.

This was considered by regressing independent variables against the dependent variable.

## 3. Results

Questionnaires were administered to SMEs' owners and operators to determine the impact of capital budgeting on the innovation capability of SMEs in Nakawa Division. The statements were put on a five-point Likert scale, with 1 indicating strong agreement and 5 indicating strong disagreement. The results were interpreted based on the means and standard deviations whose responses were computed, summarized, presented, and analyzed in Table 2 below.

### 3.1. Descriptive Statistics on Capital Budgeting Practices of SMEs (N =429)

Capital budgeting practices	Level of Agreement or Disagreement				
	SA (%)	A (%)	N (%)	D (%)	SD (%)
I forecast the future demand and supply of the goods I produce or sell.	114(26.6)	119(27.7)	11(2.6)	100(23.3)	85(19.8)
I make projections on the future operating expenses of my businesses.	129(30.1)	99(23.1)	62(14.5)	123(28.7)	16(3.7)
I make a budgetary allocation for all the expenses I incur in running the business.	178(41.5)	69(16.1)	8(1.9)	106(24.7)	68(15.9)
I make a budget schedule for all the goods I produce or sell.	204(47.6)	117(27.3)	10(2.3)	42(9.8)	56(13.1)
I do not spend more than my income/revenue.	85(19.8)	119(27.7)	3(0.7)	125(29.1)	97(22.6)

Table 2: Descriptive Statistics on Capital Budgeting Practices of SMEs (N =429)

Source: Analysis of Primary Data (June, 2021)

Table 2 above describes the capital budgeting practices of SMEs in Nakawa Division.

Based on the results presented in the table above, it is revealed that most of the respondents agreed to have made forecasts on the future demand and supply of the goods that they produce or sell as agreed upon by most of the respondents (27.7%), much as the least respondents (2.6%) were not sure about it. This means that SMEs owners and operators can gain the opportunity to innovate their businesses by avoiding overstocking and under stocking during peak periods.

Most respondents, as indicated in the table above, also strongly agreed that they used to make projections on the future operating expenses of their businesses (30.1%). Therefore, the finding implies that SMEs in Nakawa Division are operated in the sense of economizing the financial resources to be used for operating costs.

The results in Table 2 above also show that SMEs owners and operators always endeavored to allocate budgets to every expense incurred in running their businesses. This is supported by 41.5 percent of respondents who strongly agreed about it; hence, this implies that there is an observation of proper means of budgeting the monetary and non-monetary resources and assets of the business, like the projection of future inventories and other expenses among SMEs in Nakawa Division.

Furthermore, it was discovered that owners and operators of SMEs made use of budget schedules for all the goods they produced or sold. This assessment is based on the large proportion of respondents (47.6%) who strongly agreed, yet 27.3 percent of the respondents agreed. This means that SMEs' capability to innovate is also based on minimizing resource wastage in business for which they can increase profits.

Lastly, the results in the table above show that respondents disagreed that they did not spend more than their income/ revenue (29.1%). This signifies that SMEs owners and operators in Nakawa Division spend little income from the business extravagantly without planning, which is questionable in leading to innovation capability of business in the SME industry.

### 3.2. Correlation Matrix for Capital Budgeting and Innovation Capability of SMEs

Table 3 shows how capital budgeting impacts on innovation capability of SMEs in Nakawa Division with the aid of Pearson correlation coefficient.

		Capital Budgeting	Innovation Capabilities
Capital Budgeting	Pearson Correlation	1	.911**
	Sig. (2-tailed)		.000
	N	429	429
Innovation Capabilities	Pearson Correlation	.911**	1
	Sig. (2-tailed)	.000	
	N	429	429

\*\* Correlation is significant at the 0.01 level (2-tailed).

Table 3: Correlation Matrix for Capital Budgeting and Innovation Capability of SMEs  
Source: Analysis of Primary Data (June, 2021)

Results in Table 3 above revealed that capital budgeting significantly impacts the innovation capability of Small and Medium Enterprises in Nakawa Division because the p-value (.000) is less than the significance level. Furthermore, the correlation coefficient (0.911) shows a strong positive impact of capital budgeting on innovation capability. Therefore, capital budgeting has a statistically significant and strong positive impact on the innovation capability of SMEs in Nakawa Division.

### 3.3. Regression Analysis of the Study Variables

		Coefficients <sup>a</sup>				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.324	.048		-6.729	.000
	Capital Budgeting	.155	.052	.156	3.000	.003
a. Dependent Variable: Innovation Capability						
R = .958		R Square = .918		Adjusted R Square = .917		Sig = .000

Table 4: Regression Analysis of the Study Variables  
Source: Analysis of Primary Data (June, 2021)

The results above show that capital budgeting significantly predicts the innovation capability of SMEs since the p-value (.000) is less than the significance level of 0.05. Furthermore, the correlation coefficient (.958) revealed that the study variable had a strong positive impact on the innovation capability of SMEs. Hence, the study variables explain 91.8% of the innovation capability of SMEs in Nakawa Division. Specifically, there was a correlation between capital budgeting and the innovation capability of SMEs ( $b=0.155$ ,  $p=0.003$ ).

This implies that for SMEs owners and operators in Nakawa Division to be fully capable of innovating their businesses, they need to focus on routinely reporting all their finances to the government and recording them. In the same way, proper management of inventories and effective budgeting for available capital in business is also crucial for SMEs to realize innovation in the near future.

The study established that SMEs that embark on efforts to adopt good capital budgeting practices are businesses that would most likely gain the capability to innovate. This is explained in the results of the correlations, which showed a statistically significant and strong positive impact of capital budgeting on the innovation capability of SMEs in Nakawa Division. This is in line with the study of Cheruyot (2019), who determined the effect of capital budgeting on the organizational performance of manufacturing SMEs in Kericho County and found out that incorporation of capital budgeting in firms resulted in increased returns. Similarly, Nyakundi et al. (2016) also agreed that working capital management practices influence the firm performance of SMEs, which managers need to embrace as a strategy to survive in the turbulent business environment. In addition, the study findings collaborated with the study of Mulani, Chi, and Yang (2015), who found a positive relationship between firm performance and the budgeting process among SMEs in India.

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