

# Capital budgeting in zimbabwe essay sample



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Capital budgeting is the most important function done by financial managers and it is not only a popular corporate finance topic but one that has been widely researched by academics particularly in international researches. A capital budgeting project is a decision to make a cash outlay to receive future cash inflows, therefore shareholder value is created if the present value of cash inflows exceeds that of the outlay.

The importance of the capital budgeting process for the firm lies in the fact that relatively large amounts of money are committed for a long time thus once the decision is made to embark on a particular project the process cannot be reversed unless a value destruction decision is taken to salvage what has been invested.(J Hall 2001) .

A number of stages, calculations, evaluation methods and refinements to the capital budgeting process can be used and it is these aspects of the capital budgeting process that are investigated in this study and the uncertainty involved in the process.

## 1. 1 Background to the Study

“ Honorable members will be aware that in the hyperinflationary environment characterizing the economy at present, our people are now using multiple currencies for day to day business transactions, alongside the Zimbabwe Dollar. These currencies include the South African rand, United States dollar, Botswana pula, Euro, pound Sterling, among others. In line with the prevailing practices by the general public, Government is, therefore, allowing the use of multiple foreign currencies for business transactions,

alongside the Zimbabwe dollar.” (Acting Minister of Finance, Cde Patrick Chinamasa on Budget Presentation to Parliament on 29 January 2009.)

The introduction of the multi-currency system by the then Acting Minister, Hon Patrick Chinamasa saw a new lease of life in local business operations, containment in inflation and a drastic reduction in currency risk greatly associated with the moribund local currency. The new dispensation of the Government of National Unity saw the resurrection of planning and budgeting which had become almost obsolete in the hyperinflationary economy as the political climate calmed and more stable currencies were in use in the transaction process system of the nation.

The era has seen organizations making out capital expenditures either to replace outdated equipment usually inherited before the nation's independence or equipment for expansion to meet the greater demand for local products. Mining houses, organizations in the communication industry and the beverage sector have been involved in multi-million (US) dollar capital outlays to enhance capacity and realize economic gains in the more stable environment in comparison with yesteryears.

Capital budgeting or investment appraisal is the planning process used to determine whether firms' long term investments such as new machinery, new plants, new products and research and development projects are worth pursuing. It is a budget for major capital, or investment expenditures of an organization and requires higher accuracy in the decision-making process and involves higher level management.

Therefore, whether in good times or in anticipation of market contractions, the expenditure of cash in exchange for future generated uncertain benefits requires a distinctive decision making structure. Central to this decision making framework is capital budgeting. The capital budgeting process is the decision makers' primary tool for evaluating the benefits of projects under consideration and for selecting long term investments from among alternative available projects.

The methods and analysis used in the acceptance or rejection of a project are important because the commitment to a given capital project involves a significantly large, future oriented sum of money and is frequently irreversible; i. e. the decision, once made, locks the firm into a production technology for an extended period of time. These decisions will directly impact the firm's expected future earnings and future cash flows as well as their timing and risk levels.

### 1. 1. 1 Overview of Capital Budgeting

Capital budgeting is the most important function performed by financial managers since results of investment appraisal decisions span for years and a firm loses its flexibility. Therefore a firm's capital budgeting decisions define its strategic direction as moves into new markets; products are preceded by capital expenditures. Therefore tomorrow's business success depends on investment decisions made today, prospects or aspects of the investment decision which are used to help management make investment decisions are often inadequate and misleading(J. H. Hall 2001). Business organizations are continually faced with the problem of deciding whether the

commitment of resources i. e. time and money, is worthwhile in terms of the expected benefits. If the expected benefits are likely to accrue over a relatively long term, the solution is more complex and chances of making an incorrect decision increase (Bierman & Smidt 1993).

### 1. 1. 2 Mobile Telecoms in Zimbabwe

Mobile Telecommunications have an important role to play Zimbabwe development. The extent of contribution these business units can make towards the growth and development of Zimbabwe is dependent on the level of success attained by their operations. The fact is that, underlying the success of a business enterprise is the establishment and application of controls by the owners or management in addition to the systematic record keeping of business transactions, which at the end of the period, keeps the owner well informed about the performance of the business.

Furthermore, analysis of capital budgeting is needed so that financial statements will be fairly and consistently describe as a financial performance. Without information and standards, users of financial statements would need to learn the accounting rules of each business, and comparisons between the firms would be difficult.

In Zimbabwe Mobile Telecommunications have dominated on the Zimbabwe Stock Exchange with respect to Econet Wireless Zimbabwe. The head offices are usually located in the Central Business Districts.

### 1. 2 Statement of the Problem

The selection of capital investments is one of the most important strategic decisions financial managers of a firm can make therefore capital budgeting is one of the most decisive influences on firm value, competitiveness and ultimately, survival.

The motivation to undertake this study stems from the better outlook in the nation though hinged on the success of the inclusive government which has resulted in capital expenditures being undertaken therefore necessitating a critical analysis of the appraisal methods in the wireless communications industry, particularly the three service providers Econet Wireless Zimbabwe, Net-one and Telecel Zimbabwe.

An industry requiring large capital outlay with a vast untapped market in Zimbabwe, and high potential for exponential growth, the telecoms industry is on its boom. The use of multiple currencies spawned massive investments in the sector as mobile operators embark on programmes to grow their subscriber base. The industry having endured a decade long of underinvestment as the economic crisis took a toll on the sector, the massive expansion programmes have resulted in the increase in the mobile penetration rate to 21% as of August 2009 from 14% in February 2009. Mobile penetration rate describes the number of active mobile phone numbers, (usually as a percentage) within a specific population.

“ The equipment facility is valued at US93. 9m. We have not been able to identify a bank or an equipment supplier willing to take the financial and political risk for such a large facility to a Zimbabwean company.” (Econet

CEO, Mr. Mboweni in response to a question by financial Gazette reporter, Munyaradzi Mugowo.)

The aim is to analyze the applicability of investment appraisal techniques in an environment of high political risk, and bring out limitations in such tools. Thus the statement, ' An analysis of capital budgeting process: mobile telecoms sector'

### 1. 3 Research Objectives

To bring out the limitations faced by a financial manager when using investment appraisal techniques for making capital expenditure decisions in environments of political uncertainty.

To establish the importance of capital budgeting.

To test the effectiveness of investment appraisal techniques.

To determine strategies used by financial managers in the capital budgeting process.

### 1. 4 Research Questions

What are the limitations faced by a financial manager in using appraisal techniques?

What strategies are used by financial managers in the capital budgeting process in an environment of uncertainty?

What is the effectiveness of investment appraisal techniques in decision making?

How significant is the analysis of capital budgeting in the mobile industry?

### 1. 5 Research Hypothesis

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Ho: A firm in an environment of high uncertainty and risk when assessing complex projects uses sophisticated capital budgeting techniques and risk based analysis.

H1: A firm in an environment of high uncertainty and risk when assessing complex projects does not use sophisticated capital budgeting techniques and risk based analysis.

### 1. 6 Scope of the Study

Econet Wireless Zimbabwe, having made the largest investment into its network of US\$115m as reported in the interim results for the half year ended 31 August 2009, including Telecel and Net-one who also have planned expansion projects.

Conceptually the study hovers around the implicit role proper analysis of capital budgeting and the techniques play far as mobile sectors business were in concern in Zimbabwe. The research was limited to Econet Wireless in Zimbabwe due to my schedule. The effectiveness of the various capital budgeting techniques were also put into consideration

### 1. 7 Significance of the Study

This research's aim is to explore the use of investment appraisal techniques reflecting their limitations. The research will assist financial managers in project appraisal in environments of great uncertainty, as ' we cannot direct the wind, but we can adjust our sails.' Therefore the research seeks to have a capital budgeting process in a high risk environment and to reflect the use of risk based analysis by financial managers when assessing projects.