Research Article

Capital Budgeting and Maximization of Shareholders Wealth in Selected Manufacturing Firms in Nigeria

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Received: August 26, 2021 Accepted: September 6, 2021 Published: September 17, 2021

Abstract: The paper investigated capital budgeting and maximization of shareholders wealth of selected manufacturing firms in Nigeria. Primary data used for the study were obtained through questionnaire distributed to accountants, officers and managers in Accounting Departments of various manufacturing companies at Ilupeju Industrial Estate in Lagos-Nigeria. Data gathered were analyzed using regression estimate. The study concluded that companies with higher profitability attract more shareholders and that companies that pay regular dividend were patronized by shareholders. The study therefore recommended that companies should maintain the shareholders' wealth maximization objective through regular payment of dividend so as to ensure shareholders receive benefit of their investment as at when due.

Keywords: Capital budgeting, Manufacturing firms, Shareholders and Wealth maximization.

1.0 Introduction

One of the many objectives of corporate financial manager is to ensure the lower cost of capital and thus maximize the wealth of the shareholders of the company. A firm investment decision has an important influence on the financial performance and firm efficiency. One of the investment decisions a firm can make is in the area of capital budgeting or investment appraisal. Capital budgeting or investment appraisal decisions are of considerable importance to the firm since they tend to determine its value by influencing its growth, profitability and risk.

Capital budgeting has been defined as the planning process used to determine a firm's expenditure on access whose cash flow is expected to extend beyond one year (Tuoyo, 2017).

Proper capital budgeting is critical to a firm's successful performance because capital investment decision can improve the cash flow and lead to higher stock prices. Furthermore, it can have a significant impact on the firm's financial performance as poor decision can lead to financial distress or even bankruptcy of the firm.

Capital budgeting is the process by which firms determine how to invest their capital. Included in this process are the decisions to invest in new project, reassess the amount of capital already invested in existing projects, allocate and ration capital across division and acquire other firms. In essence, the capital budgeting process defines the set and size of a firm's real assets, which in turn generate the cashflows that ultimately determine its profitability, values and viability. In principle, a firm's decision to invest in a new project should be made according to whether the project increases the wealth of the shareholders (Obi and Adeyemo, 2014).

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Capital budgeting addresses the question of how a company decides to make investment in additional capacity or in new products and to replace worn-out fixed assets (Awomewe and Ogundele, 2008). They went further to state that several companies have lost their identities or liquidated due to wrong capital budgeting decision they made at one particular time or the other.

Pandey (2010) stated the feature of investment decision to be: the exchange of current funds for future benefits; the funds are invested in long term assets and that the future benefits will occur to the firm over a series of year. Pandey went further to state the importance of investment decisions as follows: 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; and they are among the most difficult decision to make.

Capital budgeting has a wide application in government as well as in private enterprises (firms). In the former, it is usually referred to as cost-effectiveness Analysis or System Analysis in a broader sense. At the core of capital budgeting is the time element since the benefits of a project are received over some future period. The firm must therefore time the commencement of a project to take advantage of short to take advantage of short-term business conditions. This is necessary because construction costs for instance in the case of executing a large-scale industrial project usually vary with the stages of the business cycle (Owualah, 2003).

Olawale, Olumuyiwa and George (2010) stated that traditionally capital budgeting methods have been used to evaluate and justify advanced manufacturing technology. In this context, capital budgeting is defined as the process of analyzing, evaluating and deciding whether resources should be allocated to a project or not. Capital budgeting decisions are critical to a firm's success for several reasons. Firstly, capital expenditure typically requires large outlay of funds. Secondly, firms must ascertain the best way to raise and repay these funds. Thirdly, most capital budgeting decisions require a long-term commitment and finally, the timing of capital budgeting decisions is crucial (Chen, 2004). Frankly (2000) noted that the appraisal of new and existing capital investment projects is fundamental to the success of the small firm. Seitz and Ellison (1999) postulate that in a perfect market, the value of the firm is maximized when the projects with the highest net present value are selected. We can infer from this that the way to maximize a firm's value is to make good and unbiased estimates of the net present value of projects. Hermes, Smid and Yao (2007) stated the importance of cost of capital in project evaluation. Estimating the cost of capital is necessary when a firm applies discounting techniques like the net present value (NPV) or internal rate of return (IRR). Hermes et al suggested methods like project dependent (risk adjusted) cost of capital (PDCC), weighted average cost of capital (WACC), cost of debt. In their conclusion, they stated that PDCC and WACC are the more sophisticated methods, the cost of debt is clearly the least sophisticated of the three methods. In fact, using the cost of debt for capital budgeting purposes is in most cases not appropriate. Yet since in many cases projects are financed by newly issued debt, using the cost of debt is tempting also because of the ease with which it can be calculated.

In investment decision rule requires a sound appraisal technique to be used to measure the economic worth of an investment project. The essential property of a sound technique is that it should be able to maximize the shareholders' wealth.

Pandey (2010) listed the characteristics to be possessed by a sound investment evaluation criteria as follows: it should consider all cash flows to determine the true profitability of the project; it should help ranking of projects according to their true profitability; it should recognize the fact that bigger cashflows are preferable to smaller ones and early cash flow are preferable to later ones; it should help to choose among mutually exclusive projects that project which maximizes the shareholders' wealth and it should be a criteria which is applicable to any conceivable investment project, independent of others.

Nigerian manufacturing firms have been confronted with many challenges one of which is the economic environment in which they operate, this has made it difficult for them to correctly budget for long-term expenditure for survival and growth. It is in consideration of this that this study seeks to investigate capital budgeting and maximization of shareholders wealth of quoted selected manufacturing firms in Nigeria.

2.0 Literature Review

This section contains the review of the literature from different authors. This is done in three ways:

- a) Concept/techniques of capital budgeting.
- b) Theories in respect of capital budgeting and
- c) Empirically reviewing works by previous authors on capital budgeting.

2.1 Concepts/Techniques of Capital Budgeting

The need for relevant information and analysis of capital budgeting alternatives has inspired the evolution of a series of methods to assist firms in making the best allocation of resources.

Amongst the earliest methods available were the non-discounted cash flows methods and the discounted cash flow techniques. The non-discounted cash flow methods are form of capital budgeting technique used in evaluating the uncertainty and risk of the value of a firm without considering the time value of money. These techniques are biased in selecting projects and also do not consider cash flows in investment decisions. The techniques constitute the payback period (PBP) and the accounting rate of return (ARR) (Olawale, Olumuyiwa & George, 2010).

2.1.1 Payback Period (PBP): CIMA (2002) defines payback as "the time it takes the cash inflows from a capital investment project to equal the cash out flows, usually expressed in years". When deciding between two or more competing projects, the usual decision is to accept the one with the shortest payback.

Payback period can be computed as: Payback = Total cash outlay/Annual cash inflows Payback = Number of years

This approach can be used where the annual cash inflows are uniform.

The payback period method is not without limitations when compared to other methods of capital budgeting. This method does not consider inflows beyond the payback date which could be higher than the inflows in the early stage of the investment. This method ignores investment that could be more profitable in the long run in favour of short-term profit.

2.1.2 Accounting Rate of Return (ARR): The accounting rate of return is the ratio of the project's average after-tax income in relation to its average book value (Copper, 1999). Accounting rate of return (ARR) evaluates the project based on standard historical cost accounting estimates. The accounting rate of return also referred as the book rate of return, bases project evaluation on average income and on accounting data rather than the project cash flows. Unlike the payback period, this technique produces a percentage rate of return figure which is then used to rank the alternative investments. It can be computed using any of the following formula

ARR = Average Profit/ Average Investment x 100/1

ARR = Total Profit/ Initial Investment x 100/1

ARR = Average Profit/ Initial Investment x 100/1

Simplicity and ease of understanding are often advanced as advantages gained by computing rate of return as the ratio of annual saving to project assets. This method embodies the concept of "net earning" while evaluating capital investment projects which is absent in case of all other methods.

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Discounted cash flow analysis on the other hand is a method of evaluating an investment by estimating future cash flows and taking into consideration the time value of money. The discounted cash flow technique requires both an understanding of compound interest and an ability to set out the inflows and outflows likely to result from a particular decision to invest.

Maximizing a firm's value is dependent on correct investment choices, thus management needs sound and reliable too to minimize the risk of poor investment decisions. Under discounted cash flow are:

2.1.3 Net Present Value (NPV): This is the present value of cash flows discounted at the cost of capital less the investment outlay. An understanding of various project evaluation techniques provides investor with valuable tools for determining which projects, if any should be accepted or rejected. The net present value decision rule is to accept all projects with positive NPV in an unconstrained environment, or if projects are mutually exclusive, accept the one with the highest net present value (NPV). The net present value considers the flow of income throughout the life of a project. The net present value (NPV) is a popular technique for investment because it is a financial measure that ascertains the time value of money invested in business (Peel and Bridge, 1998).

However, limitation of the net present value (NPV) is the fact that it uses cash flows which could be affected by inflation and other economic factors.

The net present value will be calculated as follows: PV = 1/(1+r)

Where: r = rate of return/cost of capital n = number of years of investment

If the present value is positive, an investment is considered desirable as it will add to the wealth of the shareholders. On the other hand, if the net present value is negative, then the investment should not be undertaken since the wealth of shareholders will be reduced (Bierman & Smith, 1971).

2.1.4 Internal Rate of Return (IRR): The internal rate of return (IRR) is defined as the discount rate that gives a net present value (NPV) of zero. It is a commonly used measure of investment efficiency. The internal rate of return (IRR) method according to the International federation of Accountants (2008), will result in the same decision as the NPV method for non-mutually exclusive projects in an unconstrained environment. If the IRR is greater than the project's cost of capital or hurdle rate, (the required rate of return in a discounted cash flow analysis) the project will add value to the company. One of the short coming of the IRR method according to the International Federation of Accountants (2008), is that it is commonly misunderstood to convey the actual annual profitability of an investment. However, this is not the case because intermediate cash flows are almost never reinvested at the projects IRR; and therefore, the actual rate of return is almost certainly going to be lower. IRR is computed as follow:

$$IRR = A + \left(\frac{x}{x-y} \quad BA \right)$$

Where:

A = One rate of return B = Other rate of return X = The NPV at rate A Y= The NPV at rate B The discounted cash flow rate of return is "the maximum rate of interest that could be paid for the capital employed over the life of an investment without loss on the project".

2.1.5 Profitability Index (PI): The profitability index is also referred to as the benefit cost ratio. Benefit cost ratio is a tool which modern financial analysts adopt before undertaking any financial operation for commercial activity.

Benefit cost ratio is an attempt to quantify the social advantage and disadvantages of alternative courses of action in terms of a common monetary unit. It is used to evaluate proposal for which net present values have been determined. The profitability index is determined by dividing the present value of each proposal by its initial investment i.e.

PI = NPV/Io

Where: NPV = Net present value Io = Initial outlay

A project is acceptable if its PI is greater than 1.0 and the higher the PI, the higher the project ranking.

2.2 Theories

According to Olowe (2017), a firm that raises funds from investors must make an investment decision to ensure that adequate returns are earned on the funds contributed to the firm. In order to maximize shareholders wealth, some theories were developed. The theories are discussed below:

2.2.1 The Stakeholders' Theory

Stakeholder theory has it academic roots in research related to business ethics and business and society. Freeman (1984) is regarded as the original proponent of the concept. Freeman argued that corporate management should look beyond shareholders and proposed a stakeholder perspective in managing the firm. Since then, a number of books and articles have been written on what is purported to be the stakeholder theory. Jones and Wicks (1999) have provided a good review of the current research and also attempt a synthesis of the extant research into a "convergent" theory. Jones and Wicks (1999) listed the following as "essential premises" of the theory: corporation has relationships with many stakeholders; the theory is concerned with the nature of the relationships in terms of both processes and outcomes; interest of all legitimate stakeholders have value; it is about managerial decision making; and the theory is "explicitly moral".

2.2.2 Agency Theory

Berle and Means (1932) initially developed the agency theory. They argued that there is an increase in the gap between ownership and control of large organizations' arising from a decrease in equity ownership. This particular situation provides a platform for managers to pursue their own interest instead of maximizing returns to the shareholders. In theory, shareholders of a company are the real owners of the business and the duty of top management should be solely to ensure that shareholders' interests are met. In other words, the duty of top managers is to manage the company in such a way that returns to shareholders are maximized thereby increasing the profit level and cash flows of the company.

2.2.3 Wealth Maximization Theory

Wealth maximization is one of the modern approaches. Wealth maximization is also known as value maximization or net present worth maximization. The theory of financing a firm is based on the assumption that the objective of the firm is to create value for the shareholders. As the legal owner of the firm, all residual earnings of the business belong to the ordinary shareholders (equity owners),

and any retained earnings are their undistributed wealth. Therefore, if the objective of the firm is to maximize its value and maximizing the value of the firm means maximizing the wealth of the shareholders since any extra wealth created belong to them. The increase in the wealth of the shareholders will consequently make the market price of the firm's share to group if it is quoted on the Stock Exchange (Adeyemi & Oboh, 2011). Wealth maximization is considered to be very important in that it takes into consideration timing of returns risk and return and the fact that the balances short and long-term benefits which profit maximization connote (Akintoye, 2016).

2.2.4 The Incrementalism Theory

Incrementalism incidentally is the main theory that influences capital budgeting decisions. It can also be noted that the literature on budgeting decisions has been dominated by the theory of incrementalism and its various meaning (Berry, 1990). The incrementalism theory suggests that policy makers use "rules of thumb" in order to deal with the technical complexity of expenditure decisions. Wildavsky, the founder of this theory suggests that the people who design the budget are concerned with relatively small increments to an existing base denoted as their fair share. It follows that budgeting is incremental to the extent that it results in marginal and regularity of changes in expenditure. Regularity embodies the idea of routine behavior in expenditure decisions. This view of incrementalism opines that small changes in expenditure base may be seen as preserving constancy.

2.3 Empirical Review

Barasa (2014) investigated the effect of firm-level investment appraisal on shareholder wealth maximization in Kenya by using questionnaires to elicit response from respondents who were top and middle level management executive of 57 selected firms quoted on the Nairobi Stock Exchange. The study used stratified sampling technique, and correlation analysis showed that shareholder wealth maximization is positively correlated with asset allocation and the market timing of stock.

Uwah and Asuquo (2016) in their study potential benefit of value addition consideration when making decision relating to capital budgeting and how it affects shareholder wealth maximization. The data for the study were obtained from both primary and secondary sources. The study used exploratory research design. Results from the regression analysis provides mixed results by finding some proxies for capital budgeting to exert significant positive effect on shareholder wealth maximization, while others were found not to be significant.

Uwem and Akabom (2016) examined the relationship between capital budgeting process and wealth maximization objectives in Nigeria firms. The results showed that capital budgeting process indicated by investment identification and selection. Project evaluation and capital budget proposal. Budgeting approval and authorization, project tracking and development, monitoring and control of projects and post completion audit have a significant relationship with wealth maximization objectives of firms in Nigeria.

Ozumba, Anichebe and Okoye (2016) explored the link between dividend policies on the wealth maximization of some selected companies listed in Nigeria. The study adopted a survey research design by using primary source of data obtained through the administration of questionnaires while adopting quota random sampling technique to ensure that each of the industries in the Nigerian Stock Exchange is adequately represented. The finding from the ANOVA revealed that dividend policy has significant influence on shareholder wealth maximization in Nigerian listed companies.

Osefual and Gyeke (2017) investigated financial management and shareholder wealth maximization with specific emphasis on the working capital management and market price per share of listed non-financial firms in Johannesburg Stock Exchange. The study used regression to analyze the secondary data obtained from annual reports and accounts of the sampled 75 companies for ten (10) years. The empirical finding from the regression revealed that both inventory conversion period and receivables conversion receivable conversion periods significantly and positively influence firms' value, while

cash conversion cycle was found to exert positive but not significant effect on firms' value. Findings also revealed that payables payment periods significantly and positively affect profitability.

Tuoyo (2017) investigated capital budgeting and shareholders wealth maximization. The study employed descriptive survey research design while Taro Yamene's formula was used in determining the sample size of 397 out of the entire population 53,528 member of staff of twelve Deposit Money Banks (DMBs). The study found that different shareholders wealth maximization proxies (dividend per share, profit, retained earnings, and market price per shares) are significantly affected by capital budgeting moderators such as inflation, political instability, management attitude to risk, and economic conditions, influenced shareholder's wealth positively in the Nigeria deposit money banks.

3.0 Methodology

This section gave detail information about the method and procedure that were adopted in gathering relevant data and how the data collected were analyzed. The primary data used for the study were collected through a survey conducted among different levels of employees of different manufacturing companies at Ilupeju Industrial Estate Lagos. The employees of the manufacturing companies are Accountants, officers and managers. A well-structured questionnaire was designed and distributed by hand to selected sample of employees. The questionnaire was designed in accordance with the objectives of the study. Selected respondents were drawn from the total population through simple random sampling. The procedure gave opportunity to all respondents to be selected evenly. The sample size for this study was eighty (80) respondents. Collected data were analyzed using statistical programme SSPS. Linkert scale quintet has been used while five options for each questionnaire on a 5-point scale e.g 5-strongly agree, 4-agree; 3-neutral; 2-disagree and 1-strongly disagree.

Variables	Group	Frequencies	%
Sex	Male	64	80
	Female	16	20
Total		80	100
Age	Less than 25 years	10	12.50
C	From 25 years -35 years	20	25.00
	More than 35 years-45 years	35	43.75
	More than 45 years	15	18.75
Total		80	100
Qualifications	HND/Bachelor's Degree/ACA	65	81.25
	MBA/Master Degree	11	13.75
	Other	4	5.00
Total		80	100
Job Title	Accountant	50	62.50
	Officer	12	15.00
	Manager	18	22.50
Total		80	100
Experiences	Less than 5 years	30	37.50
	From 5 years-10 years	35	43.75
	More than 10 years- 15 years	10	12.50
	More than 15 years	5	6.25
Total		80	100
	Source: Researcher's Computa	tion, 2021	

Data Analysis of the Demographic Characteristics of the Respondents

The respondent were 80% male and 20% female, most of them were between the age of 25 years and 45 years i.e 68.75% while 18.75% were above the age of 45 years. Most of the respondents had average experience of between 5 and 10 years. Of the respondents, 62.50% were Accountants, 15% were officers and 22.5% were managers. Out of the 80 respondents, 65 of them i.e 81.25% were having either Higher National Diploma (HND), Bachelor degree or Professional Accountants (ACA/FCA), while 13.75 were having Second degree i.e Master degree and 5% were having National Diploma or equivalent.

4.0 Results and Discussion

The purpose of this study is to evaluate how capital budgeting has affected shareholders wealth in Nigeria manufacturing companies. To achieve this objective primary data was employed and the result obtained are discussed below:

Table 2. Regression Results					
Sig	R ²	R	Calculated F	Tabulated F	Result
0.000	0.238	0.394	23.143	2.43	Significant
Source: SPSS Field Data Analysis 2021					

Table 2. Regression Results

From the table above, we can infer that there is a significance effect where the adjusted R² is 0.238 at the significant level $\alpha \le 0.05$. Calculated F value is 23.143 which is higher than tabulated value of 2.004 and as the level of statistical significance amounted to 0.000 which is less than the specified value 0.05, and therefore we accept the alternative hypothesis and reject the null hypothesis. This means that there is no statistical significance effect at the level of significance $\alpha \le 0.05$. This means that there is a significant impact of capital budgeting on the maximization of shareholders wealth in the Nigeria manufacturing companies.

5.1 Conclusion

This study considers capital budgeting and maximization of shareholders wealth in selected listed manufacturing firms in Nigeria. The study concluded that:

- a) Companies with higher profitability attract more shareholders
- b) Shareholders are more attracted to companies that pay dividend than those who do not pay dividend as they are uncertain about the state of such companies.
- c) Shareholders tend to be sensitive about the stock leverage of the company of their interest, so as to ensure that there are not left with nothing in case of liquidation.

5.2 Recommendations

Recommending investment for consideration means that investment managers must take into consideration factors such as political situation of the country inflation, risk associated with the projects and lastly project with positive net present value (NPV) as this will enhance the market price per share of the company. The study therefore recommends the following:

- a) Potential shareholders should make proper investigation about the financial state of the company of their interest before making investment decision.
- b) Companies should maintain the shareholders' wealth maximization objective through regular payment of dividend so as to ensure shareholders receive the benefit of their investment as at when due
- c) Shareholders should seek the advice of Investment Analysts so that they can be properly guided in their investment decisions.

Conflicts of interest: There is no conflict of interest of any kind.

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Citation: Abolade Francis Akintola, Pius Okafor Onichabor and Bamidele Olusegun Ebo. 2021. Capital Budgeting and Maximization of Shareholders Wealth in Selected Manufacturing Firms in Nigeria. International Journal of Recent Innovations in Academic Research, 5(9): 37-46.

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