Received 23 July 2024
Revised 9 November 2024
2 April 2025
10 July 2025
Accepted 8 September 2025

Perceptions of capital budgeting and political risk among small- and medium-sized enterprises: evidence from Lebanon

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Abstract

Purpose – This paper aims to investigate the investment appraisal process of small- and medium-sized enterprises (SMEs) in Lebanon and examine how political risk and Islamic finance considerations impact the capital budgeting (CB) process.

Design/methodology/approach – This paper conducts semi-structured interviews with senior executives of Lebanese SMEs to investigate their CB practices.

Findings – The results indicate that Lebanese SMEs place more emphasis on non-financial factors, such as political priorities and personal experience, than financial factors when analysing potential projects. Lebanese companies also use more than one method of investment appraisal, with payback being the most popular technique. Most interviewees indicated that their companies had experienced capital rationing and that it tended to be imposed externally. Political risk was consistently cited as a key determinant of project evaluation methods, while some respondents also acknowledged informal alignment with Islamic finance principles.

Originality/value – This paper contributes to the literature by examining whether capital investment appraisal techniques used in advanced Western economies are applicable in an emerging Middle Eastern context. It advances the understanding of how political risk and institutional fragility reshape CB behaviour among SMEs. The study also offers early evidence on how Islamic finance norms may inform investment decisions even in secular or mixed financial environments. Overall, it highlights the need for context-sensitive adaptations to conventional CB frameworks in high-risk, culturally embedded business environments.

Keywords Capital budgeting, Political risk, SMEs, Lebanon, Islamic finance

Paper type Research paper

1. Introduction

Capital budgeting (CB) refers to the process of evaluating and selecting the most beneficial investment opportunities from a set of alternatives. The effective deployment of capital into long-term assets is intended to generate optimal returns for owners and shareholders, aligning investment decisions with broader value-maximisation objectives (Graham, 2022). For small- and medium-sized enterprises (SMEs), this resource allocation process is particularly critical, as it underpins long-term sustainability and resilience, rather than simply

Competing interests: There are no competing interests to declare.

International Journal of Islamic and Middle Eastern Finance and Management
Vol. 19 No. 3, 2026
pp. 824-839

1753-8394
DOI 10.1108/IMEFM-07-2024-0357

delivering short-term gains (Graham, 2022). Given that a firm's future profitability is shaped by its current investment choices, CB serves as a mechanism for ensuring continued growth and competitive success (Harris and Raviv, 1996). Capital expenditure decisions often carry long-term implications, particularly when the cost of abandoning a project exceeds that of completing it (Stein, 1996). Given that a firm's present value is determined by its expected future cash flows and cost of capital, careful project selection is essential to maintaining financial health (Graham, 2022); poorly made CB decisions are frequently early indicators of financial distress and, in some cases, bankruptcy (Argenti, 1977).

This paper explores how CB procedures are implemented and how political risk is considered by corporate managers in Lebanese SMEs. The research addresses:

- How are capital investments appraised by Lebanese SMEs?
- Is risk incorporated in the process?
- How important is political risk?
- Do Lebanese SMEs face capital rationing, and is it internally or externally imposed? and
- Whether Islamic finance principles influence the CB process of Lebanese SMEs?

This study contributes to the finance literature by investigating the CB practices of Lebanese SMEs, a segment that remains under-researched. Most existing CB studies are grounded in the context of developed economies and are not readily generalisable to environments marked by volatility, institutional fragility and significant information asymmetry (Khamees *et al.*, 2010; Bakri *et al.*, 2022; Sureka *et al.*, 2022). Lebanon presents a compelling case for such an inquiry: the country has endured over five decades of political conflict, large-scale refugee inflows and continuous reconstruction demands. SMEs represent approximately 90% of Lebanese businesses and use nearly half the national workforce, making them central to economic activity and resilience. Furthermore, Lebanon's stock market is small and underdeveloped, rendering large public corporations less representative of prevailing business practices. In contrast, SMEs provide a more authentic lens through which to examine financial decision-making in high-risk, undercapitalised environments (Saleh *et al.*, 2008; Sureka *et al.*, 2022). This paper contributes to the literature by assessing whether CB techniques derived from Western models are used by SMEs in an emerging Middle Eastern context, how political risk shapes these practices and whether conventional CB frameworks require adaptation to reflect the realities of unstable economies. A nascent theme is the potential influence of Islamic finance principles on the CB process.

The study demonstrates that conventional CB models, designed for stable, market-oriented economies, fail to adequately capture the decision-making realities of SMEs operating in politically unstable environments. The findings challenge the presumed universality of the net present value (NPV) rule by revealing a consistent preference among Lebanese SMEs for payback (PB) methods, driven primarily by liquidity constraints and pervasive political uncertainty. This pattern underscores the need to revise CB theory to incorporate exogenous, non-financial influences, particularly political risk, as central determinants of investment behaviour in emerging markets. By highlighting how instability reshapes both risk assessment and the prioritisation of financial tools, the study advances a context-sensitive extension of CB theory that reflects the adaptive strategies of firms in high-risk economies.

While previous studies have documented the use of PB methods and acknowledged the influence of political risk on CB in emerging markets (Bakri *et al.*, 2022; Sureka *et al.*, 2022), this paper extends the literature by framing these patterns as deliberate, adaptive responses to persistent political instability. Rather than interpreting Lebanese SMEs' preference for simpler appraisal techniques as a shortcoming, this study positions it as a rational, contextually informed strategy shaped by institutional fragility and economic uncertainty. Unlike much of the extant literature, which treats political risk as an external limitation, the findings reveal how it actively restructures investment decision-making, displacing conventional financial logic and reshaping normative practice. In this way, the study not only deepens our understanding of CB behaviour in high-risk environments but also advances theoretical development by introducing a context-sensitive interpretation of financial adaptation. Additionally, by incorporating Islamic finance considerations, such as risk-sharing and ethical constraints, the paper offers new directions for revising CB models in culturally embedded and religiously governed financial systems.

The remainder of the paper is organised as follows. Section 2 presents an overview of the relevant theory and literature, while Section 3 outlines the sample of interviewees. Section 4 reports the interview results. Finally, Section 5 summarises the findings and presents some concluding observations.

2. Theory and literature review

2.1 Theoretical framework

The theoretical framework underpinning this study is rooted in the microeconomic foundations of finance theory, which maintains that the primary objective of CB is to maximise shareholder wealth (Arnold and Lewis, 2019). Given the inherent risk of investment, stakeholders expect compensation in the form of returns generated from a project's anticipated future cash flows. Foundational contributions by Fisher (1930) and Hirshleifer (1958) assert that firms should invest in projects until the internal rate of return (IRR) equals the required rate of return, at which point the project's NPV is zero. This framework assumes that investors can freely lend or borrow at market rates to optimise utility (Arnold and Lewis, 2019).

According to finance theory, a firm's value is determined by the aggregate NPV of its investment portfolio. Projects with a positive NPV contribute directly to shareholder wealth by increasing the firm's equity value (Fisher, 1930; Hirshleifer, 1958). Accordingly, investment decisions should be guided by discounted cash flow (DCF) analysis, which calculates the present value of expected net cash flows minus the initial capital outlay. A positive NPV signals value creation and is typically associated with a rise in the firm's share price. Because NPV is closely aligned with firm value and consistent with the investor's goal of wealth maximisation, it is widely regarded as the most robust and appropriate appraisal method for CB decisions.

In practice, well-managed firms dedicate substantial effort to developing CB proposals. While theory recommends accepting all projects with a positive NPV, and selecting the one with the highest NPV when alternatives are mutually exclusive, the decision-making process is often more complex. Differences between borrowing and lending rates, along with incomplete information about investment outcomes, frequently lead firms to impose internal constraints on capital expenditures, a practice known as capital rationing (Brigham and Ehrhardt, 2013). Moreover, the classical models proposed by Fisher (1930) and Hirshleifer (1958), which are based on simplified two-period assumptions, do not fully capture the extended time horizons of real-world projects. Classical models also fail to take account of CB contexts where political risk and an adherence to Islamic finance principles may characterise corporate behaviour. Nevertheless, their conceptual insights continue to shape contemporary financial thinking about investment evaluation and prioritisation.

2.2 Literature review

CB research has traditionally focused on large firms in stable economies, promoting DCF methods such as NPV and IRR as normative best practices (Damodaran, 2015; Graham, 2022).

However, empirical evidence consistently reveals a disconnect between theory and practice, with managers frequently preferring simpler techniques like PB, driven by liquidity pressures, managerial discretion and aversion to uncertainty (Sangster, 1993; Arnold and Hatzopoulos, 2000). This persistent divergence underscores a long-standing theory-practice gap in capital investment decision-making (Jones and Dugdale, 1994; Arnold and Hatzopoulos, 2000; Haka, 2006).

In emerging markets, where volatility is the norm, this gap becomes even more pronounced. CB models developed for stable environments often falter under political and economic uncertainty (Hermes *et al.*, 2007; Damodaran, 2011; Sureka *et al.*, 2022). Studies from the Middle East and North Africa region show that firms regularly operate under institutional and financial constraints that limit the applicability of textbook models (Bakri *et al.*, 2022). For instance, SMEs in Libya, Jordan and Kuwait continue to favour PB despite being aware of DCF tools – a pragmatic adaptation to environmental instability and institutional weakness (Khamees *et al.*, 2010; Mohammed, 2013; AlKulaib *et al.*, 2016).

Political risk has emerged as a significant yet under-theorised factor shaping CB decisions. It affects both project selection and funding access, prompting firms to prioritise short-term recoverability and political expedience over long-term value creation (Holmen and Pramborg, 2009; Belkhir *et al.*, 2017). Although empirical findings are strong, most studies treat political risk as an external constraint rather than a factor that reshapes CB behaviour from within (Bakri *et al.*, 2022). This limits theoretical insight into how firms adapt internally to systemic instability.

SMEs in politically fragile settings often face capital rationing and lack access to equity markets or reliable forecasting tools (Chazi *et al.*, 2010; Awdeh, 2014; Bakri *et al.*, 2022). These constraints trigger behavioural shifts, such as centralised, owner-led decision-making and the use of informal heuristics, that deviate from the rational actor assumptions of conventional CB theory (Saleh *et al.*, 2008). Yet these responses are rarely framed as rational, context-sensitive strategies, leaving room for reinterpretation.

While previous studies have documented the prevalence of PB, the impact of political risk and institutional barriers in emerging markets, few have framed these as rational responses to endemic volatility. Similarly, the influence of Islamic finance on CB practices remains marginal in the literature (Habib, 2018). This study contributes by synthesising these strands to propose a context-sensitive understanding of CB among Lebanese SMEs – one that integrates political risk, institutional constraints and cultural–religious factors into the investment decision-making process.

Islamic finance introduces a distinctive framework for financial decision-making that diverges from conventional Western models, particularly through its emphasis on risk-sharing and the prohibition of riba or interest (Habib, 2018). These principles exert a growing influence on the CB decisions of Lebanese SMEs, particularly among firms that operate within culturally or religiously conservative segments of the business community.

The principle of risk-sharing alters how investment risk is distributed between financiers and entrepreneurs. Unlike conventional debt arrangements, which oblige borrowers to make fixed repayments regardless of project outcomes, Islamic finance instruments, such as mudarabah (profit-sharing) and musharakah (joint ventures), require both parties to share in the profits and losses of the venture (Habib, 2018). This structure shifts the emphasis in CB away from purely quantitative indicators like NPV or IRR, towards a more holistic assessment of profit potential and operational viability. As a result, Lebanese SMEs aligned with Islamic finance principles may be more inclined to invest in projects that exhibit clear profit-sharing opportunities and tangible asset backing, while employing risk assessment techniques such as scenario analysis to anticipate a range of outcomes and ensure equitable returns.

Equally influential is the prohibition of riba, which precludes the use of interest-based financing. This restriction limits access to conventional bank loans and forces firms to seek Shariah-compliant funding alternatives, which remain underdeveloped in Lebanon. Consequently, many SMEs must rely on internal funds or equity-based arrangements, creating additional constraints on capital availability (Al Dabbas, 2023). In turn, this often results in more conservative investment behaviour and a stronger preference for appraisal techniques that prioritise liquidity and rapid cost recovery, such as the PB method. Furthermore, the absence of interest as a permissible discount factor challenges the use of DCF models. Some firms address this by adopting alternative evaluation metrics based on expected profit-sharing ratios or informal benchmarks, although these approaches are less standardised and more subjective.

Despite the relatively limited institutional infrastructure supporting Islamic finance in Lebanon, its principles have begun to permeate decision-making practices, particularly in family-owned or closely held SMEs. Even in cases where conventional bank loans are utilised, some firms internally avoid interest-based logic in their investment appraisals and evaluate projects based on ethical considerations, community benefit or alignment with religious norms. This introduces an additional layer of qualitative judgement into CB, further distinguishing it from the practices typically observed in Western financial systems. Overall, Islamic finance principles contribute to a broader context in which CB decisions are shaped not only by financial calculations but also by ethical, cultural and institutional factors.

3. Sample and research method

Twelve interviews were conducted across three Lebanese regions: Beirut, Zahle and West Bekaa. Participants were selected using purposive sampling to ensure variation in firm characteristics and enhance transparency. Selection criteria included:

(1) participants held senior managerial roles to ensure familiarity with CB processes;

(2) firms operated across diverse sectors to explore potential industry-specific practices; and

(3) banks and firms had varied ownership structures.

The sample included firms in construction, consultancy, food production, and banking, selected from different regions to reflect variations in economic exposure and political context. All SMEs met the formal definition of employing fewer than 250 people, with most having fewer than 140 employees. Ownership types ranged from family-run businesses to corporately managed firms.

Due to the absence of a centralised SME registry in Lebanon, initial access was facilitated through personal contacts. However, inclusion was based strictly on predefined criteria. While the sample size of 12 may appear modest, it aligns with qualitative research standards focused on depth over breadth (Patton, 2015; Creswell and Poth, 2016). Studies indicate that data saturation is often reached with 12 interviews in relatively homogeneous groups (Hennink and Kaiser, 2022).

To further diversify perspectives, the sample was split into two groups: nine “insiders” from firms and three “outsiders” (bankers and accountants). Interviews were conducted during a period of political unrest, and logistics were occasionally affected by travel constraints. Interview times were arranged by telephone, and the semi-structured format allowed participants to raise additional points. Supplementary questions helped probe deeper into key themes. All interviews lasted around 40 min, and detailed notes were taken throughout. Analysis focused on both shared themes and outlier responses, as deviations from normative practices offered additional insight into CB behaviour in Lebanon. Two tailored versions of the interview guide were developed: one for company representatives and another for "outsiders". Company-focused questions explored actual CB processes, while "outsider" interviews elicited general views on SME practices in Lebanon.

Table 1 summarises interviewee characteristics. The corporate sample included two Chief Executive Officers (CEOs), one Chief Financial Officer (CFO), four managers and two owners, all from firms with fewer than 140 employees. The "outsider" group comprised two bank managers and one chartered accountant. Educational backgrounds were strong: 10 held Master's degrees and 2 had undergraduate qualifications. About one-third studied in Lebanon, with the rest educated in the UK or the USA, mainly in finance or accounting. Most interviewees had over five years of experience, and the "outsiders" had more than two decades of managerial exposure.

Bank respondents disclosed that their institutions maintained annual lending budgets ranging from US$1.46bn to US$5.12bn. They approved funding between US$7.5m and US$55m for CB projects, figures that are consistent with Lebanon's historically strong banking sector (Awdeh, 2014). Interviewees were asked about planned capital investments and funding sources and most cited internal cash flows and bank debt, which is expected given Lebanon's underdeveloped stock market and the private nature of the firms.

4. Results of the interviews

4.1 The CB process of Lebanese SMEs

Table 2 summarises the responses to the interview questions. The table shows that the CB methods used by Lebanese firms are broadly consistent with international trends regarding the widespread use of the PB method (Klammer and Walker, 1984; Sangster, 1993; Elumilade *et al.*, 2006; Graham, 2022). All interviewees confirmed that PB was used to rank projects, either in isolation or alongside other methods, aligning with findings from similar regional studies.

Although studies such as Pike (1983), Klammer and Walker (1984), AlKulaib *et al.* (2016) and Graham (2022) suggest a growing adoption of DCF techniques, evidence from Lebanon indicates that this trend is emerging slowly and remains sector specific. For example, interviewees from the food sector reported exclusive reliance on PB. In contrast, all "outsider" participants confirmed the use of NPV. Consistent with earlier research (Sangster, 1993; Elumilade *et al.*, 2006; Pike *et al.*, 2018; Graham, 2022), 83% of respondents stated that Lebanese SMEs use both PB and DCF methods in tandem.

A notable pattern emerged within the food sector, where only PB was used. When asked about this, Interviewee C6 explained: "Capital projects in this company are very small … DCF methods are not suitable for short-term investing". He added that decisions are owner driven, with a preference for simplicity. Other interviewees echoed this sentiment, emphasising PB's ease and its usefulness in estimating PB periods. While some highlighted NPV as more accurate, all agreed on the practical value of using multiple methods, including IRR and modified IRR (MIRR).

The "outsiders" advocated for combining appraisal techniques. In particular, bankers favoured IRR and MIRR, while the accountant stressed PB and NPV. Interviewee CB2 remarked "Companies cannot just rely on PB … NPV, IRR, and MIRR should be used to achieve the best decision." Meanwhile, CA1 described PB as "accurate and simple", making it accessible to managers unfamiliar with more complex methods. Despite this, none of the

Table 1. Summary details about the interviewees

Interviewee	C1	C2	C3	C4	C5	C6	C7	C8	C9	CB1	CB2	CA1
Age	31–40	31–40	31–40	20–30	41–50	41–50	31–40	20–30	41–50	>50	41–50	>50
Highest degree	MSc	MSc	BSc	BSc	MBA	MBA	MBA	MSc	MSc	MBA	MSc	MSc
Subject	Finance	Finance	Accounting	Accounting	Mgmt	Mgmt	Mgmt	Finance	Finance	Mgmt	Finance	Accounting
Place of graduation	UK	UK	Lebanon	USA	Lebanon	Lebanon	Lebanon	UK	UK	USA	UK	USA
Experience (years)	8	6	9	3	12	15	10	5	13	20s	15	22
Position	CFO	CEO	Manager	Owner	Manager	Manager	Manager	Owner	CEO	Manager	Manager	CA
Number of employees	120	105	82	92	138	60	45	22	86	32	28	12

Note(s): This table provides background details about the 12 interviewees. C1–C9 represent the companies that were interviewed, CB1 and CB2 indicate the banker interviewees and CA1 denotes the chartered accountant. CEO = Chief Executive Officer; CFO = Chief Financial Officer; CA = Chartered Accountant; Mgmt = management
Source(s): Authors' own work

Table 2. Capital budgeting practices of Lebanese companies: summary of responses

Interviewees	C1	C2	C3	C4	C5	C6	C7	C8	C9	CB1	CB2	CA1
What methods do Lebanese companies use when appraising investment projects?	PB, NPV, IRR	PB, NPV	PB, NPV	PB, NPV, MIRR	PB, NPV, PI	PB	PB	PB, NPV, MIRR	PB, NPV	PB, NPV	PB, NPV	PB, NPV
Do investment appraisal methods play a key role in the investment decision?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Does the size, the nature of the project and/or the funding source make a difference in terms of the technique(s) used?	Yes	Yes	Yes	Yes	Yes	No	No	Yes	Yes	Yes	Yes	Yes
How do you select the discount rate that is used to assess new projects?	WACC	WACC	WACC	WACC	WACC	IR	IR	IR	WACC	IR	IR	WACC
What technique(s) do you use to assess the risk of a project?	SCE, SEN	SCE	SCE	SCE	SCE	Raising IR	N/A	SEN	SCE	SCE	SCE	SCE
Is political risk important for investment appraisal in Lebanon?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
If political risk is important, how is it taken into account?	Calc	Calc	Calc	Calc	Calc	N/A	N/A	Calc	Calc	Calc	Calc	Calc
If political risk is considered quantitatively, does it affect the discount rate, the cash flows, or both?	Cash flows	Cash flows	Cash flows	Cash flows	Cash flows	N/A	N/A	Cash flows	Cash flows	Cash flows	Cash flows	Cash flows
What capital budgeting method(s) are used when political risk is deemed to be important?	PB	PB	PB	PB	PB	PB	PB	PB	PB	PB	PB	PB
Has your firm (companies)/have Lebanese firms (outsiders) ever experienced capital rationing?	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	No	Yes	Yes	Yes
Is capital rationing imposed internally or externally?	External	External	External	External	Both	Internal	N/A	External	Internal	Both	External	External
Do you think that the development of the Lebanese stock market will help to alleviate the restrictions on funding?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Note(s): The table summarises the responses from the interviews. C1–C9 represent the company interviewees, CB1 and CB2 show the responses from the bankers that were interviewed, and CA1 gives the responses from the accountant interviewee. PB represents payback, NPV denotes net present value, MIRR is the modified internal rate of return, and PI represents the profitability index. WACC indicates the weighted average costs of capital, and IR represents the interest rate. SCE denotes scenario analysis and SEN indicates sensitivity analysis
Source(s): Authors' own work

"outsiders" reported pressuring SMEs to use a particular method, suggesting that firms were generally aware of expectations.

All interviewees acknowledged that CB methods inform decision-making, though several noted that non-financial factors also play a role. Interviewees C1, C3 and C9 referred to political pressure and limited legal protections. For instance, C1 recounted being compelled by a politician to build a factory in a location deemed unviable by financial appraisal. In such cases, projects were accepted despite negative NPVs, revealing how external influences can override financial logic. One respondent noted: "In some cases, even if a project is profitable on paper, it might be rejected if the owner lacks passion or experience in that field". C1 concluded: "The owner is the one who decides, even if the methods say otherwise".

These findings reflect Lebanon's informal business environment, where decision-making is shaped by personal networks, trust-based relationships and family ownership structures (Saleh *et al.*, 2008). In contrast to the transparency and corporate governance norms seen in Western contexts, Lebanese SMEs often prioritise owner experience over formal models. This pattern aligns with findings from other emerging markets, where decision-making authority is centralised and qualitative factors outweigh quantitative analysis (Sureka *et al.*, 2022).

Eighty-three per cent of respondents noted that project size, nature and funding source influenced the choice of appraisal method. For instance, C9 asserted that larger projects required NPV and IRR, as PB alone would be insufficient. C1 added that bank-funded projects necessitated more rigorous methods, as lenders expected formal evaluations. These findings are consistent with studies such as Pike (1996), Hermes *et al.* (2007) and Sureka *et al.* (2022), which highlight the contextual factors influencing CB decisions.

Lebanon's long-standing political instability has fostered a risk-averse business culture where liquidity and short-term recovery often take precedence over long-term gains (Salem and Azoury, 2017). In such environments, SMEs rely more on personal judgement, informal risk assessments and political alignment than on conventional financial models. Political uncertainty, including shifting regulations and tax policies, reduces confidence in long-term forecasting and encourages reliance on faster-return projects, even at the expense of optimal financial outcomes (Holmen and Pramborg, 2009).

The "outsiders" agreed that project characteristics should guide appraisal methods. Interviewee CA1 noted that PB was inadequate for long-term projects, stating: "A 15-year project cannot be assessed using PB alone." Others emphasised the importance of using the Weighted Average Cost of Capital (WACC), arguing that it provides a fuller picture of project profitability. Interviewee C7 justified using the bank's interest rate as a discount factor, given that most projects were debt-funded, when he said that "What is important is to discount cash flows by the interest rate set by the bank that is funding the project." Interviewee C8 added that using the interest rate was quicker and yielded results comparable to WACC:

> Discounting the cash flows using the interest rate is much easier, saves time, and gives the same results as calculating the WACC.

These insights align with Kester *et al.* (1999), who found that debt cost was the most commonly used measure of capital cost in several Pacific countries. Overall, the findings show that Lebanese firms primarily use interest rates to calculate discount rates, reflecting a reliance on debt financing and a limited focus on the cost of equity.

4.2 Risk in CB

With the exception of one respondent from the food sector, all corporate and external interviewees reported that their organisations undertook some form of objective risk assessment as part of the CB process. Among corporate participants, scenario analysis emerged as the dominant technique, either used independently or in conjunction with sensitivity analysis. This finding contrasts with evidence from Western and Gulf contexts, where sensitivity analysis is typically reported as the most frequently used risk evaluation method (Klammer and Walker, 1984; Pike, 1988; Al Mutairi *et al.*, 2009; Chazi *et al.*, 2010; Khamees *et al.*, 2010; Al-Ajmi *et al.*, 2011; Szűcsné Markovics, 2016). The preference for scenario analysis appears to reflect contextual adaptations to Lebanon's volatile macro-political environment. One interviewee remarked:

> In Lebanon, it is difficult to calculate risk – it is essentially infinite due to regional instability […] especially now that we have no president and are still grappling with the Syrian refugee crisis. Risk in Lebanon equals infinity.

Interviewee C3 confirmed the application of scenario analysis in his firm, while Interviewee C1 elaborated that his organisation combined scenario and sensitivity analysis, describing the former as "one of the most accurate ways of measuring risk." He further noted that he was introduced to the method during his academic training and endeavoured to apply it consistently across investment decisions.

External stakeholders, including bank managers and an accountant, corroborated these observations. Bank respondents noted that scenario analysis frequently appeared in loan documentation submitted by SMEs. However, some expressed doubts regarding the depth and rigour of such analyses. Interviewee CB2 stated:

> Even when companies claim to use scenario analysis, I am sceptical. They measure risk, but often through simpler means, like tightening the payback period, rather than conducting full scenario modelling.

In contrast, the chartered accountant affirmed that his firm consistently applied detailed scenario analysis when advising clients on capital investment decisions.

This variation in risk assessment practices reflects broader structural and institutional constraints in Lebanon's financial environment. In a setting marked by weak regulatory oversight and limited access to robust forecasting tools, firms may adopt simplified or informal methods under the guise of formal analysis. Such behaviours underscore the need for a more contextually grounded understanding of risk assessment in CB, particularly in politically unstable or institutionally fragile economies across the Middle East.

4.3 Political risk and CB

All "outsider" interviewees expressed cautious optimism regarding recent changes in Lebanon's economic environment. Nevertheless, concerns about the depth and effectiveness of these reforms were raised. For instance, Interviewee CB2 emphasised that while improvements were evident, they may not be sufficient to achieve the reforms' intended objectives, citing a pervasive lack of trust among both local and foreign investors:

> I am positive that recent changes have improved the Lebanese environment for investment, but it could be much better if the government gained the trust of foreign investors. People do not have enough trust to invest in Lebanon. They just see a dangerous country without a president. As a bank, we are happy to provide funding for projects in Lebanon, as we do not doubt that they will be profitable, but at the same time, we need to see that the country is advancing.

Among SMEs, a general willingness to invest was observed, though political stability emerged as a prerequisite. Participants consistently identified public sector reform as critical to restoring investor confidence and encouraging private sector engagement with available loan facilities. Interviewee C1 reflected:

> Political instability in Lebanon has been one of the most important topics. We have been experiencing this from the day we were born. Before the civil war, Lebanon was one of the most attractive countries regarding investment, but after it, everything changed and now we are at the back of the queue.

In terms of the "outsiders", Interviewee CB2 noted:

> Political instability affects us, even if we have a strong banking sector. Years ago, we had more deposits from abroad and more real estate purchases. Today, Lebanon has the potential to attract investment, but the politicians must unite.

When asked how political risk is incorporated into CB decisions, 83% of participants reported adjusting either cash flows or appraisal techniques. However, firms in the food sector tended not to formally account for political risk. Interviewee C6 stated:

> Political risk in the country should not be considered. It is very normal for Lebanon to have political turmoil. If we take political risk into account, then I think all projects will appear to be unsustainable and we will have to abandon them.

He added that during periods of instability, alternative methods should be used, as forward-looking models become unreliable.

Most participants reported adjusting projected cash flows to reflect political uncertainty. Interviewee C5 explained:

> Political instability in Lebanon affects how we appraise projects. The cash flows of a project are affected by any new political event. We cannot evaluate projects using DCF methods under such conditions. Normally, we use NPV, PI, and PB, but during periods of heightened instability, we rely on simpler methods like PB.

This sentiment was widely shared. All respondents confirmed that, during times of significant political risk, their firms adopt less sophisticated tools, especially PB, due to its emphasis on liquidity and short-term recoverability. For example, Interviewee C2 commented:

> We usually use NPV to appraise projects and then PB to gain a second perspective. When political risk is high, PB works better as it ignores the time value of money.

Interviewee CB2 added:

> During periods of political instability, Lebanese companies prefer PB because sophisticated techniques look too far into the future, which is not advisable.

These findings are consistent with Holmen and Pramborg (2009), who found that the use of NPV declines and the use of PB increases as political risk rises. Interviewee C8 corroborated this, noting:

> We use PB when political risk is high because this type of risk is very difficult to measure. It is not like standard project risk, which can be quantified through established models. As a result, executives tend to rely on simple rules of thumb when making investment decisions under political uncertainty.

Interviewees C4 and C8 echoed this conclusion. Overall, the evidence suggests that Lebanese SMEs resort to simplified CB methods under conditions of political instability, driven by the belief that no conventional risk measure can fully account for such uncertainty.

4.4 Capital rationing

A majority of company-based interviewees reported having experienced capital rationing in the recent past, while all "outsider" participants perceived capital constraints to be a widespread issue among Lebanese SMEs. In most cases, participants attributed this rationing to external constraints rather than internal policy decisions. This finding contrasts with the literature on developed economies, where internal capital rationing is more commonly observed (Pike, 1983; Trivoli and McDaniel, 1987; Mukherjee and Hingorani, 1999; Mukherjee *et al.*, 2000). However, in the Lebanese context, external rationing appears to be driven primarily by political instability and macroeconomic uncertainty. As Interviewee C3 explained:

> Sales figures in the construction sector are low this year due to political instability. This instability is hampering our ability to sell and, in turn, affecting the funding of new projects.

An "outsider" interviewee corroborated this:

> Lebanese SMEs face rationing due to external factors. When political turmoil is high, many companies experience declining sales and a corresponding shortage of funds for future projects. We see this reflected in the drop in loan applications during times of heightened political risk.

Where internal capital rationing was reported, it was typically motivated by a desire to control debt exposure or manage risk conservatively. Interviewee C6 illustrated this approach:

> As a manager, I place constraints on the level of funding we take from banks. If I did not, our debt levels would become unmanageable because we constantly generate new project ideas.

The interviewees also pointed to Lebanon's underdeveloped capital markets as a structural barrier to funding. One respondent (Interviewee CA1) expressed frustration:

> All Lebanese companies would prefer a strong stock market to fund their projects. But it is the government's responsibility to improve this situation. It is disappointing that only ten securities are listed on the Beirut Stock Exchange, and six of them are banks.

This sentiment was widely shared. Several participants indicated that they would consider listing their companies once the capital markets improve and regulatory reforms are implemented.

Overall, the findings suggest that Lebanese SMEs frequently face external capital rationing, driven by the country's political volatility and weak financial infrastructure. With limited access to equity markets and cautious lending from banks, many firms are forced to rely on internal funds. As a result, CB decisions are often shaped more by liquidity constraints and personal risk assessments than by formal financial evaluation. These findings mirror patterns observed in other emerging economies, where constrained access to finance often elevates the role of non-financial considerations in investment decision-making (Lazaridis, 2004; Chazi *et al.*, 2010).

4.5 The influence of Islamic finance on CB

While not the central focus of the interviews, several participants referenced ethical or religious considerations that align with Islamic finance principles. These appeared most often in firms with family-based ownership or conservative cultural orientations. A few interviewees reported a reluctance to take on interest-bearing loans, instead preferring to rely on internally generated funds or informal profit-sharing arrangements when financing capital projects. For example, Interviewee C6 remarked that "debt should not earn interest just because time passes - our family avoids it when possible." This stance reflects a broader sensitivity to the prohibition of riba in Islamic finance, even among firms not formally aligned with Shariah-compliant financial institutions.

Additionally, two interviewees suggested that religious principles subtly influence the types of projects pursued. For example, they favoured investments perceived as socially beneficial or ethically aligned, even when financial metrics were neutral. While none of the SMEs in the sample reported the formal use of Islamic finance tools such as mudarabah or musharakah, there was evidence of informal adoption of risk-sharing practices, particularly among firms that co-invested with trusted partners or shared downside exposure with suppliers or clients.

These insights suggest that although Islamic finance is not yet institutionally embedded in the CB practices of most Lebanese SMEs, its ethical and cultural underpinnings inform certain financing preferences and risk postures. This finding invites further research into how religious values may influence investment decision-making, particularly in settings where formal Islamic finance infrastructure remains underdeveloped.

5. Conclusion

This study presents qualitative insights into CB practices among Lebanese SMEs, based on 12 semi-structured interviews with senior decision-makers and external stakeholders. The interviews were designed to uncover how firms navigate CB in a volatile political and financial environment, with particular attention to risk management, methodological choices, and institutional constraints.

One key finding concerns the widespread use of PB, often in combination with DCF techniques. PB emerged as the most commonly used approach across firms, echoing the transitional pattern observed in developed economies during the 1970s and 1980s, when businesses began shifting from simple heuristics to time-value-sensitive methods. Lebanese SMEs appear to be undergoing a similar evolution, albeit constrained by contextual factors.

Regarding discounting practices, most firms used the WACC or interest rate benchmarks, yet none adjusted the discount rate to reflect project-specific risk. Nevertheless, risk assessment was addressed through scenario analysis, either as a standalone tool or in conjunction with other methods. This finding contrasts with results from studies in more stable markets, where sensitivity analysis dominates (Klammer and Walker, 1984; Pike, 1988; Al-Ajmi *et al.*, 2011).

Political instability emerged as the most salient contextual variable influencing CB behaviour. All participants emphasised its disruptive impact, noting that heightened political risk drives firms towards simpler, more liquid-oriented appraisal tools like PB. This preference reflects a rational response to institutional fragility, in which long-term financial projections become unreliable. The inability to forecast stable cash flows underpins a broader reliance on non-financial considerations, such as managerial discretion, political affiliations and informal networks, in investment decision-making.

The findings also reveal the dual nature of capital rationing. Most SMEs reported external rationing due to limited access to equity markets and risk-averse lending practices, particularly during periods of political unrest. However, some participants described internal rationing aimed at limiting debt exposure or reducing firm-level risk. These insights resonate with broader literature on CB in emerging markets, where liquidity constraints and macroeconomic volatility shape investment logic (Sureka *et al.*, 2022).

Crucially, this study supports the argument that conventional CB theory, grounded in rationality, perfect information, and market efficiency, requires modification to remain applicable in high-risk, low-transparency environments. Lebanese SMEs' reliance on PB should not be viewed as a deviation from best practice, but as an adaptive strategy that prioritises resilience and short-term recoverability over theoretical optimisation. The data suggest a reconceptualisation of CB practices in such settings as contextually grounded and strategically conservative.

The influence of political risk further challenges traditional finance models. Instances where SMEs were pressured into unviable projects due to political affiliations illustrate how political economy variables become endogenous to CB processes. These observations extend the microeconomic foundations of finance theory by incorporating institutional and political constraints as integral, rather than peripheral, elements.

Moreover, although nascent in practice, Islamic finance considerations offer a complementary lens for interpreting SME investment behaviour in Lebanon. Principles such as risk-sharing, asset-backing and ethical governance, embedded in Shariah-compliant finance, could reshape CB practices in ways not captured by conventional models. The study, therefore, invites further investigation into how Islamic financial ethics interact with investment decisions in unstable political climates.

Policy and managerial implications follow from these findings. For policymakers, the results underscore the need for institutional reform to restore investor confidence and reduce external capital rationing. Targeted interventions, such as tax incentives or government-backed guarantees for SME investments in high-risk sectors, could catalyse private investment. Developing the local capital market would also expand financing alternatives beyond bank loans.

For SME managers, the findings suggest the value of diversifying appraisal approaches and embedding real options analysis or scenario planning into CB practice. Firms should also seek strategic partnerships, domestically or internationally, to enhance resilience. Greater engagement with industry bodies and policy forums could help align public initiatives with SME needs.

This study offers a foundation for future research. Mixed-methods studies could extend the findings and enhance generalisability, while longitudinal case studies could provide deeper insights into CB project life cycles, from proposal to post-implementation review. A particularly promising avenue lies in examining how Shariah-compliant investment frameworks operate in practice. As Islamic finance gains traction in the Middle East, understanding its practical implications for CB could enrich both theory and applied policy in high-risk economic environments.

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