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# Effect of Leverage on the financial performance of non-financial firms listed on the Nigerian Stock Exchange (NSE)

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***Abstract***: *The study examined the association between leverage and the financial Performance of non-financial firms listed on the Nigerian Stock Exchange (NSE).The study utilized the secondary source of data, collected from the annual reports and accounts of all the sampled financial service firms listed on the Nigerian Exchange Group covering the period of twelve years from 2011 to 2022. This study will contribute to the existing pool of literature on the link between leverage and firms' financial performance. The study revealed that increase (or decrease) in leverage; increase return on equity and enhances the wealth of shareholders. The results also show an insignificantly positive relationship between financial leverage (debt- equity ratio) and return on capital employed. The study recommends that government should create an enabling business environment so that businesses can thrive and thus increase shareholder returns, such as increasing tax relief, which will allow Nigerian companies to have enough profit after tax to retain earnings and improve internal investment.*

***Keywords:*** *Leverage, Return on Equity, Return on Capital Employed, Return pn Asset*

## 1.0 Introduction

Financing decision is one of the fundamental functions of corporate decision making and decision is very important and should not be undermined. It is ranked under much more preference to other functions that help financial managers on deciding where, how and when to obtain finances to meet investment needs of the firm (Abdul & Badmus, 2017). Also, the decision on financing of a firm is very crucial (Nazir and Saita, 2013). Debt financing has been revealed to have a notable implication for firms as far as its operations is concerned. Debt financing can lead to better performance of an organization and expansion as well as failure of a same organization. As such, financial managers of firms got to be careful while making financial decisions.

The term financial leverage refers to the use of debts or borrowed capital for investment with the aim of expanding a firm's asset base and generating returns (Hayes et al., 2021). It describes the capacity of an organization to utilize capital debt in its financial structure and use it to its advantage. Financial leverage used by firms is usually meant to earn more as far as fixed charges on funds are concerned than on costs. Financial leverage entails variations of shareholders' income

in response to change in operating profits which result from financing a firm's assets with preferences stocks or debt (Rehman, 2013). However, inadequate financial decisions, most often than not, is associated with the failure of most corporate bodies when these wrong decisions lead to non-beneficial financial structures; therefore, it should be properly executed in all the companies.

According to Khoa and Thai (2021), the primary objective of corporate governance is to guarantee that the business acts in the best interests of its shareholders. Although, owners' interests may be different from representatives' interests, corporate governance can work as a mechanism to align the interests of stakeholders and management. Companies following well-defined corporate governance practices are better able to manage effective mechanisms, control oversight, offer more opportunities to flourish, and have better access to resources and hence improve overall performance as well as reduce risks (Bhagat & Bolton 2019).

Hence, the effective monitoring and controlling against managers' opportunistic behavior can be reduced and the impact on corporate governance minimized by increasing debt financing. As a result, debt contracts and financial leverage have the potential to improve firm fianancial performance. Hence, to address the question of whether financial leverage mediates the relationship between corporate governance and financial performance of listed financial service firms and is important for a number of reasons. First, corporate governance may not impact the firm performance directly. If the impact of corporate governance on firm performance is not direct, then the mediating impact between these variables could give mixed results. Second, when financial leverage is examined as a mediator, it is valuable to ascertain how that change impacts on corporate governance and firm performance using financial services firms.

## 1.2 STATEMENT OF THE PROBLEM

In an attempts to restore investors' confidence in the capital market, the relationship between corporate governance, financial leverage and firm performance have attracted interest from key stakeholders, particular government, policy makers/regulators, the public and academia. Therefore, corporate governance structure and practices are prone to various intervening factors that led to scandals and corporate failures in both developed and developing economy. Thus, a good corporate governance policy is necessary to guide top management in making effective capital structure decisions that will aid in achieving the financial goal of the firm because failed to achieved that it have consequences to the health and long-term survival of organisations. Most of these studies focused on the direct relationship between corporate governance and financial performance or corporate governance and financial leverage. Furthermore, others focused on financial leverage and financial performance.

At international arena, a number of studies have investigated the relationship between corporate governance and financial performance. Notably, Aernan et al. (2023), Appah and Tebepah (2023), Alabi et al. (2022), Buhari and Zango (2022), Egiyi (2022), Zelalem et al. (2021), Lima et al. (2020), Rajkovic (2020), Li et al. (2020), Sathyamoorthi et al. (2017), Sheikh et al. (2018),

Atuahene (2016), and Farhat (2014). Similarly, the works of Sarwar et al. (2022), Grabinska et al. (2021), Ibrahimy and Aidi (2021), Balagobei (2020), Feng et al. (2020), Hassan and Elamer (2020) examined the impact of corporate governance on financial leverage. In addition, the work of Anis et al. (2022), Korir et al. (2022), Shaikh et al. (2022) and Alhanssan et al. (2021) focused on the impact of financial leverage on financial performance. In all these studies, board size, board meetings, board financial expertise, board independence, board gender diversity, audit committees size, audit committee's meetings, audit committee's independence, audit committee's financial expertise, managerial ownership, institutional ownership, foreign ownership and ownership concentration were used as proxies for corporate governance. While financial leverage was proxied by total debts to total assets, long tern to total assets and short term to total assets while financial performance was proxied by return on assets, return on equity, share price, market to book ratio, Tobin's Q among others.

In Nigeria, most of the studies, notably, Aernan et al. (2023), Appah and Tebepah (2023), Adegboyegun and Igbekoyi (2022), Alabi *et al*. (2022), Buhari and Zango (2022), Egiyi (2022), Eni-Egwu *et al*. (2022), Korolo and Korolo (2022), Ogunlokun *et al*. (2022), Onyebuchi (2022), Gwaison and Maimako (2021), Ndum and Oranefo (2021), Esan *et al*. (2020), Ogunmakin *et al*. (2020), Okoye *et al.* (2020), Wilcox and Osho (2020), Gbadebo (2019), Yakubu et al. (2019) examined the relationship between corporate governance and financial performance while Damina *et al*. (2022), Kajola *et al.* (2019), Aminu and Murtala (2018), Ozegbe (2017) and Ganiyu and Abiodun (2012) focused on the impact of corporate governance and financial leverage. Only few studies, precisely, Aribaba *et al*. (2022), Bawa (2022), Etukudo *et al*. (2022), Ofulue *et al.* (2022), Ogbonna *et al.* (2022), Olaoye and Adesina (2022), Alhanssan *et al*. (2021) assessed the impact of financial leverage on financial performance. However, most studies (national and international) documented a very strong relationship between corporate governance and financial performance. This is an indication that there are hiding variables that assist the relationship. Hence, financial leverage may be part of these hiding variables.

## 1.3 Objectives Of The Study

The general purpose of this study was to examine the association between leverage and the financial Performance of non-financial firms listed on the Nigerian Stock Exchange (NSE).

1. Establish the association between leverage and the firms' financial performance as measured by ROA.
2. Examine the relationship between leverage and the firms' financial performance as measured by ROE.
3. Explore the link between leverage and the firms' financial performance as measured by ROCE.

## 2.0 Literature Review

### Financial Leverage

Firms need funds to expand their operations and financial their assets. There are a multiple of financing sources available to finance their assets. Basically, two sources of finance can be used: internal financing sources which include reserves and retained earnings and external financing

which includes long-term loans, bond issuance, ordinary and preferred stock issuance. Financial leverage is the use of borrowed money (i.e. debt) as capital by using different sources of funds in the form of either short term debt or long term debt in the form of debenture or bonds (Khalid *et al*., 2017).

According to Horne (2009) the term financial leverage is the employment of an asset or fund for which the firm pays a fixed cost of fixed return. Leverage is one of the methods being used by owners/managers to finance their capital. To gain a general idea of how much debt is employed by a company, a total interest bearing debt is compared to total assets or capital as the case may be. A higher percentage implies more dependent on debt and so a riskier venture. It can determine the overall level of financial risk (Khalid *et al.*, 2017).

The proportion of debt to equity in the capital structure of a company is refers to leverage. It refers to the extent with which a company uses both their equity and borrowings to increase their performance. The financing decision is purely a managerial decision in that it influences the shareholder's return, risk and market value (Nwanna & Ivie, 2017). Companies that borrowed a huge and large sum of money could be seen as highly leverage if this occurred during the business recession and this might pose a great potential risk. Financial leverage is the use of borrowed money (debts) to finance the acquisition of assets with the hope that the capital gain from the acquisition of the new assets will exceed the cost of borrowing. It can also be referred to as the measure of how much firm uses debts and equity to finance its assets in order to increase the operating profit of the firm.

In general, companies may raise money from internal and external sources. The companies can raise fund from internal sources by plowing back part of their profits, which would otherwise have been distributed as dividend to shareholders. Funds could also be raised from external sources by an issue of debt or equity. The firm's leverage decision centers on the allocation between debt and equity in financing the company (Sagin & Eragbhe, 2014). According to Adetunji et al. (2016) financial leverage is the extent to which fixed income securities (such as debt) are used in a firm's capital structure.

Financing options may consist of debt, equity and hybrid securities which will reflect the firm value and performance. Higher level of debt financing may result in default and bankruptcy cost while equity financing will give bad signal to the public on the performance of the firm. Good capital structure decision taken by the managers will maximize the utilization of the investment and sustain the firm operation in the long run (Ibrahimy & Aidi, 2021). Therefore, it will ensure the achievement of firms' objective in maximizing the shareholders' wealth or the value of the firm

A levered firm comprises of debt and equity while the unlevered firm is an all- equity firm (Andy *et al*., 2002). In finance, capital structure decision has become important and of interest to researchers. Although, the issue of financial leverage in the developing countries has been reviewed yet, substantial examination of the effect of financial leverage on firm performance in Nigeria can still be done. It is as a result of this, that this research work is geared toward examining such effect. Therefore, financial leverage measure such as total debt to total assets will be used in

this study because it helps the firms in taking financial decisions and it measure how much a firm uses her total debts to finance its assets, it also reflects the debt amount used in the capital structure of the firm and therefore, has an impact on the firm's returns proportionate to the extent to which the firm's assets are financed with debt (Ibrahimy & Aidi, 2021).

**Financial Performance**

Many scholars believed that research on financial performance originated from strategic management and organization theory (Samuel & Abdulatef, 2016). In view of this, to analyze firms' financial performance, emphasis should be geared to describe the concept of financial performance which covers different dimensions upon which firm's financial performance emanated. Firm financial performance can be defined as a process by which company manages its resources in line with its operational strategies and objectives to develop competitive advantage.

To Ibrahim and Abdullahi (2019) financial performance is defined as the ability of a firm to maximize its cost of operations, efficiently use its assets and maximize the value of shareholders. It shows the effectiveness and efficiency of management in the use of corporate resources. It is further defined as the attempt by a firm to meet established goals or effective productivity. Also, it is a measure of the firm's earnings, profits and appreciation in its value which is disclosed by the rise in the market value of shares (Ibrahim & Abdullahi, 2019).

Corporate performance measure has different aspects and choosing relevant measures are important for pursuing research intentions. Performance measurements offer insights into appropriate measures for answering research questions. However, it is not always agreed as to what performance measures should be employed and used (Haniffa & Hudaib, 2006). There are various measures which have been used regularly in past studies as a measure for firm performance (e.g., value ratio, labour productivity, net present value, market-to-book value, and earnings per share). The measures of performance for the purpose of this proposition could be divided into two majors' groups: market measures and accounting measures, specifically Tobin's Q, ROA and ROE.

Regarding Return on Assets (ROA), several studies have used this measure such as Farhat (2014), Lin *et al.* (2008), Haniffa and Hudaib (2006), Al-Khouri (2006), Gedajlovic and Shapiro (1998), and Denis and Denis (1994). In view of that, ROA is measured as earnings after interest expenses and taxes divided by total assets. ROE is a measure of financial performance calculated by dividing net income by shareholders' equity because shareholders' equity is equal to a company's assets minus its debt. ROE could be thought of as the return on net assets. According to Panigrahi and Vachhani (2021), return on equity is a measure of the profitability of a business in relation to the equity. It is a measure of how well a company uses investments to generate earnings growth. Return on equity (ROE) is a ratio that provides investors with insight into how efficiently a company (or more specifically, its management team) is handling the resources that shareholders have contributed to it (Sani *et al.*, 2019; and Panigrahi & Vachhani, 2021). In other words, it measures the profitability of a corporation in relation to stockholders' equity. The higher the ROE, the more efficient a company's management is at generating income and growth from its equity financing

With respect to Tobin's Q which was first introduced by Tobin in 1967, it has been used by many researchers such as, Farhat (2014), Haniffa and Hudaib (2006), Holderness *et al.* (1999), Cho (1998) and Morck *et al*. (1988). Tobin's Q is measured as the ratio of market value of assets (equity and debt) by the replacement value of assets. However, other studies used Tobin's Q and were calculated in different ways. For instance, in Tobin's calculation, Yermack (1996) calculated Q by dividing the market value by the estimated replacement costs of assets. Chung and Pruitt (1994) compared their model, which defined Tobin's Q as the market value of equity plus the value of preferred stock plus total debt divided by the book value of total assets, with the Lindenberg and Ross (1981) model finding that the replacement value for the firms' plant, equipment, and inventories is equal to their book value.

In both developed and developing countries, Tobin's Q the ratio of market value of assets (equity and debt) to the replacement value of assets is broadly used as a proxy of firm performance measure. Firm's accounting and reporting systems provide financial accounting data, and this quantitative data regards the financial position and performance of the firm over a specified and particular period. (Farhat, 2014). While accounting data is very important in corporate governance, accounting measures do not reflect all agency costs because the management of the firm provides financial statements which are subject to audit to prove that they are fairly presented according to the general accounting principles and standards.

Prowse (1992) postulated that as stock market returns are suspected to modify for any conflicts between managers and shareholders, accounting measures are favourable for examining the relationship between firm performance and corporate governance. The role of accounting data in the operation of corporate governance mechanisms has been examined in previous studies in corporate governance (for instance, Farhat, 2014; Haniffa & Hudaib, 2006; Morck et al., 1988; Holderness & Sheehan, 1988 among others). However, accounting measures need to be carefully considered as the study results might be biased by using accounting measures without copulating together with the market performance measure. Accounting measures are normally established on historical data, which could cause lack of comparability and lead to distortions amongst firms. Therefore, the accounting valuation may be not up to date. Tobin's Q displays the financial strength of the firm and it is used in the financial market as a proxy for a firm performance. Tobin's Q has been used in several studies as captured above; however, there are some disadvantages when using market indicators as performance measures.

## 3.0 Methodology

### The Study Area

Federal Republic of Nigeria is a sovereign country located in West Africa; Nigeria is a federal constitutional republic comprising thirty-six states and a Federal Capital Territory. Nigeria borders the Republic of Benin in the west, Chad and Cameroon in the east, and Niger in the north. Its coast lies on the Gulf of Guinea, part of the Southern Atlantic Ocean. The people of Nigeria have an extensive history, and archaeological evidence shows that human habitation of the area dates back to at least 9000 BC. Nigeria is the most populous country in Africa and the eighth most populous

country in the world with a population of over 205 million. The country is listed among the "Next Eleven" economies, and is one of the fastest growing in the world with the International Monetary Fund projecting growth of 9% in 2008 and 8.3% in 2009 (C I A, 2020; IMF, 2020; McIntosh, 1981).

The financial services industry as regulated by the Central Bank of Nigeria (CBN) is made up of Deposit Money Banks and insurance companies. There are three regulators in the Nigerian Banking industry and insurance companies namely the CBN, PENCOM and the Nigerian Deposit Insurance Company (NDIC). These are government institutions set up by law to regulate, monitor and control the activities of the actors in the financial services firms, and entire financial sectors in Nigeria. The focus of this study however is restricted to the activities of financial services firms in Nigeria.

### 3.1 Population

For this study, the population is the fifty (50) listed financial service firms on the Nigeria Exchange Group floor as at 31st December 2022. This will be done to enable the researcher to have the complete data needed for the study's time frame

### 3.2 Sample Size and Sampling Technique

The sample will be extracted from the population of all listed financial service firms on the Nigeria Exchange Group and will be filtered based on some criteria (a judgmental non probabilistic sampling technique). Judgment sampling technique will be used in arriving at sample size of the study.

### 3.3 Source of Data and Method of Data Collection

The study will utilize the secondary source of data, collected from the annual reports and accounts of all the sampled financial service firms listed on the Nigerian Exchange Group covering the period of twelve years from 2011 to 2022.

## 4.0 ANALYSIS OF DATA

**Descriptive Statistics**

| | LEV | ROA | ROE | ROCE |
|---|---|---|---|---|
| Mean | 0.574545 | 0.043727 | 0.35790 | 0.04372 |
| Median | 0.454000 | 0.061000 | 0.12800 | 0.06100 |
| Maximum | 1.320000 | 0.190000 | 1.55500 | 0.19000 |
| Minimum | 0.062000 | -0.369000 | - | - |
| Std. Dev. | 0.432901 | 0.148408 | 0.62772 | 0.14840 |
| Skewness | 0.514213 | -2.086101 | 0.66503 | - |
| Kurtosis | 2.000035 | 6.730226 | 2.17371 | 6.73022 |
| Jarque-Bera | 0.943062 | 14.35585 | 1.12376 | 14.3558 |
| Probability | 0.624046 | 0.000763 | 0.57013 | 0.00076 |
| Sum | 6.320000 | 0.481000 | 3.93700 | 0.48100 |
| Sum Sq. Dev. | 1.874037 | 0.220250 | 3.94041 | 0.22025 |

### Discussion of Results

Table 1 displays the mean (average) for each variable, as well as their maximum and minimum values, standard deviation, and Jarque-Bera (JB) statistics (normality test). The findings in Table 1 provided some insight into the nature of the selected Nigerian publicly traded food companies used in this study.

It was discovered that the sampled quoted companies in Nigeria had positive leverage (DER) = 0.575 on average over the period under study. Furthermore, the large difference between the maximum and minimum value of the = return on equity (ROE) and profit margin (ROA demonstrates that the sampled quoted companies in this study are not dominated by companies with high leverage ratios. Furthermore, the average, the Jarque-Bera (JB) test, which tests for normality or the presence of outlier or extreme values among the

Variables, shows that all of our variables are normally distributed, even though the result is not significant at the 5% level, and the result could be generalized. This also implies that the pooled regression models.

### CONCLUSION AND RECOMMENDATIONS

This study focused on the relationship pattern of leverage and performance, thus shows the Importance of leverage in stockholders returns that intend to affect the wealth maximization goal of a firm. The results of the analysis show statistically insignificant correlation between financial performances (as measured by return on equity and ROCE). This reveals that increase (or decrease) in leverage; return on equity enhances the wealth of shareholders. The results also show a insignificantly positive relationship between financial leverage (debt- equity ratio).

### Recommendations

The following recommendations were made based on the findings:

1. The government should create an enabling business environment so that businesses can thrive

and thus increase shareholder returns, such as increasing tax relief, which will allow Nigerian companies to have enough profit after tax to retain earnings and improve internal investment.

2. Firms are advised to conduct detailed feasibility studies on any proposed investment in order to determine the assets' and investment's viability. The institution's management should make the optimal capital structure decision in order to use funds wisely and maximize shareholder wealth.

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