

THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

Financial Leverage and Performance of Bank and Non-bank Firms in Nigeria

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Abstract:

The study investigates the effects of financial leverage on the performance of firms in Nigeria. Specifically, the study examines the effect of financial leverage on firm size of the selected bank and non-bank firms in Nigeria; assess the relationship between financial leverage and debt to equity ratio of selected banks and non-bank firms in Nigeria across seven firms in Nigeria from 2007 to 2018. The study proxied return on an asset as the dependent variable while return on capital employed, firm size and debt to equity ratio were the explanatory variables. Static panel regression was made as to the main technique, and evidence from the result showed and concluded that financial leverage exerts a negative influence on the performance of firms in Nigeria. Thus, it was recommended that firms should endeavour to embark on capital investments in a bid to increase the performance of firms in Nigeria adequately.

Keywords: Financial leverage, firm performance, bank, non-Bank, static panel regression, Nigeria

1. Introduction

Financial liberalization is viewed as a double-edged sword. This is because the growth-stimulating effect is accompanied with increase in financial fragility experienced by both developed and developing countries. The proponents of financial liberalization opined that liberalization of the financial system influences economic growth through better allocation of savings and private investments; another school of thought represented by the Keynesian economists (Stiglitz, 2003) believes that a liberal financial system hurts the economic development adversely. Since the widespread acceptance of the ideals of financial liberalization shown in the seminal works of Mckinnon (1973) and Shaw (1973), many developing countries including Nigeria, have attempted to liberalize their financial sector. The resultant effect opened up the Nigerian economy to the global market, which has generated increasing apprehension in the economy and has exposed the financial fragility and vulnerability of her financial system.

A vital financing decision that firms must take is to decide the proportion of debt and equity that will constitute their capital structure. It is usually a difficult task for managers to ensure that business organizations operate on the optimal mix of equity and debt. They are in a constant struggle of ensuring the adequate sources of long-term financing that will maximize the wealth of shareholders (Njeri & Kagiri, 2013). Any combination of common stock, preferred stock and debt used in financing the assets of a firm creates some level of financial risk. In other words, financial risk is directly related to the firm's capital and financial structure/leverage (Pandey 2010).

There are ever-increasing and growing variances in the performance of commercial banks concerning the financing of their operations. The study seeks to find how banks can minimize risk and remain optimally financed. The financial performance of companies is a problem that has attracted a lot of attention, comments and interests from financial experts, researchers, the general public and corporate administration. However, selecting the most successful companies has always been a difficult task for many, since a company can have a high level of profitability, but at the same time find itself in a terrible situation with regards to its liquidity and efficiency (Omondi and Muturi, 2013). Financial management in public companies aims to maximize the company's market value or maximize the value of shares on the market. The achievement of this goal depends on a series of variables that vary in their impact on the value of the company from one variable to another and from one market to another and from one sector to another. From the review of previous work by several researchers, it was concluded that leverage has a positive effect on profitability and efficiency and that significant effects on liquidity, on the size and on the value of market capitalization have been found.

Several studies have been carried out in the past on this subject. Still, the review of previous empirical literature revealed a lack of proper understanding. It resulted in the effect of financial liberalization on the bank and non-bank performance in the research findings of past researchers. This indicates the existence of a research gap. Other research

works focused on the impact of financial liberalization on the deposit money banks in Nigeria and in other countries includes, Ogar and Oka (2016), Okafor (2017), Abata (2016), Ayuba (2017), Macek (2018) Ude and Agodi (2017) resolved into the conclusion that financial liberalization exacts a positive effect on the bank and non-bank financial performance. Otu and Theophilus (2018), Gacanja (2017) and Muriithi (2018) resulted in a negative effect of financial liberalization on bank and non-bank financial performance. This divergence in point of various authors led this research into a gap of examining the effect of financial leverage on performance of Nigeria banks. Thus, the objective of the study is to investigate the effect of financial leverage on performance of Nigeria banks. The specific objectives are: To ascertain the effect of financial leverage on the performance of selected Bank and Non-bank firm; to examine the effect of financial leverage on Firm size of the selected bank and non-bank firms in Nigeria; to assess the relationship between financial leverage and debt to equity ratio of selected banks and non-bank firms in Nigeria.

2. Literature Review

Leverage refers to the extent to which firms make use of their money, borrowings (debts financing) to increase profitability and is measured by total liabilities to equity. Leverage refers to the proportion of debt to equity in the capital structure of a firm. The financing or leverage decision is a significant managerial decision because it influences the shareholder's return and risk and the market value of the firm (Omondi & Muturi, 2013). Leverage is viewed as a result of events that determines companies' source of financing to run the business (Alkhatib, 2012). Firms that borrow large sums of money during a business recession are more likely to default to pay off their debts as they mature; they will end up with high leverage and are more likely to end up with a potential risk of bankruptcy.

Firms with high leverage are expected to disclose more information than firms with low leverage. The disclosure of information can be used to lower the monitoring costs of creditors. Creditors would like more information to be disclosed to control their own credit risk. Business owners seek to increase their wealth and the performance of their firms. Njeri and Kagiri (2013) opine that leverage increases the level of the debt in the capital structure and the turnover of the business and hence its profit, increasing returns to the business owners. They also claim that an increase in interest rate is expected to result in reduced borrowing, increased interest expenses and thus reduced returns to business owners. On the other hand, financial performance is the function of the ability of an organization to gain and manage the resources in several different ways to develop a competitive advantage. Financial performance emphasizes on variables related directly to financial report (Iswatia & Anshoria, 2017). Almajali, Alamro and AlSoub (2012) opined that financial performance can be measured in three ways namely, profitability, return on capital employee and firm size. Profit is the ultimate goal of business organizations, commercial banks inclusive. Leverage levels are likely to influence profitability since it affects the Weighted Average Cost of Capital (WACC). On a different note, profitable firms can issue debt at low rates of interest since they are seen as less risky by the creditors (Mazur, 2007). Return on Capital Employed (ROCE) is a financial ratio that refers to how much profit a company earned compared to the total amount of capital invested or found in the statement of financial position (Ongore & Kusa, 2013). It is the return per naira of capital employed in the firm. A business with high returns on capital employed is more likely to be one that is capable of generating cash internally. Thus, the higher the ROCE the better the company is in terms of profit generation. Lastly, all firms exist to grow very large. This is because firm growth serves as a motivation for stakeholders like Investors, Employees, Suppliers, Government and the Society at large. When firms enlarge, there is a level of satisfaction that board of directors and management are making use of organizational resources and using opportunities to the advantage of the firm. Size is proxy using the natural logarithm of total assets.

2.1. Theoretical Framework

This study is based on the theory of offsets because it proposes that a company's optimal debt-to-GDP ratio is determined by offsetting the costs and benefits of the loans. The remuneration theory of the capital structure is the idea that a company chooses the amount of debt financing to be used by balancing costs and benefits. Anup and Suman (2017) assessed the impact of capital structure on the value of firm of Bangladesh by using secondary data of publicly listed companies traded on Dhaka Stock Exchange and Chittagong Stock Exchange using share price as a proxy for firm's value and different ratios for capital structure decision. It was found that maximizing wealth for the shareholders requires a perfect combination of debt and equity. That cost of capital is negatively correlated and therefore, to be reduced to the minimum level. Berger and Wharton (2018) in the same vein studied capital structure and firm performance testing agency cost theory hypothesis. The study focused the banking sector only. Their findings are well consistent with agency cost hypothesis-lower leverage or higher equity capital ratio is associated with higher profit efficiency. Ong and Teh (2016) studied capital structure and performance of construction companies for a period of four years, 2014 – 2018 in Malaysia. Long term debt to capital, debt to capital, debt to asset, debt to equity market value, debt to common equity, long term debt to common equity were used as proxies and independent variables. Return on capital, return on equity, earnings per share, operating profit margin were used to substitute corporate performance. The result showed that there is a relationship between capital structure and corporate performance.

2.2. Empirical Review

Pratomo and Ismail (2017) studied capital structure and performance of Islamic Banks of Malaysia. They used the profit efficiency of the bank as an indicator for reducing agency cost and the equity ratio of the bank as an indicator for leverage. Their findings were also inconsistent with the agency hypotheses. Abubakar (2015) studied the relationship between leverage and financial performance of deposit banks in Nigeria, with specific reference to how the debt / equity ratio and the debt ratio affect the return on money banks' capital. of deposit in Nigeria. The correlation analysis revealed a

significant relationship between the debt / equity ratio and the power of financial performance from the return on equity. However, no significant relationship was found between the debt / debt ratio and the ROE. The study recommends, inter alia, that banks adopt an appropriate combination of debt and equity if they want to improve their financial performance, survive and remain competitive.

Akinmulegun (2012) examined the effect of leverage on selected indicators of corporate performance in Nigeria. Financial leverage therefore significantly affects corporate performance in Nigeria. Examine the impact of leverage on earnings per share and equity per share of corporate companies in Nigeria. The study observed that leverage shocks (debt / equity ratio) have a significant effect on corporate performance, especially when net assets per share (NAPS) are used as an indicator of corporate performance in Nigeria during the period covered by the study. Enekwe, Agu and Eziedo (2018) explored the effect of financial leverage on the financial performance of Nigeria pharmaceutical companies. The study used secondary data for the year 2012 to 2018 a sample of three companies. The study employed the Pearson correlation and regressions models to analyze data collected. It was established that both the debt ratio and debt-equity ratio had a negative relation with profitability when measured using ROA. The study also found that the ration on interest coverage had a positive relationship with the profitability of pharmaceutical companies in Nigeria. However, the study revealed that the debt to equity ratio, debt ratio and interest coverage ratio had an insignificant impact on the profitability of the pharmaceutical industry in Nigeria.

Oke and Afolabi (2017) investigated the impact of capital structure on industrial performance in Nigeria. They considered a sample of five quoted firms. Debt financing, equity financing and debt/equity financing were used as a proxy for capital structure while profiting efficiency a surrogate for performance. For equity and debt/equity finances, a positive relationship existed but a negative relationship between debt financing and performance. Onaolapo and Kajola (2018) studied the impact of capital structure on performance of Nigerian firms focusing on the non-financial sector with a sample of thirty listed firms for seven years, 2010-2017 from agency cost theory point of view. The result revealed that capital structure surrogated by debt ratio has a significant negative impact on financial measures, return on assets and return on equity and therefore in support of the agency cost theory's position.

3. Methodology

3.1. Research Design, Population, Sample Size and Sampling Technique

The study made use of *ex-post-facto* research design. A sample of four (4) banks and three (3) manufacturing firms were selected for analytical purpose. The firms were purposively selected and include First Bank Plc, Guaranty Trust Bank (GTB), Wema Bank Plc, United Bank for Africa Bank Plc, Julius Berger Nig. Plc, Unilever Nig. Plc and Guinness Nig. Plc.

3.2. Model Specification, Estimation Technique

The study referenced the model used by Wabwile, Chitiavi, Alala and Douglas (2014); however, with modification, the model is stated as:

$$ROA = f(ROCE, FZ, DEQY) \dots\dots\dots 1$$

Where;

ROA	=	Return on Asset
ROCE	=	Return on Capital Employed
FS	=	Firm size
DEQY	=	Debt to Equity Ratio

Static panel regression estimates are adopted. The regression involves three estimations namely, pool constant effect, fixed effect and random effect. Hence the most appropriate model to employ is the Hausman test. The model is specified as:

$$ROA = \alpha + \beta_1ROCE + \beta_2SIZE + \beta_3DEQY + \epsilon_t \dots\dots\dots 2$$

3.3. Sources and Description of Variable of Data

The model is estimated using time series annual data for the period 2007 -2018. The data on return on asset, return on capital employed, size, and debt to equity ratio are obtained from the published annual reports of the selected Nigerian banks.

Return on Asset (ROA): It represents the amount received as income on every unit of naira invested in the form of banks assets. The return on asset is derived from the formula: profit after tax/total asset.

Return on Capital Employed (ROCE): This variable is used to measure the overall profitability of the firms considered, the formula is used as profit after interest and tax over capital employed.

Firm Size: This is used to capture the financial value of the firms considered, i.e. it used to underpin the capacity of the firms considered.

*Debt/equity ratio (DE):*Debt to equity ratio is used in the study to represent the capital structure of the firms considered. It is usually calculated as total debt/equity otherwise restated as long-term debt/equity. It is a measure of the relationship between the capital contributed by creditors and contributed by shareholders.

4. Results and Discussion

4.1. Constant Effect Result

Variables	Coefficients	Standard Error	Probability
ROCE	0.368647	0.111713	0.0015
SIZE	0.142955	0.244044	0.5597
DEQY	-0.285011	0.129255	0.0304
C	2.117544	3.987563	0.5969

Table 1: Summary of Result

$$R^2 = 0.156934 \quad \text{Adj } R^2 = 0.124919 \quad F\text{-STAT} = 4.901866 \quad DW\text{-STAT} = 1.235700$$

Source: Author's Computation (2019)

Table 1 shows the relationship that exists between the dependent variable (ROA) and the independent variables (ROCE, SIZE, & DEQY) can be expressed mathematically as:

$$ROA = 2.117544 + 0.368647_{ROCE} + 0.142955_{SIZE} - 0.285011_{DEQY} + \mu$$

From this equation, the coefficient of the constant parameter of the selected Nigerian firms shows a positive figure of 2.117544, which implies that if all the explanatory variables are held constant, the dependent variable ROA will increase by 2.117544 units. Also, all the independent variables (ROCE & SIZE) are positively related to the dependent variable (ROA) except the Debt to Equity ratio (DEQY). The coefficient of return on capital employed is positively related to ROA with an estimate of 0.368647, and this implies that a unit increase in the level of Return on capital employed (ROCE) of the selected Firms will lead to an increase in the Return on Asset (ROA) by 0.368647. The coefficient of Firm size (SIZE) shows a positive figure of 0.142955, meaning that an increase in firm size (SIZE) of Nigerian firms will lead to 0.142955 units increase in the Return on Asset (ROA) of the firms. In any case, Debt to Equity (DEQY) of the selected Nigeria Firms shows an inverse relationship with Return on Asset (ROA) having a negative coefficient of 0.285011 as could be seen from the results. Thus, an increase in Debt to Equity will lead to corresponding decrease in the Return on Asset of the selected Nigerian firms by its coefficient (0.285011). This figure of the R^2 means that 15.6% changes in the dependent variable is caused by the independent variables, while the remaining 84.4% changes can be accounted for by the stochastic variable. The result of the R-squared in the constant effect model is rather insignificant since the totality of the independent variable cannot significantly account for changes in the performance of Nigeria Firms. Therefore, the R-squared should be subjected to further test under the fixed effect model.

4.2. Result of the Fixed Effect Result

Variables	Coefficients	Standard Error	Probability
ROCE	0.395586	0.120761	0.0016
SIZE	-0.123068	0.236703	0.6047
DEQY	-0.163295	0.133526	0.2253
C	5.081301	4.011528	0.2093
Fixed Effects (Cross)			
FIRSTB--C	-0.869609		
GTB--C	1.582897		
WEMA--C	-1.092698		
UBA--C	-0.298956		
JULIUS--C	-0.391697		
UNILEVER--C	0.832644		
GUINNESS--C	0.212505		

Table 2: Summary of Result

$$R^2 = 0.366387 \quad \text{Adj } R^2 = 0.285238 \quad F\text{-STAT} = 4.635944 \quad DW\text{-STAT} = 1.548956$$

Source: Author's Computation (2019)

Table 2 shows the relationship between the dependent variable (ROA) and the independent variables (ROCE, SIZE, & DEQY) can be expressed mathematically as:

$$ROA = 0.395586_{ROCE} - 0.123068_{SIZE} - 0.153295_{DEQY} + \mu$$

Table 2 shows the relationship between the variables, and it depicts the general coefficients for all the independent variables with a constant parameter for each bank used in this study, as shown in Table 2. Three of the firms (GTB, UNILEVER, & GUINNESS) show a constant positive relationship, while the other four banks show a constant positive relationship with the dependent variable (ROA). These positive coefficients are given as 1.582897 for Guaranty Trust Bank, 0.832644 for Unilever Nig. Plc., and 0.212505 for Guinness Nig. Plc., the Table 2 reviews that if all independent variables are held constant, the dependent variable (ROA) will increase by their constant parameters, the remaining four registered firms reviews that First Bank, WEMA Bank, UBA Bank, and Julius Nig. Plc. are negatively related to the dependent variable (ROA). A unit increase in First Bank, WEMA Bank, UBA Bank, and Julius Nig. Plc. The coefficient will result in 0.869609, 1.092698, 0.298956, and 0.391697 units decrease in the dependent variable (ROA), respectively. The

fixed effect gives a rather significant R-squared result compared with that obtained under the constant effect, the R-squared obtained under the fixed effect explains that the explanatory variables (ROCE, SIZE, & DEQY) accounted for 36.36% behaviour of the dependent variable (ROA). In comparison, the remaining 63.64% is accounted for by the stochastic variable for the result on the fixed effect.

4.3. Summary of Findings

This research work has been able to establish the relationship between the effects of Financial Leverage on the performance of the firms in Nigeria, the study uses financial statement of seven (7) leading firms in Nigeria (First Bank, Guaranty Trust Bank, WEMA Bank, UBA Bank, Julius Berger Nig. Plc, Unilever Nig. Ltd, and Guinness Nig. Plc.) in Nigeria to obtain data used in the study. Pooled Least Square was used to examine the cross-sectional effect of financial leverage on the performance of firms. Return on capital employed, Firm Size, and Debt to equity ratio are the independent variables used. At the same time, Return on Asset is the dependent variable used to proxy the performance of the Nigeria firms.

From the result obtained from the study, Constant and Fixed effect are used to test the relationship and the significant effect of the independent variables on the dependent variable (ROA). Based on the research questions raised in the preceding chapter to know the relationship between financial leverage on the performance of banks and non-banks firms in Nigeria. Return on capital employed (ROCE) shows a positive relationship with the dependent variable (ROA) and if firms could properly manage and utilizes their returns on investment, it will boost the firm's performance. The probability value attached to the T-stats shows that the variable is statistically significant in explaining the variable. The second question shows whether firm size has any significant impact on the performance of firms (Bank & Non-Bank), the result obtained also shows that if firm size increase, it will also increase the performance of the Banks and Non-Bank firm. Still, the T-stats shows that the variable used is not statistically significant in the model. The debt to equity ratio shows a negative relationship with the dependent variable (ROA), thus, if the DEQY should increase, it will decrease the performance of the Banks and Non-banks, which implies that if firms have been unable to manage their financial leverage (DEQTY) very well, it will cause their performance to drop.

The study implies that if the selected firms could adequately invest their funds, there will be a favorable impact of such investment on the performance of the bank and non-bank firms. The firm size exacts a positive effect on the performance of banks and non-banks firm, but the size of a firm is insignificant in explaining the variation that occurs in the performance of a firm. That is financial leverage does not necessarily increase the performance of a firm. The debt to equity ratio representing the financial leverage reviews that the performance of firms in Nigeria cannot rise if firm indulges in high leverage investments. That is, firms in Nigeria should consider more of equity capital for investment in a bid to replace the debt of such organization.

5. Conclusion and Recommendations

From the fact that there is a negative relationship between Debt to Equity ratio and Return of Asset using a measure of performance in Nigeria organizations (Bank and Non-Bank Firms). The resultant effect shows that banks have been able to manage their debts to equity very well because it is a major source of banks returns. Hence inability to properly scrutinized it becomes a problem and may lead debt to equity ratio to significantly affects the performance of banks and non-bank firms in Nigeria. Return on capital employed exact a positive relationship with the dependent variable (ROA), this implies that if the firms could engage themselves in investment there will be a rise in the returns from such investment at this would increase the performance of such firms. Furthermore, this research advocates that the firms should devise means of funding investments as it could significantly affect the firm's performance. The study agrees with the conclusion of Oke and Afolabi (2017) that the financial leverage exacts a negative influence on the performance of firms in Nigeria. The study from the findings thus recommends that; firms should endeavour to embark on capital investments in a bid to increase the performance of firms in Nigeria adequately; the bank and non-banks firms in Nigeria should avoid the use of a debt as means of investments; organizational management should give adequate attention to the financial leverage of such firm in a bid to suppress the negative effect of financial leverage on the performance of the firms.

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