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EFFECT OF LEVERAGE ON SHAREHOLDERS' EARNINGS: ACCENTING THE RELATIONSHIP BETWEEN CAPITAL STRUCUTRE AND SHAREHOLDERS' EQUITY

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ABSTRACT:

This study investigates the effect of leverage on earnings. This was motivated by the presumed paucity of recent literature in this regard, especially now that economic and environmental factors have left corporate organizations and stakeholders wondering what the ideal combination of debt should be. Hence, there is need to provide evidence on this decision area for more informed decisions in the future. This study thus, examined the effect of leverage ratios and debt-equity ratios on earnings per share of 15 manufacturing companies listed on Nigerian Exchange (NGX) Group. Ex-post facto research design was adopted and applied on data sourced from annual reports of the companies under study from 2012 to 2020 representing nine years period. Inferential statistics and multiple regression technique were adopted for the purpose of data analysis and hypothesis testing respectively. Results from this study showed that leverage ratios have positive effect on earnings per share while debt-equity ratios have negative effect on earnings per share. However, both effects were found not statistically significant at 5% significance level. The study thus, concludes that, financial leverage has no significant effect on shareholders' earnings in Nigeria. it is recommended that total leverage management should be one of the focal points in business management for Nigerian manufacturing companies as there is positive effect of leverage on earnings per share. Even the insignificance of the effect may be moderated with good management emphasis on leverage management. Also, directors and managers of manufacturing companies in Nigeria are advised to employ effective and adequate debt policies to properly manage debts to enhance shareholders' earnings.

Key words: *Deposit Capital structure, Debt-Equity, Earnings per share. Leverage Management, Leverage Ratio,*

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1. INTRODUCTION

The choice of the optimal financing is the basic need of firms no matter the differences in sector of business operation. Managements try to adopt that financial pattern which gives maximum benefits to Shareholders who are the equity owners. The main goal of a firm is to increase the Shareholder's wealth. This can only be achieved by increasing the average returns to shareholders in earnings through adequate structure formation (Gweyi & Karanja, 2014). Leverage indicates the effectiveness

of a firm in capital utilization and indicates the future growth possibilities of a firm in earnings. The performance of companies in terms of total return to its equity owners may somewhat bear the effect of bad financing decisions as may be represented by the distributable profit available for the owners at the end of a period. In order words, the Capital structure decision of a business is important because a poor decision can affect a firm's profitability leading to a decrease in shareholders' value and investors' ratings of the business as a whole. The overriding objective of financial decisions is to maximize the wealth of shareholders (Iliemena, Wobo & Goodluck, 2023; Nadillah, Ulfah, Hayati, Midesia & Puspita, 2019). The goal of financial decisions is to maximize the market value of existing owners' equity. Good financial decisions increase the market value of the owners' equity and poor financial decisions decrease it. The effect that capital structure decisions have on profitability and firm value is that, it increases value through the present value of tax savings from the use of debt. Intuitively, this may imply that firms should use 100% debt to maximize their value especially in the manufacturing sector. However, existing evidence indicates these manufacturing companies are passing through challenges in determining what constitutes an adequate structure for their firm as this cuts across a lot of decision areas. Over the years Researchers have identified financial leverage as variables that affect profitability of the firm. But prior Researchers are yet to find the optimum level of leverage to balance the cost, benefits and how they affect shareholder's earnings based on the Researchers' knowledge.

Leverage consists of various financial instruments or borrowed capital used to increase the potential return of an investment of a firm. It is that amount of debt used to finance a Firm's Assets (Lin, Li &Yung, 2006) and this makes it a very relevant consideration in capital structure (Soeindoen & Siagian, 2021; Alghusin, 2015; Ahmed & Ibrahim, 2015) . However, most studies that captured leverage are already out of date and leverage is known to change overtime which renders outdated evidences irrelevant in decision making (Alghusin 2015,Ahmed & Ibrahim 2015; Grannath & Thorsell 2014; Apergis & Sorros 2011).

The Debt/Equity ratio is another way of measuring leverage, which is a ratio of ordinary Shareholders' equity compared to the stake of creditors in a company. In other words, it is a measure of a company's financial leverage. A high debt/equity ratio generally means that a company has been aggressive in financing its growth with debt. Several but previous studies in this regard have focused more on non- manufacturing industries and cross-comparison might have damaging effects on the shareholders' confidence. As the Debt/Equity ratio depends on the industry in which a company operates, more evidence needs to emanate from the manufacturing industries to enable shareholders and companies have a comparative review for more informed decisions (Maverick, 2020). To keep the economy alive and stakeholders informed on certain decision implications, there is need to provide the general public an up to date information especially as it relates to decisions regarding capital structure decisions to forestall future corporate scandals.

1.1 Objective of the Study

The objective of the study is therefore to determine the effect of financial leverage on shareholders' earnings of manufacturing firms listed in Nigeria from 2012 - 2020, using leverage ratios and debt – equity ratios (proxies to financial leverage) on earnings per share (proxy to shareholders' earnings) respectively.

1.2 Hypothesis

H_{O1}: There is no significant effect of leverage on Earnings per share.

2. LITERATURE REVIEW

2.1 Conceptual review

2.1.1 Leverage

The financing or leverage decision is a significant managerial decision because it may influence the shareholder's value, risk and the market value of the firm. According to Ahmed and Ibrahim (2015), leverage is the ratio of total liabilities to total assets. It refers to the proportion of debt to equity in the capital structure of a firm (Soeindoen & Siagian, 2021). The ratio of debt-equity has implications for the shareholders‟ dividends and risk. This affects the cost of capital and the market value of the firm (Pandey, 2007). Several researchers have studied firms' debt use and suggested the determinants of financial leverage by reporting that firms' debt-equity decision is generally based on a trade-off between interest tax shields and the costs of financial stress. According to the trade-off theory of capital structure, optimal debt level balances the benefits of debt against the costs of debt (Gu, 1993) hence, the use of debt to a certain debt ratio results in higher value on equity. However, the benefit of debt would be lower than the cost after this level of capital structure. In other words, the more a company uses debt, the less income tax the company pays, but the greater its financial risk. Based on the trade-off theory for capital structure, firms can take advantage of debt to make a better value on equity. Leverage finance refers to the funding of a company or business entity with debt with the hope of improving the firms' financial performance. Leverage financing is commonly employed by a company to achieve a specific or temporary objective, such as acquisition of another business, to affect a buy-out, to purchase shares or fund a one-time dividend, or to invest in self-sustaining cash-generating assets (Pachori & Tatala, 2012).

Leverage financing on the other hand refers to the ratio of debt to equity capital of a company. As a result of the payment of interest and repayment of principal amount of the debt a large part of the firm's cash flow would decrease (Magpayo, 2011). Financial leverage also involved the use of debt to acquire additional assets. It can be financial or operating leverage. Financial leverage is the use of borrowed money to increase production volume and sales as well as earnings of a company for better performance. It is measured as the ratio of total debt to equity of a firm (Yoon & Jang, 2005). The greater the amount of debt, the greater the financial leverage of a firm. Since interest is a fixed cost which can be written off against revenue, a loan allows an organization to generate more earnings without a corresponding increase in equity capital which will require increase in dividend payment that cannot be written off against the firms' earnings (Magpayo, 2011). However, high leverage may be beneficial in boom periods; and it may cause serious cash flow problems in recession periods, because there might not be enough sales revenue to cover the interest payment (Tudose, 2012). In other words, leverage is the advantageous condition of having a relatively small amount of cost yield and a relatively high level of values. Operating leverage is the extent to which a firm commits itself to high level of fixed operating costs which vary with time, such as insurance, rent, salary, with no interest attached to it as compared to the level of variable costs which vary with volume of energy, labour and raw materials (Tudose, 2012). Firms with high level of operating leverage have high break-even points, but when the break-even point is crossed, they show a greater increase in operating income with every increase in sales revenue and greater losses with every drop in sales revenue in comparison with firms that have lower operating leverage. Investment leverage is the ability of a firm to control a large value of commodities or securities in a future contract by buying on margin and thus, leveraging a relatively small investment. Thus, leverage is a concept of borrowing money to buy an asset that will appreciate in value, so that the ultimate sale will value profits on equity invested and on the borrowed funds. The use of various financial instruments or borrowed capital, such as margin to increase the potential value on investment is also known as leverage (Omolehinwa, 2016).

2.1.2. Debt-Equity ratio

The basic options which are available for a firm to finance its investments and business operations are basically from two options; either using equity finance, debt finance or a combination of debt

and equity finance options. Equity finance involves increasing the owners' or shareholders' equity to acquire an asset or increase operations. Equity financing involves selling a portion of a company's equity in return for capital. Equity financing places no additional financial burden on the company. Debt finance involves the borrowing of money and paying it back with interest. The debt-to-Equity ratio is a ratio of the stake of creditors in relation to ordinary Shareholders' equity in a company. In other words, it is a measure of a company's financial leverage. A high debt/equity ratio generally means that a company has been aggressive in financing its growth with debt. If a company applies a lot of debt to finance increase in operations (high debt to equity), it could generate more earnings than it would ordinarily have without this outside financing. Researchers such as Jensen and Meckling (1976), Kim (1978), to mention only a few, support the view that management's priority is to evaluate the various costs and benefits associated with the use of both debt and equity. Management will base their decision with regard to the combination of debt and equity on these various costs and benefits. The choice of the optimal financing is the basic need of firms as the shareholders' assessment of a firm is based on its ability to generate sufficient return on invested capital (Iliemena, Amedu & Uagbale-Ekatah, 2022). Managements try to adopt that financial pattern which gives maximum benefits to Shareholders.

2.1.3. Earnings per share

Earnings per share (EPS) are the unit of earnings attributable to a unit of equity investment in shares. EPS is the portion of a company's profit that is allocated to every individual share of the stock. More explicitly it is a term that is of much importance to investors and people who trade in the stock market. As noted by Iliemena, Wobo and Goodluck (2023), "EPS are considered an unbiased measure of financial performance which measures the weight of profit earned comparatively by the number of ordinary shares outstanding at the end of an accounting period". EPS clearly indicates how much money a company makes for each share of its stock and considered by Investopedia (2021) as a widely used metric for estimating corporate value. A higher EPS indicates greater value because investors will pay more for a company's shares if they think the company has higher profits relative to its share price. A study carried out by Kumar (2017) in India which investigated the effect of Earning per share among other variables on market price of shares showed that earnings ratio have significant effect on stock price prediction. The higher the earnings per share of a company, the better its profitability (Iliemena, Wobo & Goodluck, 2023; Economic Times, 2021).

For the purpose of this study, we adopted the formula in Investopedia (2021) for EPS. Thus, this study measured EPS as the amount of net profit after tax divided by the number of common shares outstanding at the end of an accounting year. We adopted this formula because it is more generally accepted as indicated in the financial statement notes on EPS compositions.

2.2 Theoretical Review

2.2.1 Signaling theory

This theory was propounded by Ross (1977). Signaling theory is concerned with understanding why certain signals are reliable and others are not in terms of decision making. The signaling theory posits that if managers have inside information; their choice of capital structure which is an aspect of firm structure will signal information to the market. The theory looks at the quality and reliability of accounting information sent by a company to its users of accounting information for investment decision making by the potential investors. Spence (1973) posited that a well performing firm distinguishes itself from the nonperforming one by sending a credible signal about its performance to capital markets as well as potential investors. Signals sent by a firm are the results of its operating activities which would inform investors about the company's future prospects. Signaling theory was adopted in this study to underpin leverage as basic in capital structure represented by leverage and debt-to-equity ratio because a sound liquidity position of a company shows its ability to meet up with its short term financial need without stoppages in production. Also, effective management and

staff would enable a company to maximize its operating efficiency of production thereby leading to an improvement in firm's financial performance and firm value which by implication is showing a good signal to both current and potential investors that the company can continue to operate in line with the going concern concept of accounting as well as satisfying the interest of its shareholders through wealth maximization.

2.3 Empirical Review

Among the existing previous studies related to the concepts of this research are; Soeindoen and Siagian (2021) which study aimed to determine the effect of leverage and earnings per share on profitability. The variable leverage (DER) and earnings per share (EPS) as independent variables (independent) and profitability (ROE) as independent variables (dependent). The number of samples used in this study was 48 there are infrastructure companies in the energy sub-sector (6), toll roads, airports, ports, and the like (5), and telecommunications (8) registered on the IDX, the company provides financial reports and annual reports in 2015-2018. Data were collected using a purposive sampling method based on certain conditions. The method in this study uses a non-participant observation method or used secondary data. Data were analyzed using linear regression models. The results show that leverage does not oppose profitability, while earnings per share tend to profitability.

Nadillah, Ulfah, Hayati, Midesia and Puspita (2019) investigated the relationship between leverages, earning per share (EPS) and earning management using discretionary accrual as a proxy for earning management. For measuring Accrual Earning Management (AEM), revenue discretionary model and revenue model (model stubben) were used in the study. The sampling technique used purposive sampling and a regression method for panel data, namely fixed effect based on the Hausman test result. Panel data regression models were applied for the period from 2016-2018 on a sample size of 31 companies listed on Indonesia stock exchange, taking LQ 45 index as a benchmark. The data analysis testing employed E-views (Econometric View). The result showed leverage affect on the earning management negatively and earnings per share (EPS) affect on the earning management positively.

Kumar (2017) investigated the influence of earning per share and price to earnings ratio on market price of share in India. Multiple regression analysis was used to examine the impact between the variables using a study period of 2011 to 2016 with sample of eight (8) auto based companies. The findings shows that price to earnings ratio have significant effect on stock price prediction of select companies in India. However, the study did not carry out pre and post diagnostic tests to validate and confirm assumptions of classical linear regression model. The result of significance effect between the variables may therefore be spurious. There is therefore, a need to add more independent variables and use panel regression analysis with a view to getting more robust results.

The study conducted by Alghusin (2015) investigated the impact of leverage on profitability of listed industrial companies in Amman stock exchange. A sample of 25 Jordanian Industrial listed companies for a period of 10 years (from 1995-2005) was selected and hypothesis tested using regression technique. The results of the study show that there is a significant effect of the Financial Leverage and Growth on profitability of industrial companies. Therefore, industrial companies may enhance the profitability of their firms by minimizing the debt, and increasing financial assets compared with total assets. The period of 1995-2005 is considered out of date.

In the work of Ahmed and Ibrahim (2015) that examined the relationship between financial leverage and profitability in Pakistani listed firms in cement and service sector for the period of 2006 to 2012. The study employed correlation analyses on the 19 listed cement firms. The results of

the correlation analyses shows that in cement sector Financial leverage (FL) has a negative relationship with profitability (ROA), while Size of the firm (FS) and growth of the firm (FG) have no impact on financial leverage. It means that as financial leverage increases profitability decreases. In Services sector financial leverage (FL) has a positive relation with Size of the firm (FS) while profitability (ROA) and growth of the firm (FG) have no impact on financial leverage (FL). It means that as size increases financial leverage also increases. This study was limited to 2012; future study is therefore needed to close this age gap in study.

Ramadan (2015) investigated the impact of leverage on the firms' value utilizing unbalanced pooled Ordinary Least Square (OLS) cross-sectional time series panel data regression approach of 56 listed companies in Amman Stock Exchange (ASE) during the period 2000-2013. The results shows that the firms' leverage level affect the firms' value for the Jordanian listed companies included in the sample test. This study was limited to 2013 which makes it out of date.

Grannath and Thorsell (2014), evaluated the factors that affect a firm's capital structure decision and how the capital structure affects a firm's shareholder value. By using a dataset consisting of 502 large US firms during the years 2005 to 2014 and generalized least square (GLS) regression, the study finds that a firm's leverage has a positive effect on shareholder value. Evidence emanated from US which is known as a developed economy with its stock market fully developed which could have played out in the generated result.

The study conducted in Kenya by Gweyi and Karanja (2014) examined the effect of financial leverage on financial performance of deposit taking savings and credit co-operative society (SACCOS).The sample data was extracted from 40 SACCOS registered by Sacco Society Regulatory Authority (SASRA) extended from the period 2010 to 2012. The secondary data used for analysis was collected from the financial statements of the various deposit taking SACCOS and tested using correlation techniques. The results show perfect positive correlation between debt equity ratio with return on equity and profit after tax at 99% confidence interval and a weak positive correlation between debt equity ratio with return on assets and income growth. This study was also limited to 2012 which makes it out of date.

Chambers, Sezgin and Karaaslan (2013) investigated the effect of capital structure on stock values of 65 industrial companies listed on Istanbul Stock Exchange. The study used three periods: the whole period from 1994 to 2010, the sub-period from 1994 to 2002 and another sub-period from 2003 to 2010. Panel regression analysis was used in which total debt to market value (TD/MV) and beta ratio were found to have statistically significant effect on both nominal and real stock values in all the three periods. The TD/MV ratio is also found to be statistically significant but with a negative effect on both nominal and real stock values in the 1994 to 2002 sub-period but in the 1994 to 2010 period only real stock value that was statistically significant. The scope of 1994 -2010 is further considered out of date.

Akhtar, Javed, Maryam and Sadia, (2012) investigated the impact of shareholders return in Fuel and Energy Sector of 20 listed public companies at Karachi stock exchange(Pakistan). The study employed regression analyses technique in testing the data generated for the study. Test results demonstrated that financial leverage has got a positive relationship with financial performance. Hence, the companies in the fuel and energy sector may enhance their financial performance and can play their role for the growth of the economy while improving at their optimal capital structures. As a limitation, this study focused only on energy sector and with a small sample of 20 firms.

Apergis and Sorros (2011), on the other hand, investigated the impact of long-term debt on the value of the firm for international listed manufacturing firms using OLS regression. The testing period is based on quarterly data from 1999 to 2009, while 346 internationally listed firms are employed

derived from five international stock exchanges, that is, the NYSE, London, Frankfurt, Hong Kong and Tokyo. The empirical findings show that long-term leverage obligations have a significant negative impact on the value of the firm. The impact, however, is differentiated with respect to the size of the firm as well as with the type of long-term investment the long-term debt is spent. Even though this study is related to our objective, findings need to be updated with evidence from African markets.

3. MATERIAL AND METHOD

Ex-post facto research design was used for this study because it emphasizes events that have happened and non-manipulatable data are already in existence regarding such occurrence. The population of this study comprises of 15 manufacturing companies listed on Nigerian Exchange (NGX) Group and with constant market presence from 2012 to 2020. Due to the manageability of the population, the entire population was therefore adopted as the study sample. Study data were sourced from companies' websites, Fact Books of the Nigerian Exchange (NGX) Group and annual reports and annual reports. This study employed inferential statistics for the test of relevant hypotheses with the aid of Statistical Package for Social Sciences research software, version21. The regression model for the hypotheses was adapted from Mohammed (2015), and, Iliemena and Goodluck (2019) as follows:

$SE = \square + \beta_1 TLR_{it} + \beta_2 DER_{it} + \mu_{it}$

Hypothetically;

$ROE = \square + \beta_1 TLR_{it} + \beta_2 DER_{it} + \mu_{it}$ ---------- H_O

Where:

$\square$ = Constant term

β_1- β_2 = Beta Coefficients to be estimated

SE = Shareholders' equity measured by Earnings per Share (EPS)

TLR = Total leverage ratio í in period t

DER= Debt-equity ratio í in period t

4. RESULT AND DISCUSSIONS

4.1 Data Analysis

4.1.1 Descriptive statistics

Table 1: Descriptive Statistics for listed manufacturing companies in Nigeria (NG)

Variables	observations	Minimum	Maximum	Mean	Std. Deviation
TLR	135	.14	1.48	.6035	.19452
DER	135	.33	3.69	1.2768	.62403
EPS	135	-11.81	54.12	6.4218	11.81063

Source: Researchers' computation 2023

KEYS: TLR = Total Leverage Ratio, DER = Debt-to-Equity Ratio, EPS = Earnings per Share

The descriptive statistics in Table 1 above shows the basic features of the data of the 15 listed manufacturing companies in Nigeria used as sample for this study for in the nine years period under review. From the table above, total leverage ratio as indicated above has a minimum value of 0.14, maximum value of 1.48, mean of 0.60 and standard deviation of 0.20. The debt –equity ratio had mean value of 0.33, maximum value of 3.69, mean value of 1.28 and standard deviation observed as 0.62. The earnings per share performance shows minimum loss of 11.81, maximum earning of 54.12, mean value of 6.42 and standard deviation of 11.82.

4.2 Test of hypothesis

Ho: there is no significant effect of leverage on EPS.

$EPS= \square + \beta_1 TLR_{it} + \beta_2 DER_{it} + \mu_{it}$

Table 2: Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta	T	
(Constant)	B	STD ERROR	BETA	T	
	6.766	5.463			.218
TLR	4.111	5.453	-.068	-.255	.002
DER	-1.254	1.672	-.067	.197	.455

Source: Researchers' computation 2023

Table 3: Model Summary of the effect of leverage on Earnings per share

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics			Durbin-Watson
				R Square Change	F Change	Sig. F Change	
.123[a]	.576	-.023	11.86623	.015	.396	.851	1.944

a. Dependent Variable: EPS source: Researchers' computation 2023

EPS= 6.766 + 4.111TLR – 1.254DER + 0.05

From the results of the multiple regression analysis presented above, R-square is 0.576. This implies that the explanatory variable TLR and DER explain changes in EPS in listed manufacturing firms in Nigeria to the extent of 58%. Focusing only on the result for leverage, the multiple regression result indicated that TLR has positive effect on EPS (4.111). DER was found to have negative effect on EPS. The extent of these effects was determined using the t-test statistics for significance as 0.068 and 0.158 respectively, which are both greater than 0.05 (error margin). Hence, we accepted the null hypotheses that there is no significant effect of leverage on EPS.

Although the study employed multiple regression analysis here, it focused on simultaneous observation of the effect of both TLR and DER on Earnings per share (EPS) used as one of the proxy for shareholders' earnings, the result of the regression analysis revealed that there is no significant effect of leverage on earnings per share only in Nigeria with P- value greater than 5% (0.05) level of significance. In line with this outcome, another Pakistan based evidence (Ahmed & Ibrahim, 2015) found negative effect of leverage on earnings. Studies by Apergis and Sorros (2011) further reported negative impact of leverage on earnings. Other works that have found negative effect include Chen and Chen (2011), and, Ahmed, Muneeb and Mehta (2014).

Contrary to this, Alghusin (2015) found a significant effect of leverage on shareholders' equity. The result generated by Ramadan (2015) revealed that leverage affects firm value; this could have in effect enhanced its effect on earnings per share. This also supported by an earlier US study by Granath and Thorsell (2014) which affirmed that leverage has positive effect on shareholders' earnings. Also, a Pakistan based evidence, Safdar, Hazoor, Toheed and Ammara (2013) found significant positive impact of firm characteristics including leverage on EPS.

CONCLUSION AND RECOMMENDATIONS

Owing to the above, the researchers had cause to conclude that financial leverage has no significant effect on shareholders' earnings in Nigeria. This study was carried out as a way of encouraging greater prudence in issues regarding financing decisions and generating good return to shareholders which have been one of the major issues at the fore-front of organizational management and stewardship reporting. This implies that the higher the investment of time and efforts on issues regarding leverage ratios, the higher the expected effect on shareholders' earnings while other factors not captured in this study may have undermined the level of this effect and also negated the effect of debt to equity ratio on earnings. Consequently, it is recommended that total leverage management should be one of the focal points in business management for Nigerian manufacturing companies as there is positive effect of leverage on earnings per share. Even the insignificance of the effect may be moderated with good management emphasis on leverage management. Also, Directors and Managers of manufacturing companies in Nigeria are advised to employ effective and adequate debt policies to properly manage debts to enhance shareholders' earnings.

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APPENDIX I

Population and Sample of Study

11 plc (Mobil)
Capital oil
Caverton offshore support
Conoil
Eternal
Forte oil
Mrs oil Nigeria
Oando
Rak unity petroleum
Seplat petrpleum development
Total Nigeria
A.G. Leventis
Cement company of Northern Nigeria
Chellarams
Cutix

Source: Nigerian Exchange Group.