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Cost of Loan Capital and Capital Asset Acquisition in Nigeria: Implications on Organisational Profitability

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ABSTRACT
This paper discusses the extent to which cost of loan capital (measured in terms of interest charges) moderates the influence of capital asset on organisational profitability from the perspective of construction companies quoted on the Nigerian Stock Exchange. Data are collected through questionnaire. Analyses were performed using descriptive statistics, Pearson's product moment co-efficient of correlation and multiple regression analysis. From the findings, capital asset as a resource significantly accounted for changes in organisational profitability measured in terms of net profit by 34.81%. The emergence of cost of loan capital (as a moderating variable) introducing borrowed funds improved the explanatory power to 38.1%. However, an evaluation of the individual regression coefficients indicate that cost of loan capital has the least contribution per naira of net profit, apparently, due to the fact that interest charges reduce net profit. Against the thinking of some scholars, borrowed funds which attract costs in the context of interest charges enhance cashflow for investment in capital assets and improvement of organisational profitability. In sourcing for funds to improve profitability, the impact of cost of loan capital in its individual capacity should be considered.
Key words: Cost of loan capital, capital asset, profitability, construction, Nigerian Stock Exchange, Nigeria.

Introduction

Business costs constitute intrinsic proportion of factors that determine growth potentials of organisations. From the accountant's perspective, costs that impact profitability are those related to trading operations; they comprise administrative, finance and marketing costs. These consumable expenses are incurred while utilizing capital assets (non-current assets) to propel corporate activities for the purpose of achieving organisational profit. Germane amongst them is cost of loan capital (interest rate) charged by banks for loans extended to organizations in order to have sufficient fund for the acquisition of capital assets. Heavy equipment reliant companies such as those in the construction, transportation and shipping industries may confront this scenario in their effort to source for funds to meet their level of capital asset utilization. This paper does not discuss deposit rates on savings with financial institutions. It also ignores cost of capital and weighted average cost of capital which are the target rate of return (discount rate) on investment and the estimated cost of the elements which make up the overall supply of capital (Lucey, 1983). It is primarily on interest rate on loans which represents a percentage charged.

Scholars have in the past undertaken research works on costs as it affects organizations. Nyom (2005, p. 13) did a theoretical study on cost management: veritable tool for corporate productivity and profitability. The study emphasized the need for organisations to adopt cost-cutting measures to increase productivity and profitability; with a caution to manufacturers to aim at reducing cost of operations in their production management systems. Ferson and Locke (1998, p. 485) in the United States of America performed an empirical work on estimating the cost of capital through time: an analysis of the sources of error. The study observed long reliance on the capital asset pricing model (CAPM) by practitioners needing estimation of a firm's equity cost of capital, despite evidence from recent studies of the doubt on the validity of the CAPM and beta. According to them, great majority of the error in estimating the cost of equity capital is found in the risk premium estimate and relatively small errors are due to the risk measure or beta. It was suggested that analysts should improve estimation procedures for market risk premiums, which are commonly based on historical averages by using regression models or by purchasing forecasts from firms that specialize in their production. Similarly, Hubbard *et al* (2002, pp. 559 – 581), empirically investigated bank effects in borrowers' costs of funds, with evidence drawn from a matched sample of borrowers and banks. The data consisted a sample of 11,621 loan agreements covering about 4,840 business firms in the United States of America for the period 1987-1992. Using a matched sample of individual loans, borrowers and banks, the study found significant evidence that certain groups of firms – generally, smaller firms or firms with no bond rating – face a higher borrowing cost when their bank has low equity capital – together with a significant weak-bank effect on borrowing costs for the same groups of borrowers when unobserved borrower heterogeneity was controlled. It was concluded that, all things being equal, high – information – cost firms hold more cash than other firms particularly when they are the loan customers of weak banks.

These studies did not consider cost of loan capital to organizations obtained in an attempt to raise sufficient funds to address their demand for capital assets, particularly construction entities which rely extensively on heavy duty machinery for their activities. This paper aims at filling this gap by empirically examining the extent to which cost of loan capital impact the influence of capital asset on organizational profitability, particularly, construction industries. The next sections will consider literature review, methodology and data presentation and analysis. This will be followed by discussion of findings, conclusions and recommendations.

Literature Review

Cost of Loan Capital

Cost of loan capital represents the interest rate charged by banks on loans granted to organizations. In financial statements, they are categorized as finance costs and referred to as the amount of interest owed to lenders on borrowed money (Longenecker, *et al,* 1997).

Interest rate constitutes significant factor in determining the quantum of funds available to investors. They influence the level of cashflow for economic growth. It is influenced by the forces of demand and supply in the financial market (Fisher, 1930). Aside the forces of demand and supply, other factors determining interest rate are levels of income, inflation rates, market imperfections, fiscal and monetary policies, organisational factors and the power of financial institutions (Bosire *et al* 2014, pp.18-20).

They act as veritable policy instruments in the financial system to influence savings and investment (Rose 1989). And represents the price a borrower must pay to secure loan from a lender for a given period of time (Rose 1989). It is an amount received in relation to an amount loaned expressed as a ratio. Lending institutions give out money in terms of loans on which they charge a percentage rate as interest payment (Bosire *et al* 2014, pp. 18-20). High interest rate on lending implies high cost of borrowing which discourages potential borrowers as this leads to high production costs with attendant negative impact on returns (Kinyua, 1997).

Capital Asset

Capital assets refer to non-current or tangible assets acquired by organisations and used in productive activities. They are also described as real or physical capital and represent the stock of produced goods that contribute to the production of other goods and services. In the views of Begg *et al,* 1994, the stock of physical capital includes the assembly line machinery used to make cars, railway lines that produce transport services, school buildings that produce education services, dwellings that produce housing services and consumer durables such as televisions that produce entertainment services. Capital asset acquisition, therefore involves the commitment of capital expenditure for the ownership of real or tangible assets such as land, buildings, plant and machinery, equipment, furniture and fittings and motor vehicles. Investment in capital assets is a major capital budgeting decision.

Construction contracting firms in both the building and civil engineering sub-sectors require various types of efficiently managed assets in different mix to successfully and profitably carry out their primary (core) operations. In a complex and highly competitive industry as the construction industry, with ever changing operating environment, the capital assets portfolio of any contracting firm determines how far they can go, what they can handle and what share of the market they can get (Kehinde and Mosaku, 2006 p. 634). Consequently, acquisition of capital assets increases an organisation's wealth leading to subsequent growth in the general economy.

Capital assets posses some characteristics. They are tangible, not acquired for resale, used for a period of more than one year and subject to depreciation; for tax purposes, they confer on their owners a claim for capital allowances. Also, profits arising from their disposal attract capital gains tax. The tangibility of capital assets arises from the fact that they are fixed and in some cases, immovable; for example buildings. Unlike trading inventories which are purchased for resale, capital assets are acquired for use in running business operations for the objective of earning profits. The wear and tear associated with the utilization of capital assets is accounted for through depreciation; which is a systematic write-off of their costs over the estimated economic useful life.

Aside its prominent consumption for the production and supply of goods and services, capital assets can be available for rental to others or for administrative purposes on a continuing basis in reporting entity's activities (Robins 1999). In addition, they play prominent roles in assessing the financial strength of organizations. For instance, reference is usually made to the level of investment in capital assets especially in situations of merger, acquisition and takeover. This fact underscores the preference by majority of investors to prefer capital asset basis of business valuation than the earnings and dividend capitalization approaches. This is because funds invested could be recouped through disposal of equipment, plants, machinery etc; in the event of liquidation.

Most privatization programmes in the country were successfully implemented because of the sufficiency of investment in capital assets by the companies affected.

Adequate investment in capital assets should be accorded top priority by companies in their capital expenditure decisions, especially, those whose activities are capital asset intensive, such as; construction, manufacturing, shipping, oil and gas. Empirical studies have shown that acquisition of capital assets influences an organisation's performance. Firer and Williams (2003, pp. 348 – 358) found that the business environment and the market in South Africa place greater weight on corporate performance based on physical capital assets. They concluded that physical capital remains the most significant underlying resource of corporate performance in South Africa.

Profitability

In the business spectrum, profitability describes the extent to which an organization has improved in its line of activities. It encompasses its profit level, size (in terms of expansion and investment), quality of employees, products and services, community and social responsibility involvements. Often times, it is used as a basis for assessing an organisation's going concern ability. In the expressions of Owolabi and Obida (2012, pp. 10-25), profitability is the ability to make profit from all the business activities of an organization and serves as a measure of management efficiency in the use of resources. The key consideration in evaluating profitability of an organization is its profit performance. Drawing knowledge from the accountant's background, profit is the excess of total income over total expenses during a given period of time. Total expenses refer to revenue or recurrent expenses consumed in generating the incomes. Consequently, organisational profitability is measured when comparisons of information contained in the financial statements are made with profits earned using accounting ratios. As stated by Libby *et al*, 2001; Dyckman *et al,* 1998; Van Horne, 2002 and Pandey, 1979, tests of profitability focus on measuring the adequacy of income by comparing it with one or more primary activities or factors that are measured in the financial statements. Several different tests of profitability are commonly used: return on equity, return on assets, earnings per share, net profit margin, fixed asset turnover, financial leverage percentage, price – earnings ratio, dividend payout ratio, operating expenses ratio, return on capital employed, earnings yield, dividend yield, etc.

Profit represents a legitimate objective of every business. Several reasons have been adduced for this. According to Iyiegbuniwe (1986, p. 39), profit is a measure of the productivity of economic activities; a function of the market value (price) of the output (goods and services) and the operating efficiency in terms of minimum input costs of business enterprises. As a measure of productivity, profit is universal and fundamental to economic activity. In this study, profitability is measured in terms of net profit.

Development of Hypothesis

Cost of loan capital, which in this study represents interest rate on bank loans extended to organizations is critical in capital asset acquisition decision. It is considered a significant factor when discussing capital asset acquisition/organizational profitability relationship.

The government's policy of the removal of the construction industry from the preferred sector since 1985 that gave them the privilege of enjoying between 12-17 percent of the loans issued by banks meant that contractors have to compete for loans at prevailing interest rates as other sectors. In addition, the outcome of such deregulation policy was responsible for the inability of contracting firms to gain access to long-term loans for the expansion of their fixed assets (Olateju 1992, pp.1-23). The impact of cost of loan capital (interest rate) on profitability is usually negative especially when the rate of interest is high.

Contractors generally incur much higher costs of equities because of the high business and bankruptcy risk perceived by the market (Hung *et al,* 2002, p. 443). Interest rate is a key factor in determining the intensity of a debt and internal rate of return, which consequently affects the feasibility, construction and operation of a project (Lam and Chow, 1999, pp. 84-95). In line with the above, the following hypothesis is formulated as a guide:

Cost of loan capital granted to construction companies by banks does not significantly affect the influence of capital asset acquisition on organization's net profit.

Methodology

A survey design was adopted in this paper. Data were collected through the use of questionnaire. The explanatory variables (cost of loan capital and capital asset) have one question each while the criterion variable (net profit) also has one question. Respondents were requested to rate the influence of cost of loan capital (interest rate) on funds borrowed for capital asset acquisition ranging from "very low" to "very high". They were also requested to rate their companies capital asset acquisition with funds other than by borrowing also from "very low" to "very high" as well as the performance of their companies in terms of net profit within the range of "poor" to "excellent".

To evaluate the internal consistency and homogeneity of the measurement instruments, they were subjected to reliability analysis. Table 1 shows the reliability statistics for the variables studied applying the Cronbach alpha technique. From the analysis, the alpha coefficient for cost of loan capital is 0.709. That of net profit and capital asset are 0.651 and 0.631 respectively; previous empirical works have used alpha coefficient of 0.6, for example (Bagozzi, 1994). The reliability statistics, therefore, confirm that the administered questionnaire are reliable and can generate consistent results when applied to the same subjects over a period of time.

The population of the study is represented by construction companies listed on the floor of the Nigerian Stock Exchange. From the 2006 Fact Book of the Nigerian Stock Exchange, six construction companies are listed. All the companies were sampled representing 100% of the population. The activities of these companies cover various facets of construction. They are roads, bridges, building, dredging and shore protection works.

Data Presentation and Analysis

Thirty sets of questionnaire were distributed, out of which, twenty six were returned representing 86.67% response rate (see table 2). The descriptive statistics for the explanatory variables cost of loan capital, capital asset and the response variable, net profit are indicated in tables 3a, 3b, 4a, 4b, 5a and 5b respectively.

Fifteen respondents representing 57.7% confirm that the influence of cost of loan capital on borrowed funds for capital asset acquisition is high. This is followed by six respondents with a rating of "very high" representing 23.1%. Five respondents gave a "moderate" rating scoring 19.2% of the questionnaire collected (table 3b). On the average, the influence of cost of loan capital on funds borrowed for capital asset acquisition is 80.77% (Table 3a) out of a maximum rating of 5.

On the other hand, ability of the companies to acquire capital assets independent of borrowed funds is rated 34.6% by nine respondents. This is encouraging when compared to others who rated their ability 30.8% (eight respondents) and 19.2% (five respondents) respectively; though 15.4% (four respondents) rate their company's ability "high" (table 4b). This notwithstanding, the mean rating is 2.4615 or 49.23% (table 4a) in a measurement scale of 5. Internally generated funds may not, except, supported with borrowed funds meet the demand of construction companies for capital assets.

Similarly, performance in terms of net profit is good (53.8%) from the point of view of fourteen respondents, very good (15.4%) by four respondents and fair (30.8%) by eight respondents (table 5b). Mean net profit performance is 2.4812 or approximately 49.62% in a 5 point measurement scale (table 5a). Performance of construction companies in terms of net profit is therefore, below average. Findings accord with empirical works of Chan *et al* 2005 p. 112, Chiang *et al* 1999 pp.439 – 48, Egan, 1998 and Thorpe and McCaffer (1991 pp. 163 – 94).

Test of Hypothesis

The objective of the study is to identify the extent to which cost of loan capital measured in terms of interest rate on borrowings impact the influence of capital asset on net profit of construction companies. To test the hypothesis developed (see the section on development of hypothesis), two analytical dimensions are adopted. The first is a bivariate analysis and the second is a multiple regression analysis.

Bivariate Analysis

The strength of the relationship between capital asset and net profit is analysed using Pearson's product moment coefficient of correlation (see table 6). Correlation between these variables is significant at 0.01 level with a coefficient of correlation (r) of 0.590. This shows that the relationship between these variables is positively strong. With a coefficient of determination (r^2) of 0.3481, capital asset utilization by construction companies explains change in net profit by 34.81%. Other factors aside employment of capital assets in business activities account for changes in net profit by 65.19%.

Multivariate Analysis
This analysis aims to identify if the introduction of the second explanatory variable (cost of loan capital), will increase or decrease the extent to which changes in the criterion variable (net profit) are accounted for by the explanatory variables. Tables 7a – 7c show the multiple regression analysis between the explanatory and criterion variables.

The multiple correlation coefficient (r) of 0.617 portrays a strong positive relationship between the explanatory variables and the criterion variable. As indicated by R square (multiple correlation coefficient of determination) of 0.381, a permutation of cost of loan capital and capital asset explains changes in net profit by 38.1% (table 7a); this is significant at 0.05 level. In relation to the bivariate analysis, the emergence of cost of loan capital (introducing borrowed funds) increased the level at which the explanatory variables account for changes in the criterion variable (net profit) by 0.0329 or 9.45%.

The degrees of freedom (df) for the numerator and denominator are 2 and 23 respectively. At 0.05 level of significance, the critical value of F is 3.43 (figure I).The computed value of F, 7.065 is higher than the critical value (table 7a). The analysis rejects the hypothesis. It is therefore, confirmed that cost of loan capital granted to construction companies by banks significantly affect the influence of capital asset acquisition on organisation's net profit.

The amount of contribution to net profit per naira of cost of loan capital and capital asset are 0.215 and 0.327 respectively (table 7c). That of cost of loan capital is lower because interest charges reduce net profit. However, this contribution is not significant judging from the *t* values which for cost of loan capital is less than the critical value of *t*, 2.069 (figure 2). The multiple regression model for predicting net profit in a combination of cost of loan capital and capital asset is:

$$NP = 1.171 + 0.215\ COLC + 0.327\ CA$$

Where, NP = Net profit
COLC = Cost of loan capital
CA = Capital asset.

Discussion of Findings
Results of analysis performed indicate that cost of loan capital has a very high influence on funds borrowed for capital asset acquisition. Though, burdensome, the ability of the companies to acquire capital assets independent of borrowed funds is below average (49.23%). Invariably, borrowed funds, despite associated costs (interest charges), enhance cash flow for capital asset acquisition. This fact, and considering the position of construction industries in the provision of infrastructure, would have necessitated the government to specify an acceptable interest rate to enable them access funds to improve service delivery. Unavailability of such opportunities, make funding of capital assets difficult. According to Olateju (1992, pp 1- 23), the government policy of the removal of the construction industry from the preferred sector since 1985 that gave them the privilege of enjoying between 12 -17 percent of the loans issued by banks meant that contractors have to compete for loans at prevailing interest rates as other sectors. The outcome of such deregulation policy was responsible for the inability of contracting firms to gain access to long term loans for the expansion of their fixed assets (non – current assets).

In addition, net profit performance of the industry under study was found to be below average. This assertion coincides with the reports of notable actors in the construction sector, for example, Gianotti (2003 p. 6) and Shonekon (2001 p. 5) who document that the financial performance of construction companies in Nigeria have not been encouraging.
The bivariate analysis between capital asset and net profit as well as the multivariate analysis between cost of loan capital and capital asset with net profit were found to be positively strong and significant. Whereas in the first instance, capital asset accounted for changes in net profit by 34.81%; in the second instance, the introduction of cost of loan capital accounted for changes in net profit by 38.1%. This result confirms that additional funds from borrowing enhances available cash flow for capital asset investment which improves net profit performance; the marginal effect of interest charges notwithstanding. One would have expected that the entry of cost of loan capital would have led to reduction in the explanation of changes in net profit, but the results of this study proved otherwise.

Some participants in the industry heap the blame of losses on interest charges. Koguna (2005, p. 6) observed that financial restructuring and bank debt charges resulted in a loss after tax of N389.0m while Jibunoh (2003, p. 5) at an annual general meeting of his company intimated the shareholders thus: - "we are operationally making profit but losing it to the banks via interest charges". Overall, findings indicate that cost of loan capital is a critical variable to watch in evaluating capital asset acquisition and net profit relationship.

Conclusion and Recommendation

Capital asset as a resource in construction companies explains changes in net profit by 34.81% leaving 65.19% to other factors. The emergence of cost of loan capital as a moderating variable from the point of view of incorporating borrowed funds for capital asset acquisition improved the explanation of changes in net profit to 38.1%, thereby providing evidence that improved cash flow arising from borrowed funds improves net profit performance. Consequently cost of loan capital (measured by interest charges) on funds sourced to improve cash flow for the acquisition of capital asset may not decrease net profit; rather, inadequate cash flow may be contributory.

This study adopted cost of loan capital as a moderating variable in assessing the influence of capital asset on net profit. Future research agenda should consider moderating variables such as cash flow and the effect of competition.

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Table 1

Reliability Statistics

Variables	Mean	Standard Deviation	Cronbach's Alpha
Cost of loan capital	4.0385	0.66216	0.709
Net profit	2.8462	0.67482	0.651
Capital Asset	2.4615	0.98917	0.631

Source: **IBM SPSS Version 20.**

Table2

Questionnaire Distribution and Collection

Companies	No Distributed	No Collected
1	5	3
2	5	4
3	5	5
4	5	4
5	5	5
6	5	5
	30	26

Source: **Survey data, June, 2014.**

Table 3a.

Descriptive statistics on cost of loan capital

N	**Valid** **Missing**	**26** **0**
Mean		4.0385
Std Deviation		0.66216
Minimum		3.00
Maximum		5.00

Source: **IBM SPSS Version 20.**

Table3b.

Descriptive statistics on cost of loan capital

	Frequency	**%**	**Valid %**	**Cumulative %**
Valid Moderate	5	19.2	19.2	19.2
High	15	57.7	57.7	76.9
Very high	6	23.1	23.1	100.0
Total	26	100.0	100.0	

Source: **IBM SPSS version 20. Very low = 1, low = 2, moderate = 3, high = 4, very high = 5.**

Table 4a.

Descriptive statistics on capital asset.

N	**Valid** **Missing**	**26** **0**
Mean		2.4615
Std Deviation		0.98917
Minimum		1.00
Maximum		4.00

Source: **IBM SPSS Version 20.**

Table 4b.

Descriptive statistics on capital asset

	Frequency	**%**	**Valid %**	**Cumulative %**
Valid Very Low	5	19.2	19.2	19.2
Low	8	30.8	30.8	50.0
Moderate	9	34.6	34.6	84.6
High	4	15.4	15.4	100.0
Total	26	100.0	100.0	

Source : **IBM SPSS Version 20.**
Very low = 1, Low = 2, moderate = 3, high = 4, very high = 5.

Table 5a.
Descriptive statistics on net profit

N	**Valid** **Missing**	**26** **0**
Mean		2.8462
Std Deviation		0.67482
Minimum		2.00
Maximum		4.00

Source: **IBM SPSS Version 20.**

Table 5b.
Descriptive statistics on net profit

	Frequency	**%**	**Valid %**	**Cumulative %**
Valid Fair	8	30.8	30.8	30.8
Good	14	53.8	53.8	84.6
Very good	4	15.4	15.4	100.0
Total	26	100.0	100.0	

Source: **IBM SPSS Version 20. Poor = 1, Fair = 2, Good = 3, Very good = 4, Excellent = 5.**

Table 6.
Pearson's product moment correlation analysis between capital asset and net profit

		Net Profit	**Capital Asset**
Net profit	Pearson Correlation	1	0.590**
	Sig (2 – tailed)		0.002
	N	26	26
Capital Asset	Pearson Correlation	0.590**	1
	Sig (2 – tailed)	0.002	
	N	26	26

***** Correlation is significant at the 0.01 level (2 – tailed)***

Source: **IBM SPSS Version 20.**

Multiple regression analysis between cost of loan capital, capital asset and net profit.

Table 7a

Model Summary

Model	**R**	**R Square**	**Adjusted R Square**	**Std Error of Estimate**
	0.617[a]	0.381	0.327	0.55372

a: Predictors: (constant), capital asset, cost of capital.

Table 7b

ANOVA[b]

Model		Sum of Square	df	Mean Square	F	Sig
1	Regression	4.333	2	2.166	7.065	0.004[b]
	Residual	7.052	23	0.307		
	Total	11.385	25			

a: Dependent variable: Net profit
b: Predictors: (constant), capital asset, cost of loan capital.

Table 7c
Coefficients[a]

Model	Unstandardised Coefficients		Standardised Coefficients	t	Sig	Collinearity Statistics	
	B	Std Error	Beta			Tolerance	VIF
1 Constant	1.171	0.690		1.698	0.103		
Cost of loan capital	0.215	0.196	0.211	1.098	0.284	0.728	1.373
Capital asset	0.327	0.131	0.480	2.495	0.020	0.728	1.373

a: Dependent variable: Net profit
Source: **IBM SPSS Version 20.**

Figure 1.

F. Distribution

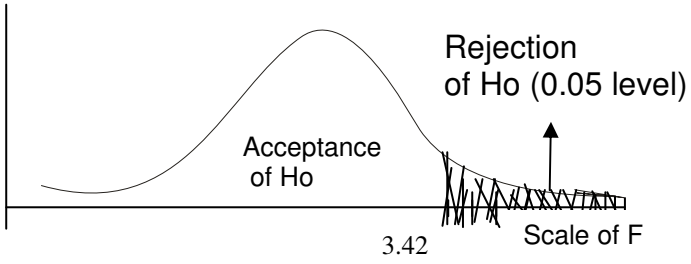
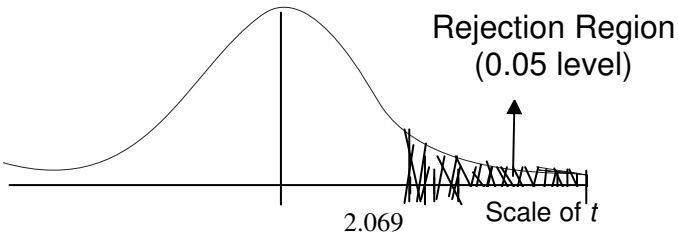


Figure 2.
Student's *t* - distribution



Source: Mason, R. D; Lind, D. A. and Marchal, W. G., *Statistical Techniques in Business and Economics*, 10th Edition, 1999, Boston, McGraw-Hill.