

The Effects of Financial Decisions on the Performance of Commercial Banks in Nigeria

Olubunmi Ikeolape OLAIFA

Department of Management and Accounting, Faculty of Management Sciences,
Ladoke Akintola University of Technology, P. M.B. 4000, Ogbomoso, Nigeria

Abstract

The main purpose of this study is to determine the effect of financial decisions on the performance of commercial banks in Nigeria using four performance indices. Both primary and secondary data were used. 20 commercial banks that operated during 2000-2013 period constitute the sampling frame. In analysing the data, Panel regression model was used to examine the effect of financial decisions on the performance of commercial banks in Nigeria. The results show that net loans to deposit a finance decision had significant impacts on Return on Asset (ROA) and Return on Capital Employed (ROCE). Likewise Capital Labour Ratio and Capital Earning to Labour Employed both investment decisions were positively significant on Return on Asset (ROA). Also, Earnings per share a dividend decision was only significant on profits. However, liquidity decision was not significant to any of the performance indices. It is against this background that these recommendations were made that banks should pay more attention to other financing decisions such as dividend and liquidity in order to keep the banks at high level of performance which is crucial to their sustainability.

Keywords: Financial decisions, Investment Decision, Liquidity Decisions, Commercial banks, Nigeria.

1. Introduction

Commercial banks are very crucial to economic growth of the nation for the services they provide such as financial mediation between savers and investors, credit creation and encouragement of capital accumulation. The health of the economy is closely related to the soundness of its banking system. Banking as an activity involves acceptance of deposits and lending or investment of money. It facilitates business activities by providing money and certain services that help in exchange of goods and services. The traditional role of banks has been that of intermediary, that is, the bringing together of borrowers and lenders (savers or depositors). This role can only be done successfully and for a sustained period with the careful management of credit and liquidity, prudent financial decisions, efficient governance structure, and interest rate risk. Corporate performance is an important concept that relates to the way and manner in which financial resources available to an organization are judiciously used to achieve the overall corporate objective of an organization, it keeps the organization in business and creates a greater prospect for future opportunities (Sunday, 2008).

The importance of financial decisions in bank performance is evident, since many of the factors that contribute to failure can be managed properly with strategies and financial decisions that drive growth and the bank's objectives. According to a number of studies (Ibarra, 1995; Van-Auken and Howard, 1993) the main causes of business failure are the lack of financial planning, limited access to funding, lack of capital, unplanned growth, low strategic and financial projection, excessive fixed-asset investment and capital mismanagement. Many of these causes of failure are challenges that can be successfully managed with financial strategies developed and implemented by the commercial banks. However, the study of financial decisions has been, for a long time, limited to large corporations, about which extensive research has been published.

Given the series of activities that have affected the efforts of banks to comply with the various consolidation policies and the antecedents of some bank operators in the Nigerian banking sector, it is therefore, pertinent to examine the need to ensure good financial decisions in banks. This will raise public confidence and ensure efficient and effective functioning of the banking system (Soludo, 2004).

The governance mechanism of banks establishes a set of relationships between stakeholders and the bank. Ciancanelli and Gonzales (2000) stated that in the banking sector, the regulation and regulator represent external corporate governance mechanisms. In the conventional literature on financial decisions and corporate governance, the market is the only external governance force with the power to discipline the agent. The existence of regulation means there is an additional external force with the power to discipline the agent. This force is quite different than the market. This implies that the power of regulation has different effects to those produced by markets. Whilst the issues become a major concern in banking practices, the conceptual issues are literarily debated. The challenges facing the banking sector following corporate financial scandals have been traced to ineffective financial decisions amongst others. A major role for ensuring the banks stability is played by the management and proper financial decisions of banks.

The financing decision is concerned with the raising of funds that finance assets (Attalah, 2011). Funds should be adequate to procure the assets necessary for operation; at the same time, if the funds are more than required, the excess would remain unutilised making no contribution to output but adding to the financing cost,

thereby considerably eroding profitability. In other words, the financing decision should ensure optimum capitalisation (Altahtamonui, 2005). The major sources of long-term capital are shares and debentures. Funds can also be obtained in the form of term loans and leases, as the latter serves as an alternative to borrowing. If sufficient funds are not raised domestically, they are obtained from sources abroad.

Financial strategy consists of three interrelated kinds of decisions: investment, funding and working capital decisions (Adeusi *et al.*, 2013). Investment decision involves the commitment of money for a certain duration for future payments that would compensate stakeholders. The investment may be an individual, company or government pension funds or investment (Reilly and Brown, 2006). According to (Patra, 2008), dividend decision is known as the amount a company is willing to pay for distribution of profits. Dividends signify the cash flow received by the shareholders as a return on their investment in the shares of the company, it has a direct impact on the share price in the market (Almedani, 2004). Liquidity refers to a company's ability to pay its current bills and expenses. It relates to the availability of cash and other assets to cover accounts payable, short term debts, and other liabilities (Gryglewicz, 2011).

2. Literature Review

The financing decision is concerned with the raising of funds that finance assets. The major sources of long-term capital are shares and debentures. Funds can also be obtained in the form of term loans and leases, as the latter serves as an alternative to borrowing. If sufficient funds are not raised domestically, they are obtained from sources abroad. Financial strategy consists of three interrelated kinds of decisions: investment, funding and working capital decisions (Ross *et al.*, 2000).

Investment decisions relate to the allocation of capital to carry out investment opportunities that are valuable (bring value) to the company, taking into account the magnitude, opportunity and risk of the future cash flows of investment. Funding decisions concern the specific mix of long-term debt and capital that the company uses to finance its operations, i.e., optimal capital structure. Working-capital decisions include the management of short-term assets and liabilities in a way that ensures the adequacy of resources for company operations. Assuming the corporate aim is to maximize profits, it is important for businesses to seek the optimum combination of the three kinds of financial decisions.

Mallete (2006) argues that an organization's financial strategy is so important to the company that it must be evaluated and adjusted as frequently as the operational strategy. He also says that the evaluation of financial strategies must be consistent with operations, needs and specificities of the business. The description of financial practices carried out by businesses represents an issue that has received more attention. Valencia *et al.* (2006) published a study of financial practices in Mexican firms taking into account the organizations' characteristics. They found that most enterprises establish an optimal leverage ratio, use investment evaluation techniques, have traditional management based on budgets and the return on investments (ROI), do not use techniques such as EVA or BSC, and apply financial ratios as a technique to analyze profitability.

Jog and Srivastava (1994) conducted a study that looked at financial decision-making processes that Canadian companies followed, as well as techniques they used to make decisions on capital budget, financing costs and sources, and dividends. Their results show that investment decisions are closely related to funding opportunities, and that the method used for the capital budget is the internal rate of return and the net present value. They also found that most Canadian companies determine an optimal debt and equity ratio. With regard to dividends decisions, present and future earnings represent the most relevant factors enterprises consider when deciding on dividend policy.

Another group of studies analyzed firms' use of certain financial analysis techniques. Lazaridis (2002) and Pohlman *et al.* (1988) investigated the way in which companies generate information to calculate cash flow, finding a large number of companies using subjective methods to forecast cash flows and just a few companies adopting sophisticated techniques. Kamath (1997) studied long-term funding decisions in large corporations and found that most companies do not maintain an objective in their debt and equity structure, preferring a financial hierarchy. They also showed that the main issues in financing decisions are those related to maintaining financial flexibility and ensuring survival in the long term. Zopounidis and Doumpou (2002) examined a technique called "Multi-criteria decision Aid" (MCDA) that helps with financial decision-making, by evaluating aspects such as corporate performance, investment, financial problems and credit; the authors showed the advantages of this technique in financial decision-making.

Likewise, there has been research focused on the analysis of financial decisions and their impact on creating value for investors. Escalera and Herrera (2006) studied the relationship between financial decision-making and economic value creation in Mexican companies. They found that companies that use supplier financing are more likely to create economic value as long as they do not have collection problems, and that investment decisions must take inventory into account. However, their study is based on small-business owners' perceptions of the importance of decisions, leaving aside the study of variables such as business performance and competitiveness when carrying out financial strategies.

Ghadome (2008), in his study aimed to analyse the determinants of capital structure through the role played by investment decisions and the financing and distribution of profits on a sample of companies listed in the Spain of 135 companies from 1990-1999. He adopted the financial reports of all the companies and focused on corporate governance due to its influence n aspects of the problem under examination.

Adepoju (2006 and 2012), in her study aimed to determine the impact of financial decisions on the profit margin of commercial bank in Nigeria had researched 9 banks categorising them into first, second and third generation banks from 1998 to 2004. She used the multiple linear regressions and determined the new generation banks had a higher significance on profit margins due to adoption of better technology and improvements in managerial skills.

Pindado and Torre (2006), analysed the determinants of capital structure through investment, financing and dividend decisions on 135 companies listed in the Spanish data base from 1990- 1999, using the financial report of all the companies. It focused on corporate governance. they emphasise the importance of monitoring external staffing as an important means of adjusting the debt and equity in the process of buying back shares as well as the promotion of staff both internally and externally to increase their shares in the company in light of high profits.

3. Materials and Methods

The study was carried out in Lagos and Abuja, Nigeria. The study areas were chosen because of its precedence, geographical location and most of the banks have their headquarters situated in the study areas. Both primary and secondary data were used. The primary data involves a structured questionnaire, which was distributed among the top officials of the sampled banks. This is due to the framework of financial decisions which rested on the administrative structure of the banks. The instrument was validated using cronbach–alpha test. While the secondary data covering 2000 – 2013 was collected from the various issues of the Statement of Accounts and Annual Reports of selected banks, the Central Bank of Nigeria’s Statistical Bulletin, and Nigeria Deposit Insurance Corporation’s Annual Account. 20 commercial banks that operated during 2000-2013 period constitute the sampling frame.

Model Specification

$$Y_{it} = \alpha + \beta X_{it} + e_{it} \dots\dots\dots (1)$$

With the subscript i denoting the cross-sectional dimension and t representing the time series dimension. The left hand variable Y_{it} , represents the dependent variable in the model which is the banks’ performance measured as profit, return on assets (ROA), return on equity (ROE), return on investments (ROI) and return on capital employed (ROCE). X_{it} contains the set of explanatory variables in the estimation model. α is the constant and β represents the coefficients. The fixed effect (FE), random effect (RE) and Hausman-test based on the difference between fixed and random effects estimators were conducted.

The fixed effect is appropriate if we are focusing on a specific set of bank and the inference is limited to the behaviour of these sets of banks. Although FE could be more appropriate, it is often observed that when there are too many parameters in the model, there is the possibility of loss of degree of freedom that can be avoided by assuming that the individual effect is random. The random effects (RE) model could thus be the appropriate specification in that situation especially when drawing a sample out of a large population. However, to determine whether to estimate an FE or an RE for the model, the specification test, known as Hausman test, devised by Hausman (1978) was performed using the procedures provided in the STATA 12 Statistical software package. Furthermore the rule to choose between random and fixed effect is that if P-value and Prob>Chiz are greater than, 0.05 the need to choose random effect otherwise fixed effect should be chosen. However, a maximum likelihood estimation method was also used to confirm the robustness of the model. Explicitly, the empirical model is specified as;

$$ROA_{it} = \alpha_0 + \beta_1 DER_{it} + \beta_2 DY_{it} + \beta_3 EPS_{it} + \beta_4 CL_{it} + \beta_5 MF + \beta_6 LQ + \beta_7 ROI + \varepsilon_{it} \dots\dots\dots (2)$$

$$ROCE_{it} = \alpha_0 + \beta_1 DER_{it} + \beta_2 DY_{it} + \beta_3 EPS_{it} + \beta_4 CL_{it} + \beta_5 MF + \beta_6 LQ + \beta_7 ROI + \varepsilon_{it} \dots\dots\dots (3)$$

$$ROE_{it} = \alpha_0 + \beta_1 DER_{it} + \beta_2 DY_{it} + \beta_3 EPS_{it} + \beta_4 CL_{it} + \beta_5 MF + \beta_6 LQ + \beta_7 ROI + \varepsilon_{it} \dots\dots\dots (4)$$

$$Profit_{it} = \alpha_0 + \beta_1 DER_{it} + \beta_2 DY_{it} + \beta_3 EPS_{it} + \beta_4 CL_{it} + \beta_5 MF + \beta_6 LQ + \beta_7 ROI + \varepsilon_{it} \dots\dots\dots (5)$$

where:

- ROA_{it} = Returns on Assets as a measure of bank i performance in time t.
- ROCE_{it} = Returns on Capital Employers of bank i in time t
- ROE_{it} = return on Equity of firm i in time t.
- DER = Debt to Equity Ratio,
- DY = Dividend Yield
- EPS = Earnings per share,
- CL = Capital labour ratio (Asset/employee ratio)
- MF = Managed Funds,
- LQ = Liquidity,

ROI	= Return on investment
α_0	= Constant,
$\beta_1 - \beta_5$	= Parameters to be estimated
ε	= error term,
i	= bank,
t	= time dimension

Where: ROA, ROCE, PROFITS AND ROE are performance indices.

4. Results and Discussion

Table 1 reports estimate of regression on measures of financial decisions on various performance measures of banks. Diagnostics of the specified models such as R^2 and F statistics indicate the fit of the model. Financial decisions were modelled based on the theoretical classification of such decisions into finance, investment, liquidity and dividend decisions. In the first model which has return on asset as the dependent variable, debt ratio which represents finance decision of the banks is found to be negative but significantly ($\beta = -0.77$, $P < 0.05$) related to performance of banks. The results indicate that increase in the debt ratio, which is a ratio of debt to asset of commercial banks in Nigeria, would lead to a loss in their return of assets, implying a bad finance decision had been made by some of the banks over the sample period. The variable is also negative and significant ($\beta = -0.55$, $p < 0.05$) for the profit model.

The result further indicates that rise in debt ratio of banks is inversely related with the profit levels of commercial banks in Nigeria. Further assessment of finance decision of banks and its impact on performance revealed that increase in net loans to deposit of the banks positively and significantly ($\beta = 0.21$, $p < 0.05$) impact performance indicators such as ROA and ROCE for the sampled period. The positive sign indicates that a balance in loan to total deposit ratio could enhance the performance of commercial banks and justify a wise financial decision. This is consistent with findings of Adepoju et al (2012) and Alslehat et al (2014). The dividend decision of the banks for the period under study was found to be positively and significantly ($\beta = 0.15$, $p < 0.05$) related to profit margin of the banks. The result is an indication of good dividend decision of the bank with a resultant effect on the profit level.

Further evidence indicated by the results show that another measure of dividend decision, earning per share, is also positive and significantly ($\beta = 0.61$, $p < 0.05$) related to profit of the sampled banks for the period under study. The findings corroborate the results obtained with dividend yield which confirm that financial decision of the banks based on dividend decision had positive impact on the performance of the banks especially the profit.

Another component of financial decisions of banks was their investment decisions. One of the measures of such decision is the ratio of capital earnings to labour employed in the banks. It is an indication of how productive the employees are which is suggestive of good investment on the training of those employees. The result indicates that bank employees do not contribute much to profit of the sampled banks and their return on capital employed. However, their contribution to return on assets was relatively high and positive. Specifically, capital labour ratio had a positive and significant effect on ROA ($\beta = 0.91$, $p < 0.05$), a negative and significant effect on profit ($\beta = -0.45$, $p < 0.05$) and ROCE ($\beta = -0.21$, $p < 0.05$) respectively.

In order to account for multicollinearity, return on investment (ROI) was only regressed on profit values of the sampled banks. The result indicates that ROI is positive and significantly impact ($\beta = 2.44$, $p < 0.05$) the performance of the banks for the period under study. Managed funds were included in the model to account for the skill of the management with regards to funds. Managed fund had a positive and significant effect on performance of the sample banks such as ROA and ROCE. An improvement in the variable is expected to increase the performance of the banks indicated by the ROA and ROCE.

Table 1: Financial decisions and the performance of commercial banks

Variables	ROA	PROFIT	ROCE	ROE
Debt ratio	-0.77** (-2.11)	-0.55* (-1.91)	0.21 (1.63)	-0.34 (-1.57)
Debt to equity	0.21** (2.24)	0.938 (1.37)	0.79* (1.65)	0.05 (4.66)
Dividend	0.51 (1.09)	0.15* (2.07)	-0.85 (-1.58)	1.12 (1.59)
Earnings	0.03 (0.17)	0.61*** (4.22)	0.88 (1.23)	-0.05 (-0.91)
Capital labour	0.91** (2.38)	-0.45** (-2.37)	-0.21** (-2.01)	0.99 (1.04)
Managed funds	0.05* (2.73)	-0.19 (-1.44)	0.37** (3.44)	0.64** (3.95)
liquidity	0.49 (1.62)	0.09 (1.92)	-0.05 (2.14)	0.34 (1.99)
ROI	-	2.44** (2.78)	-	-
R-Squared	0.79	0.459	0.865	0.8471
Adj-Squared	0.68	0.579	0.698	0.7739
F-statistics	9.04	5.62	8.22	4.55
Hausman	4.11 (0.5509)			

Source: Data analysis, 2017

**** Significant at 5%**

Hypothesis 1:

H₀₁: Financial decisions have no significant effect on the profit margin of the selected banks.

The F-test result of the hypothesis show there is significant effect of financial decisions on the profit margin of the selected banks. Based on this result, the null hypothesis of no significant effect is rejected (Table 2). The result depicts that various financial decisions taken by management of banks have strong and influencing impact on the profit margin of banks. This finding corroborate studies such as Collier *et al.* (2010) which found that financial decision such as investment decisions affect the left-hand side of the balance sheet through asset purchases. Investment decisions determine the type of assets used by the firm, the industry in which the firm operates, and the degree of operating leverage of the firm. Financing decisions affect the right-hand side of the balance sheet which shows the financial structure of the firm through security issues and retained earnings.

Financing decisions determine the capital structure of the firm and the degree of financial leverage. Available evidence (e.g. Fraser *et al.*, 2015) further shows that the result of the financial decisions made by corporate financial managers could constitute the stream of expected future cash flows of the banks. Several factors that control profit of the banks such as economic conditions, market demand, legal and political environments are controlled by financial decisions of banks such as investment and financing decisions which maximizes the profit margin of the firm.

Table 2: Hypothesis 1

Model	Sum of squares	df	Mean Square	F
Regression	150.825	3	50.275	6.982**
Residual	2191.543	127	16.858	
Total	2342.368	130		

Source: Data analysis, 2017

**** Significant at 5%**

5. Conclusions

The results shown in this study revealed that the main financial decision that is of paramount importance to the commercial banks in Nigeria is the investment decision. Also, finance decision of the banks has potential to reduce the profit of the banks if not addressed. More importantly the importance of financial decisions in performance of commercial banks is very crucial for future progress and development and success. It is against this background that these recommendations were made that banks should pay more attention to other financing decisions such as dividend and liquidity in order to keep the banks at high level of performance which is crucial to their sustainability. Also, a policy on efficient management should be put in place for bank operational expenses. This should be done by finding ways to obtain the optimal utilization of resources during production of banking products and services and efficient use, incorporation and management of all the financial decisions.

In other word, policy instruments should be able to reduce operational expenses through cost decisions. From a regulatory perspective, commercial bank performance should be based on individual commercial banks efficiency.

6. References

- Adepoju, O.I (2006): The Impact of Financial Decisions on The Profit Margin of Selected Commercial Banks in Nigeria. Unpublished Master's Thesis. Department of Management Sciences. LAUTECH, Ogbomoso.
- Adepoju, O.I and Onalapo A.A (2012): The Effect of Financial Decisions on The Profit Margin of Selected Commercial Banks in Lagos, Nigeria. Paper presented at the 3rd ICBE Conference, Cape Town South Africa.
- Adeusi, S. O., Akeke, N. I., Aribaba, F. O., and Simeon, A. O., (2013): Corporate Governance and Firm Financial Performance: Do Ownership and Board Size Matter?
- Almedani M. (2004): 'Incorporated Finance Management'. Fourth Edition. Dar Al Obeikan Publishers, Amman-Jordan.
- Alslehat Z. and Altahtamouni F. (2014): 'The Causal Relationship between Financial Decisions and their Impact on Financial Performance.' *International Journal of Academic Research in Accounting, Finance and Management Sciences*. Vol 4, No. 2, 76-84.
- Altahtamouni F. (2005): 'The Effect of the Determinants of Capital Structure on Return and value of the companies: An Applied study on industrial and service companies listed on the Amman Stock Exchange'. Unpublished Ph.D thesis.
- Ciancanelli, P. and Gonzalez, J. A. R., (2000): Corporate Governance in Banking: A Conceptual Framework, Social Science Research Network, Electronic Paper Collection: <http://www.papers.ssrn.com/paper.taf>
- Fraser S. et al (2015): What do we know about Entrepreneurial Finance and its Relationship with Growth? *International Small Business Journal*, 33(1), 70-88. ISSN 1741-2870.
- Ghadome T. (2008): The decision to finance and its impact on company's performance: An empirical study on a sample of companies listed on the AMMAN Stock Exchange Securities'. *Journal of Jordian Applied Sciences*. Vol 6, No. 5, 1-24.
- Gryglewicz S. (2011): A Theory of Corporate Financial Decisions with Liquidity and Solvency Concerns. *Journal of Financial Economics*. Vol 99, No. 2, 365-384. 2011
- Hausman J. A. (1978): 'Specification Tests in Econometrics'. *Econometrica JSTOR*. Vol 46, No 6.1251-1271.
- Ibarra, V. (1995): *Los primeros pasos al mundo empresarial: una guía para emprendedores*. México: Ed. Limusa.
- Jog V. and Srivastava F. (1994): Corporate Financial Decision Making In Canada. *Canadian Journal of Administrative Sciences*. 4(1), 81-87
- Mallette F. (2006): A framework for developing your financial strategy. *Corporate Financial Review*, 10(5), 11-20
- Patra A. (2008): 'The relationship among Financing Decisions, Investment decisions, Cash Dividends and Earnings for aggregate Stock Market in Taiwan and China'. Unpublished Master thesis, National Cheng Kung University, Taiwan.
- Saeed, M. M., Gull, A. A., and Raheed, M. Y., (2013): Impact of Capital Structure on Banking Performance (A Case Study of Pakistan), *Interdisciplinary Journal of Contemporary Research in Business* . Vol 4. No. 1, 393-403
- Shleifer, A. and Vishny, R. (1997): A Survey of Corporate Governance. *Journal of Finance* 52, 737-783.
- Soludo, C. C. (2004): *Consolidating the Nigerian Banking Industry to Meet the Development Challenges of the 21st Century*. Being an Address to the special Meeting of Bankers Committee, held on July 6.
- Sunday, K. O., (2008): Corporate Governance and Firm Performance: The Case of Nigerian Listed Firms. *European Journal of Economics, Finance and Administrative Sciences*. ISSN 1450 - 2275.
- Van Auken, P. & Howard, E. (1993): "A factor analytic study of the perceived causes of small business failure", *Journal of Small Business Management*, Vol. 31, No 4, 23-31.
- Zopounidis and Doumpos (2002) "Detecting falsified financial statement: a comparative study using multicriteria analysis and multivariate statistical techniques". *The European Accounting Review* 11:3, 509-535