

Effect of Financial Ratios on Firm Performance: Study of Selected Brewery Firms in Nigeria

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ABSTRACT

The study assessed the effect of financial ratios on performance of Quoted Breweries firms in Nigeria. It made use of ex-post facto research design. Data were gotten from secondary sources obtained from NSE fact books and annual reports/accounts of the selected Breweries Companies. The population of the study consisted of thirteen (13) quoted Breweries firms listed on the Nigerian Stock Exchange as at 31st December, 2018. Four (4) of the quoted Breweries firms are selected to form the sample of the study for the period of nine (9) years (2010 – 2018). The relevant data obtained were subjected to statistical analysis using Pearson correlation coefficient and regression analysis. The results of this study revealed that there is a significant relationship between current ratio and firm performance but negative effect. Debt equity ratio has a significant effect on return on asset of Nigerian Breweries. The result of the study concludes that Nigerian breweries companies are relatively using an optimal mix of debt to equity which is evident from the significant positive relationship of debt-equity ratio with financial performance of the Nigerian Breweries. The researchers recommended that the management should employ all carefulness while financing with long term debt instruments; endeavor to find out the best and optimal combination of long term debt and equity that will impact positively on the value of the firm.

KEYWORDS: Financial Ratios, Firm Performance, Brewery Firms, Debt Instruments, Equity

1. INTRODUCTION

The financial ratio is one of the strategies for determining an organization's degree of performance. It is defined as the methods for converting aggregate financial data into meaningful quotients that can be compared to other financial data. The difficulty in determining a firm's success with financial ratios is achieving the required trade-off between liquidity, solvency, and profitability (Padachi, 2006; Lazaridis, 2006). Financial ratio management in terms of liquidity, solvency, and profitability is critical for financial performance since it has a direct impact on business profitability (Rajesh & Ramana, 2011). Maintaining a firm's liquidity for day-to-day operations is an important component of managing its finance and working capital, since it ensures the firm functions smoothly and improves its capacity to meet its obligations (Eljelly, 2004). As a result, the ultimate goal of profitability can be realized through optimal resource allocation and shareholder value

maximization (Panwala, 2009). It can be achieved by financial performance analysis, according to Bhunia, Mukhuti, and Roy (2011). However, just because a number appears on a financial statement does not mean that number is significant or that it provides us with relevant information; the importance of the number appears only when compared with other number (Tofeeq, 1997). Financial ratios are tools used to analyze financial conditions and performance. Although financial accounting statements show the financial positions of a business at the end of a financial period, but they do not present accurate performance on the level of performance or efficiency of operations of a business at the end of financial period (Lucey 1988). The question that financial ratios seem to drive more on the values attached to firms has a very controversial issue and yet very much unresolved. Many breweries depend on measuring annual profit and few other indicators,

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probably because of the difficulty in measuring firm's growth indicators and the influence it exerts on the firm's value. Many investors in Nigeria are uneducated or illiterate and as a result of ignorance or inexperience, they cannot use or employ financial ratios in evaluating the performance of the companies (James, 2010). According Hermanson (1992), existing shareholders use the cash dividends and interest paid to them in evaluating the performance of the companies for investment decision. These parameters do not give accurate information about the performance and efficiency of operation of the companies. Based on these problems, the study examined the effect of financial ratios on firm performance.

Objectives of the Study

The main objective of this study was to assess the effect of financial ratios on performance of quoted Breweries Firms in Nigeria. It addressed the following specific objectives:

1. Evaluate the effect of current ratio on firm performance.
2. Determine the effect of debt-equity ratio on firm performance.
3. Ascertain the effect of net profit margin on firm performance.

Hypotheses of the Study

The following null hypotheses were formulated to guide the study

HO₁: There is no significant effect of current ratio on firm performance.

HO₂: There is no significant effect of debt-equity ratio on firm performance.

HO₃: There is no significant effect of net profit margin on firm performance.

2. Review of Related Literature

Conceptual Framework

Financial Ratio

Financial ratio, according to Osisioma (2000), is an investigation of the resolutions or separations of data into their elements or component parts, as well as the tracing of facts back to their source in order to find the general principles behind individual phenomena. Financial ratios, according to Okwuosa (2005), are a way of expressing the links that exist between the ratio analyses. Financial ratio is the most significant technique for assessing the performances of firms from their financial statements, according to the Institute of Chartered Accountants of Nigeria - ICAN (2006). Pandey (2010) sees financial ratio as the means of identifying the financial strength and weakness of the firm by properly establishing relationships in the firm through properly establishing

relationships between the items of the balance sheet and the profit and loss account.

Firm Performance

After controlling for risk and applying an acceptable rate of return, Kothari (2001) defined company performance as the present value of predicted future cash flows. According to Eyenubo (2013), it is the achievement of pre-defined objectives, targets, and goals within a given time frame. According to Carolyne (2015), firm performance is a subjective assessment of how successfully a company can utilise its assets from its core method of operation to generate more income. Financial performance measures are used by all firms as part of their performance management.

Current Ratio and Firm Performance

The current ratio is an indication of a firm's market liquidity and ability to meet creditors demand. Acceptable current ratios vary from industry to industry and are generally between 1.5 and 3 for healthy businesses. If a company's current ratio is in this range, then it generally indicates good short-term financial strength. If current liabilities exceed current assets (the current ratio is below 1), then the company may have problems meeting its short-term obligations. If the current ratio is too high, then the company may not be sufficiently using its current assets or its short-term financial facilities. Current ratio or working capital ratio measures current assets against current liabilities. It measures the company's ability to pay back its short-term debt obligations with its current assets. It is calculated by dividing current assets by current liabilities. James (2009) stated that it is the analysis of financial statements that is used to measure company performance. If the ratios indicate poor performance, investors may be reluctant to invest.

Debt Equity Ratio and Firm Performance

Debt equity ratio shows how efficient the organization uses other people's money and whether it is using a lot of borrowed money (Lasher, 2005). It checks the financial structure of the business by comparing debt against total capital, against total assets and against owners' funds. The ratio helps to check how "leveraged" a company is, and also the financial maneuverability of the company in difficult times. The ratio tells a lot about the business. It is calculated by taking the debt owed by the company and divided by the owner's equity, also known as capital.

Net Profit Margin and Firm Performance

Net profit margin, also known as net margin, indicates how much net income a company makes with total sales achieved Thachappilly (2009). A

higher net profit margin means that a company is more efficient at converting sales into actual profit. Net margin measures how successful a company has been at the business of making a profit on each dollar sales. It is one of the most essential financial ratios. Net margin includes all the factors that influence profitability whether under management control or not Oberholzer & Westhuizen (2004). The higher the ratio, the more effective a company is at cost control. Compared with industry average, it tells investors how well the management and operations of a company are performing against its competitors. Compared with different industries, it tells investors which industries are relatively more profitable than others.

Theoretical Framework

The study was based on Stakeholder Theory. Stakeholder Theory was propounded by Edward R Freeman in 1983. It argues that there are other parties involved in a business organization which include employees, customers, suppliers, financiers, communities, governmental bodies, political groups, trade associations, and trade unions. And their interest must also be satisfied. It posits that companies should align the interest of the shareholders and other corporate stakeholders as one. This theory is related to this study as the stakeholders assess the performance of the firms using financial ratios. Moreover, the effect of financial ratio on firm performance will directly affect the decisions made by the stakeholders of the company, and will also give them an insight on the financial performance and position of the firms.

Empirical Review

Nwankwo (2018) researched on the effect of accounting ratios on the financial performance of selected firms on brewery industry in Nigeria. One of the specific objective was to appraise the effect of dividend per share on market value of brewery firms in Nigeria. The research adopted ex-post facto research design covering the period of ten years, 2007-2016. Secondary data were collected from annual report and accounts of selected brewery firms quoted in the Nigeria Stock Exchange. The data were analyzed using multiple linear regression technique. Findings indicate that Dividend per Share had positive and significant effect on market value while return on equity has positive and insignificant effect on market value of firms. The study hereby recommended that firms should enhance both their Dividend per Share and return on equity to grow the market values of brewery firms in Nigeria.

The effect of various financial ratios on company financial performance was studied by Oruc and

Erdogan (2015). The purpose of this study was to determine the impact on the corporate financial performance to the several financial indicators. Companies that are traded continuously in Borsa İstanbul-30 (BIST-30) between 2002-2013 periods were analyzed in this study for this purpose. Current ratio, earnings per share, leverage ratio, firm size and market value to book value ratio were used as independent variables. Net profit margin was used as dependent variables. The relationship between variables was analyzed by using panel data. According to the results of analysis, there was a positive and significant relation between corporate performance (t-period) and current ratio and corporate size (t- period) and there is a negative and significant relation between corporate performance (t-period) and leverage ratio (t-period).

Rumman and Kutum (2015) carried out a research on the stability of the financial ratios of Jordanian Industrial Companies. The purpose of the study was to identify if the financial ratios of Jordanian industrial companies remained stable across sector and over time. The study used six financial ratios from fifty-six companies across six sectors with financial information from 2010 to 2014. A two way multivariate analysis of variance was performed to identify the stability of the ratios across the sectors and over the time. The results of the study showed that the financial ratios which showed some difference across sector were EBITTA (Earnings before Interest and Tax), CAT (Current Assets Turnover) and CFTA (Cash Flow to Total Assets). There were no differences observed between the financial ratios over time. The interaction of Time and Sector revealed no significant interaction effects. Recommendation was not stated.

Accounting ratios as a veritable tool for corporate investment decisions in Delta State Nigeria was studied by Aniefor and Oboro (2015). The objective of the study was to identify the extent to which accounting ratios enhances the liquidity position of an organization. Questionnaire was used as the instrument for data collection and administered on eighty (80) respondents of the organizations under study in Delta State randomly selected using Taro-Yamane formula. The sample size from a population of 100 is 80 respondents at 95% confidence level. Data analysis was made using simple percentage tables and hypotheses were tested using the Pearson product moment correlation co-efficient and the t-test at 0.05% level of significance. The result showed that positive and significant relationship exists between accounting ratios and the study of liquidity position of an organization. The result also showed that positive

and significant relationship exists between accounting ratios in providing avenue for examining the operational efficiency of management in an organization. The study, however, recommended that organizations should never base conclusion on ratio, non-recurring items whether profit or loss should be eliminated when computing ratios, interpretation of results according to the general business conditions and a host of others for effective application of accounting ratios for proper investment decisions in corporate organizations.

Borhan, Mohammed and Azmi (2014) researched on the impact of financial ratios on the financial performance of a chemical company. The purpose of the paper was to examine the impact of financial ratios on the financial performance of a chemical company: Lyondell Basell Industries (LYB). Some selected ratios: current ratio (CR) and quick ratio (QR) represent the liquidity ratios; debt ratio (DR) and debt equity ratio (DTER) represent the leverage ratios, while operating profit margin (OPM) and net profit margin (NPM) represent the profitability ratios. The financial ratios were measured from 2004 to 2011, quarterly. Secondary data were used and multiple regression analysis was employed in data analysis. The results showed that CR, QR, DR and NPM had a positive relationship while DTER and OPM had a negative relationship with the company's financial performance.

Variables measurements

Enekwe, Okwo and Ordu (2013) studied the relationship between the financial ratio analysis and profitability of the Nigerian Pharmaceutical industry over the past eleven (11) years period from 2001-2011. A multiple regression model was used. The study covered five (5) variables for the analyses such as: Inventory Turnover Ratio (ITR); Debtors' Turnover Ratio (DTR); Creditors' Velocity (CRSV); Total Assets Turnover Ratio (TATR) and Gross Profit Margin (GPM). Profitability as a dependent variable was expressed by Gross Profit Margin (GPM) while financial ratio analysis represents as ITR, DTR, CRSV and TATR for independent variables. The study reported that there is a negative relationship between all independent variables with profitability in the Nigerian pharmaceutical industry.

3. Methodology

Ex-post facto research was used in this study. From 2010 to 2018, breweries listed on the Nigerian Stock Exchange (NSE) were chosen for this study. The study's population consisted of thirteen (13) Nigerian brewing companies that are publicly traded on the Nigerian Stock Exchange (NSE). Purposive sampling was used to choose the sample size of four (4) quoted beer enterprises. Secondary data was used in the study. Pearson Coefficient and Regression Analysis with E-view 9.0 were the statistical tools utilized to test the hypothesis.

Table 3.1 Measurement of Variables

V a r i a b l e	A c r o n y m	M e a s u r e m e n t
I n d e p e n d e n t		
Financial Ratio		
Current Ratio	CR	Current Asset/Current Liability
Debt-Equity Ratio	DER	Long Term Debt/Total Asset
Net Profit Margin	NPM	Profit After Interest and tax/Revenue
Dependent		
Firm Performance		
Return on Asset	ROA	Net profit after tax/Ave net assets X 100%
Control Variable		
Firm size	FS	Natural log of total assets
Firm age	FA	No of years since incorporation in its log

Source: Researchers' Compilation (2019)

Model Specification

Firm performance (FP) = f (Financial Ratio)

Financial ratio was proxied by Current Ratio (CR), Debt Equity Ratio (DER), and Net Profit Margin (NPM), while Firm Performance was proxied by ROA. The equation is expressed as follows:

$$FP = a + B_1CR + B_2DER + B_3NPM + u$$

Where:

FP = Firm Performance

a = constant

B₁ – B₃= Coefficients of explanatory variables

CR = Current Ratio

DER = Debt-Equity Ratio

NPM = Net Profit Margin

u = Error term

The general expression of Return on Asset (ROA) in the form of equation is written as follows:

$$ROA = a + B_1CR + B_2FS + B_3FA + u \quad (1)$$

$$ROA = a + B_1DER + B_2FS + B_3FA + u \quad (2)$$

$$ROA = a + B_1NPM + B_2FS + B_3FA + u \quad (3)$$

Decision Rule

If the statistical analysis shows that the significance level is below the cut-off value of 0.05, we reject the null hypothesis and accept the alternate hypothesis.

4. Presentation and Analysis of Data

Data used in this study were obtained from the sampled companies annual reports and NSE fact book.

Data Analysis

The researcher firstly tested the data and variables to an Augmented Dickey Fuller (ADF) Unit Root Test with the aid of *E-view* statistical software Ver. 9.

Table 4.1 Augmented Dickey Fuller (ADF) Unit Root Test Results

Variables	Test Critical Values			Test Statistics Status	
	1	5	10	A D F	(Stationary)
R O A	-4.420595	-3.259808	-2.771129	-3.697365	1 (0)
C R	-2.937216	-2.006292	-1.598068	-3.943459	I (2)
D E R	-1.598068	-2.006292	-2.937216	-3.943459	I (2)
N P M	-4.582648	-3.320969	-2.801384	-4.835946	I (1)
F Z	-4.803492	-3.403313	-2.841819	-4.662274	I (1)

Source: Data Computation Output (2019)

As indicated from the table 4.2, only Return on Asset (ROA) was stationary at level. This entails that ROA and DER follow the I (2) stochastic process; CR and NPM follow the I (1) stochastic process but ROA follows the I(0) stochastic process.

Test of Hypotheses

H_{01} : There is no significant effect of current ratio on firm performance.

Table 4.2 Regression Analysis showing the effect of current ratio (CR) on Return on asset (ROA)

D e p e n d e n t V a r i a b l e : D R O E				
M e t h o d : L e a s t S q u a r e s				
D a t e : 1 1 / 1 3 / 1 9 T i m e : 0 0 : 4 9				
S a m p l e (a d j u s t e d) : 2 0 1 0 2 0 1 8				
I n c l u d e d o b s e r v a t i o n s : 9 a f t e r a d j u s t m e n t s				
V a r i a b l e	Coefficient	Std. Error	t-Statistic	Prob.
C R	-4.090658	4.264426	-0.959252	0.0045
C	-0.026495	0.118832	-0.222959	0.8310
R - s q u a r e d	0.630969	Mean dependent var		-0.053240
Adjusted R-squared	-0.711537	S.D. dependent var		0.324858
S.E. of regression	0.326726	Akaike info criterion		0.812931
Sum squared resid	0.640501	Schwarz criterion		0.832792
Log likelihood	-1.251725	Hannan-Quinn criter.		0.678981
F - s t a t i s t i c	0.920164	Durbin-Watson stat		1.639551
Prob(F-statistic)	0.004475			

Source: Researcher's E-View 9.0 Output

Interpretation

R^2 measures the percentage of return on asset that could be explained by changes in independent variable, current ratio (CR). Here, R^2 is 0.711537 (71.30%) which implies that about 13.30% of variation in return on equity could be explained by the effect of independent variable, current ratio (CR) while about 86.70% could be

attributed to other factors capable of effecting changes in return on asset of Nigerian Breweries. In this case, Durbin-Watson statistic is 1.639551. This indicates the absence of autocorrelation in the data series. In general, It can be seen from the table 4.3 (ROA), the p-value of 0.004475 is less than a-value of 0.05. Therefore, H₀ is rejected as well from the table 4.3 ROA, the p-value of 0.0045 is less than a-value of 0.05. Therefore, H₀ is rejected and H₁ still accepted. Therefore, we conclude that current ratio (CR) has statistical positive significant effect on the Return on Assets (ROA) of the listed Nigeria Breweries firms. These agreed with our apriori expectation.

H₀₂: There is no significant effect of Debt-Equity Ratio on firm performance.

Table 4.3 Regression Analysis showing the effect of Debt-Equity Ratio (DER) on Return on Assets (ROA)

D e p e n d e n t V a r i a b l e : D R O A				
M e t h o d : L e a s t S q u a r e s				
D a t e : 1 1 / 1 3 / 1 9 T i m e : 0 0 : 4 5				
S a m p l e (a d j u s t e d) : 2 0 1 0 2 0 1 8				
I n c l u d e d o b s e r v a t i o n s : 9 a f t e r a d j u s t m e n t s				
V a r i a b l e	C o e f f i c i e n t	S t d . E r r o r	t - S t a t i s t i c	P r o b .
D D E R	1.000000	5.900017	1.70E+16	0.0000
C	0.000000	1.820017	0.000000	1.0000
R - s q u a r e d	1.000000	Mean dependent var		-0.053240
Adjusted R-squared	1.000000	S.D. dependent var		0.324858
S.E. of regression	5.070017	Sum squared resid		1.540032
F - s t a t i s t i c	2.880032	Durbin-Watson stat		1.450000
Prob(F-statistic)	0.000001			

Source: Researcher's E-View 9.0 Output

Interpretation

R² measures the percentage of Return on Equity that could be explained by changes in independent variable, Debt to equity. Here, R² is 1.00 (100%) which implies that 100% of variation in return on asset could be explained by the effect of independent variable, Debt to equity while about 0% could be attributed to other factors capable of effecting changes in return on asset of Nigerian Brewery companies. Here also, the Durbin-Watson statistic is 1.450000. This indicates the absence of autocorrelation in the data series. In general, It can be seen from the table 4.2.3 (ROA), the p-value of 0.000001 is less than a p-value of 0.05. Therefore, since the p-value of 0.0000 is less than a-value of 0.05. Therefore, H₀ is rejected. Therefore, we conclude that Debt to Equity Ratio (DER) has statistical significant positive effect on the Return on Assets (ROA) of the listed Nigeria Breweries firms.

H₀₃: There is no significant effect of net profit margin on firm performance.

Table 4.4 Regression Analysis showing the effect of Net Profit Margin (NPM) on Return on Assets (ROA)

D e p e n d e n t V a r i a b l e : D R O A				
M e t h o d : L e a s t S q u a r e s				
D a t e : 1 1 / 1 3 / 1 9 T i m e : 0 0 : 5 0				
S a m p l e (a d j u s t e d) : 2 0 1 0 2 0 1 8				
I n c l u d e d o b s e r v a t i o n s : 9 a f t e r a d j u s t m e n t s				
V a r i a b l e	C o e f f i c i e n t	S t d . E r r o r	t - S t a t i s t i c	P r o b .
D T D T A	0.022290	0.184206	0.121008	0.0071
C	-0.003646	0.025961	-0.140446	0.8923
R - s q u a r e d	0.502087	Mean dependent var		-0.002792
Adjusted R-squared	-0.640471	S.D. dependent var		0.070186
S.E. of regression	0.074953	Akaike info criterion		-2.150774
Sum squared resid	0.039326	Schwarz criterion		-2.106947
Log likelihood	11.67848	Hannan-Quinn criter.		-2.245354
F - s t a t i s t i c	0.014643	Durbin-Watson stat		1.013777
Prob(F-statistic)	0.007085			

Source: Researcher's E-View 9.0 Output

Interpretation

From the regression analysis, Table 4.4 indicates that there is a positive (t-statistics, 0.022290) but significant (p-value, 0.0071) association between Net Profit Margin (NPM) and Return on Assets (ROA) of listed Nigerian Brewery companies. This positive effect implies that a 1% increase in Net Profit Margin (NPM) will tend to increase the level of Return on Assets (ROA) by 0.022290 and vice versa. Net Profit Margin (NPM) has significantly affected the Return on Assets of the listed Nigerian Brewery companies. R^2 measures the percentage of Return on asset that could be explained by changes in independent variable. In this case, R^2 is 0.002 (0.64%). This implies that about 64% of variation in return on asset could be explained by the effect of independent variable, while about 36% could be attributed to other factors capable of effecting changes in return on asset of Nigerian Brewery companies. In this case, the Durbin-Watson statistic is 1.013777. This indicates the absence of autocorrelation in the data series. Conclusively, It can be seen from the table 4.5 (ROA), the p-value of 0.007085 is less than a-value of 0.05. Therefore, H_0 is rejected and H_1 is accepted, we conclude that Net Profit Margin (NPM) has statistical significant positive effect on Return on Assets (ROA) of the listed Brewery company in Nigeria.

5. Summary of Findings, Conclusion and Recommendations

Summary of Findings

The following findings were made:

1. There is a significant effect of current ratio on firm performance (P-value 0.004475 < 0.05)
2. There is a significant effect of Debt-Equity Ratio on firm performance. (p-value 0.00001 < 0.05)
3. There is a significant effect of net profit margin on firm performance. (P-value 0.0071 < 0.05)

Conclusion

The examined the effect of financial ratios on financial performance of brewery companies quoted on the floor of Nigeria Stock Exchange. The result of the study depict that Nigerian Breweries companies are relatively using an optimal mix of debt to equity which is evident from the significant positive relationship of debt-equity ratio with financial performance of the manufacturing sector.

Recommendations

Based on the findings of this study, the researchers recommended that:

1. In order to retain a favorable significant effect on financial performance, the management of Nigerian Breweries enterprises should examine an appropriate combination of current ratios.
2. Managers should exercise extreme caution when using long-term debt instruments, attempting to discover the best and most ideal combination of long-term debt and equity that will have a beneficial influence on the firm's value.
3. Brewery companies should use debt minimization measures to improve their company's success.

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