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IMPACT OF LEVERAGES ON FINANCIAL POSITION OF PETROLEUM COMPANIES

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Abstract

Capital structure decisions are the most crucial decisions taken by corporate organizations, as these decisions have massive impact on the overall cost of capital weighted average and the resultant profitability and market value of shares. Most of the researches conducted on capital structure concluded that there is an optimal capital structure that is affected by a variety of internal and external factors. These factors usually differ from country to country and industry to industry. This paper using a case study methodology, investigated the determinant of capital structure leverages of petroleum companies. The study examined how leverages such as operating leverage, financial leverage and combined leverage of a firm impact on the financial position of the two listed petroleum companies for the period between 2009-10 and 2013-14 using statistical techniques. The findings indicated that all the factors have significant impact on financial leverage.

Keywords: *Capital Structure, Financial Leverage, Profitability, Operating Leverage, Financial Leverage.*

Introduction

Capital structure is the mix of equity and debt that a company uses to finance its operations. Capital structure of a firm is defined by its leverage; that is a mix of debt and equity financing which is subject to different financial difficulties. Financial leverage represents the total debt reported to the equity of a firm, reflecting the capacity of the financial managers to attract external financial resources in order to improve the efficiency of the equity. Leverage has been conceived also as a modality by which a company can increase its growth opportunity. So, Leverage decision is fundamental for any business organization because of the need to maximize return to the various stake holders and also because of the fact that such decision has great impact on the firms' ability to deal with competitive environment. Capital structure decisions rely on two major sets of theories namely, the trade-off theory and the pecking order theory. According to the trade-off theory of capital structure, by balancing the advantages and disadvantages of debt it could be possible to determine an optimal level of indebtedness that could reduce the cost of capital and contribute to the creation of economic value. In other words, an element of balance is introduced in capital structure choices because of the optimal combination of debt and equity. Many factors generate costs and benefits of debt and contribute to determining optimal capital structure. Firms that use debts, in fact, can take advantage not only of tax benefits derivable from the deductibility of financial obligations, but can also minimize their costs arising from information asymmetries and discipline managerial behavior with regards to firm investment policies. In other words, the more a company uses debt, the less income tax the company pays, but the greater its financial risk.

The Pecking Order theory popularized by Stewart C. Myers postulates that equity is a less preferred means of raising new capital, and is actually a last resort. The theory states that the cost of financing increases with asymmetric information. Pecking order theory does not predict an optimal or target capital structure. It argues that profitable firms will use their retained earnings first to meet their capital needs. They opt for debt as their second choice and additional equity finance as a source of last

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