Abstract:
The main objective of this topic is to analyze and understand the effect of leverage on the profitability of the oil and gas sector of Pakistan. It analyzes the relationship between leverage (Financial, operating and combined) and EPS of this sector. It aims to analyze how earning capacity of this sector is affected by operating costs and fixed financial charges. This explains the relationship between the Debt equity ratio and EPS and how effectively this sector be able debt financing. In this study selected oil and gas companies are taken for analysis and hypothesis are examined with the statistical methods of one way ANOVA and t-test.
Leverage is basically explained as the use of borrowed money to make an investment and return on that investment. It is more risky for a company which has ratio of financial leverage. But financial leverage is commonly used in various circumstances specially oil and gas sector as a means of altering the cash flow and financial position of a company. There are the following four positions which show a relationship with the level of financial leverage.
First, it is the relation of equity and debt that means the rate of capital. The other is the influences on business operations and cycle of financial leverage. Then the company's industry and its branches as whole financial leverage level. Then the correlation between the current financial leverage ratio of the company with the middle leverage level. Lastly, the possibility of company's mission and philosophy with the situation connected to the ratios of financial leverage. The outcome of the financial leverage can also be used to push up income and growth however, it is much common for business industries in the phase of the boom period. Financial leverage ratio is relative to changing of profit and contrary to stability. Financial leverage greatly affects return on assets, return on investment and return on equity.

Keywords: Liquidity ratios, leverage Ratios, Return on Investments, Return on equity, Return on Assets, Regression analysis.

Need and Objectives of the Study:
An investor who would like to be rational and scientific in his investment activity has to evaluate a lot of information about past performance and the expected future performance of the companies, industries and the economy as a whole before taking the investment decision and hence, the present study attempts to analyze the impact of leverage and liquidity on profitability of selected oil and gas companies in Pakistan.
The following are the objectives of the study
• To understand and analyze the leverage and liquidity effects of the selected oil and gas companies.
• To analyze the impact of leverage and liquidity on profitability and EPS.
• To assess the relationship between the financing mix and earnings per share.
INTRODUCTION

Liquidity management is very important for every organization that means to pay current obligations on business, the payment obligations include operating and financial expenses that are short term but maturing long term debt. Liquidity ratios are used for liquidity management in every organization in the form of current ratio, quick ratio and Acid test ratio that greatly affect on profitability of organization. So business has enough liquid assets (Cash, Bank) to meet the payment schedule by comparing the cash and near-cash with the payment obligations. Liquidity ratios work with cash and near-cash assets (together called "current" assets) of a business on one side, and the immediate payment obligations (current liabilities) on the other side. The near-cash assets mainly include receivables from customers and inventories of finished goods and raw materials. The payment obligations include dues to suppliers, operating and financial expenses that must be paid shortly and maturing installments under long-term debt.

Liquidity ratios measure a business' ability to meet the payment obligations by comparing the cash and near-cash with the payment obligations. If the coverage of the latter by the former is insufficient, it indicates that the business might face difficulties in meeting its immediate financial obligations. This can, in turn, affect the company's business operations and profitability. The Liquidity versus Profitability Principle: There is a trade-off between liquidity and profitability; gaining more of one ordinarily means giving up some of the other.

Literature Review:

Archer and D’Ambrosio in their 1972 textbook said that, "The higher the proportion of fixed costs to total costs the higher the operating leverage of the firm..." [Archer, 421]. In their 1972 textbook, Schultz and Shultz, said that, "Since a fixed expense is being compared to an amount which is a function of a fluctuating base (sales), profit-and-loss results will not bear a proportionate relationship to that base. These results in fact will be subject to magnification, the degree of which depends on the relative size of fixed costs vis-a-vis the potential range of sales volume. This entire subject is referred to as operating leverage." [Schultz, 86]

In their 1969 college textbook, Weston and Brigham told some of today’s businessmen and women that, "High fixed costs and low variable costs provide the greater percentage change in profits both upward and downward." [Weston, 86]

Luoma and Spiller [2002] discuss teaching financial leverage in the context of accounting education. Primarily arguing for specific coverage of financial leverage in introductory accounting textbooks, they essentially introduce the multi-case simplified financial statements approach common in finance textbooks to their intended audience of accounting educators. Luoma and Spiller acknowledge that such material is usually given an entire chapter in prominent finance textbooks, but express concern that the lack of coverage in introductory accounting textbooks does not communicate the importance of the issue to financial managers who may take only the typical introductory level two course sequence in accounting. Their treatment of the issue is of interest to finance professors primarily because of its inclusion of relevant common accounting terminology (for example, “leverage benefit to common shareholders”).

Liquid assets should have the following attributes: diversified, residual maturities appropriate for the institution’s specific cash flow needs; readily marketable or convertible into cash; and minimal credit risk. (2005 The Bank of Jamaica Publish: February 1996). Titman and Wessels (1988) observed that highly profitable firms have lower levels of leverage than less profitable firms because they first use their earnings before seeking outside capital.

Burney, Boyles, and Marcis [2001] discuss the use of the common comparative financial statement approach when the example statements are developed ad hoc during a spontaneous explanation of financial leverage which may arise before capital structure is formally addressed in the course. The authors point out those unintended counterproductive results may arise when such an ad hoc example is not properly structured with respect to interest rates and returns on equity. In their paper, reference is also made to the indifference point for capital structure changes as being defined relative to the Basic Earning Power (BEP) ratio, which is identical to Liang and Singh’s operating ROI.

Morris and Shin (2010) conceptually defines the liquidity ratio as “realizable cash on the balance sheet to short term liabilities.” In turn, “realizable cash” is defined as liquid assets plus other assets to which a haircut has been applied.
Ration analysis is one of the conventional ways that use financial statements to evaluate the company and create standards that have simply interpreted financial sense (George H. Pink, G. Mark Holmes 2005).

Liang and Singh [2001] assert that the typical simplified financial statement approach used in textbooks fails to focus on the key issues and may lead to student confusion by introducing additional details that must also be explained. They offer a break-even point implied by the typical EBIT-EPS analysis used in many textbooks. Liang and Singh contend the break-even point suggests a straightforward cost of funds perspective that students can easily understand. Although Liang and Singh state their indifference point in terms of operating ROI, they demonstrate the decisions suggested by their criterion are identical to those found using examples which rely on break-even EPS analysis and the associated assumptions concerning numbers of shares outstanding. According to Wald (1999), profitability, which is the most significant determinant of firms’ financial leverage, negatively affects the debt to asset ratios in the heteroskedastic tobit regression model.

Scope:

Financial Leverage

Financial Leverage is caused due to fixed financial interest in every organization. It is the ability of a business to use fixed financial charges to magnify the effects of changes in EBIT on the earning per share and profits. It involves the use of funds obtained at a fixed cost in the hope of increasing the return to the shareholders in future. The financial leverage is employed by every company is intended to earn more return on the fixed-charge funds than their costs. The surplus (or deficit) will increase (or decrease) the return on the owner’s equity and return on investments.

Combined Leverage

Operating and financial leverages together cause wide fluctuation in EPS for a given change in sales and operating costs. It can be calculated by multiplying the operating leverage and financial leverage. The operating leverage affects the EBIT and the financial leverage affects the EPS, ROE and ROI. The management has to manage a right combination of the operating and financial leverage. A company whose sales fluctuate widely and erratically should avoid use of high leverage because it will be exposed to a very high degree of risk.

Leverage and Earning Per Share

There is a close relationship between the financial leverage and Earning per Share of the company. If degree of financial leverage is high and the return on investment is greater than the cost of debt capital, then the impact of leverage on EPS will be favorable. The impact of financial leverage is unfavorable when the earning capacity of the firm is less than what is expected by the lenders (i.e.) the cost of debt.

Leverage and Return on investments:

The return on investment comes from leverage appreciation of the assets value which is normally based on income. It means assets are purchased with only a portion of the purchase price coming from the buyer and the balance coming from the lender. Any increases in the value of the entire assets represent a real return on the original amount invested and the investor will make profits in the long run.

SELECTION OF VARIABLES

Dependent variables

1- Return on assets (ROA) = Net profit before tax/ Total assets

2- Return on equity (ROE) = Net profit before tax/ shareholder’s equity

3- Return on Investments (ROI) = Net profit before tax/ Investments

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4- **Earning per share (EPS)** = Net Earnings / Outstanding Shares

Independent variables

**Financial Leverage Ratio** = Percent change in EPS / Percent change in EBIT

**Operating Leverage** = Percent change in EBIT / Percent change in sales.

**Combined Leverage**

Combined leverage, as the name implies shows the total effect of the operating and financial leverages. In other words, combined leverage shows the total risks associated with the firm. It is the product of both the leverages.

Degree of Combined Leverage (DOL) = DOL * DFL

Methodology:

**Hypothesis of the Study**

For better understanding of the effect of leverage on the profitability, the following hypothesis can be framed.

**Hypothesis 1 (H0):** There is no significant relationship between DFL, DOL and EPS.

**Hypothesis 2 (H0):** There is no significant relationship between DFL, DOL and ROA

**Hypothesis 3 (H0):** There is no significant relationship between DFL, DOL and ROI

**Hypothesis 4 (H0):** There is no significant relationship between DFL, DOL and ROE

DFL=Financial leverage, DOL=operating leverage, DCL=Combined leverage

**Models:**

**EPS** = $\alpha_1 + \beta_{11} DFL + \beta_{12} DOL + U_i$  \hspace{1cm} model (1)

**ROA** = $\alpha_4 + \beta_{41} DFL + \beta_{42} DOL + U_i$  \hspace{1cm} model (2)

**ROI** = $\alpha_3 + \beta_{31} DFL + \beta_{32} DOL + U_i$  \hspace{1cm} model (3)

**ROE** = $\alpha_2 + \beta_{21} DFL + \beta_{22} DOL + U_i$  \hspace{1cm} model (4)

Where:

**ROA**= Return on investment,  \hspace{1cm} **ROE**= Return on equity

**ROI**= Return on investment \hspace{1cm} $\alpha$: the constant, \hspace{1cm} $\beta$: the regression coefficient

DFL = Percentage change in EPS divided by Percentage change in EBIT

Leverage ratios are the financial statement ratios which show the degree to which the business is leveraging itself through its use of borrowed money.
The financial leverage ratio indicates the extent to which the business relies on debt financing.

A high financial leverage ratio indicates possible difficulty in paying interest and principal while obtaining more funding.

Sample Design

Sampling Techniques: The study is done with special reference to public limited companies. The reason is being that the data or financial statements are readily available for them. The technique of Convenient Sampling is being adopted for the study. The election of sample companies is made on the basis of market capitalization and they are selected among the top gainers during the last year.

Sample size: Eight Public Limited companies are chosen as sample size for the study on account of having the highest market capitalization.

Data Collection

Financial statements are the raw data collected from various websites like www.sbp.com and other company websites www.kse.com.

Time Period of the Study

The study has been conducted during 2004 to 2009.

Tools Used for Analysis

• Leverage analysis.
• Mean,
• Standard Deviation,
• Skewness: “Lack of symmetry” used to understand the distribution of data
• Kurtosis: ‘Flatness or peakedness’ of the frequency curve. It is the convexity of frequency curve.
• Correlation analysis and test of significance.
• Analysis of variance (ANOVA): The statistical tool that is used for testing hypothesis is oneway Analysis of Variance.

Limitations of the Study

• The study is based on secondary data and only the period of 6 years is taken for analysis.
• The pertaining to the analysis is collected from Capitaline and corporate databases.
• Some of the external factors affecting the leverage were not taken into account.

HYPOTHESIS TESTING# 01

Ho: There is no significant relationship between DFL, DOL and EPS.

Ha: There is significant relationship between DFL, DOL and EPS.

\[
EPS = \alpha_1 + \beta_11 DFL + \beta_12 DOL + U_i
\]

\[
EPS = 10.91 - 0.0038 DFL + 3.36 DOL
\]

ANOVA

<table>
<thead>
<tr>
<th>df</th>
<th>SS</th>
<th>MS</th>
<th>F</th>
<th>Significance F</th>
</tr>
</thead>
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Inference:
Since the calculated significance level 0.8609, which is greater than 0.05, the null hypothesis is accepted. Hence, it is concluded that the DFL does not differ significantly so it means there is no significant effect on EPS. A unit increase in DFL decreases the EPS by 0.00376 units while a unit increase in DOL increases the EPS by 3.362437 units.

Correlation: Between EPS and DFL

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<tr>
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<th>Column 3</th>
</tr>
</thead>
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<tr>
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</tr>
<tr>
<td>Column 3</td>
<td>0.050714</td>
<td>-0.00485</td>
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</tbody>
</table>

Inference:
Correlation between EPS and DFL is -0.06397, shows negative relationship which means increase in DFL, decreases the EPS. Correlation between EPS and DOL is 0.050714, shows positive relationship i.e; increase in DOL increases the EPS.

HYPOTHESIS TESTING #02

Ho: There is no significant relationship between DFL, DOL and ROA

Ha: There is significant relationship between DFL, DOL and ROA

\[ \text{ROA} = \alpha + \beta_1 \text{DFL} + \beta_2 \text{DOL} + \text{Ui} \]

\[ \text{ROA} = 10.17 - 0.002 \text{DFL} + 2.89 \text{DOL} \]

ANOVA

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<tr>
<td>Residual</td>
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<td>424.91</td>
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<tr>
<td>Total</td>
<td>47</td>
<td>19277.37</td>
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</table>

Square R= 0.006633

Inference: Since the calculated significance level 0.832, which is greater than 0.05, the null hypothesis is accepted. Hence, it is concluded that the DFL does not differ significantly. A unit increase in DFL decreases the ROA by 0.00202 units while a unit increase in DOL increases the ROA by 2.88703 units.

Correlation: ROA and DFL

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<tr>
<th>Column 1</th>
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<tbody>
<tr>
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<tr>
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<tr>
<td>Column 3</td>
<td>0.070781</td>
<td>-0.00485</td>
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</tbody>
</table>
correlation between ROA and DFL is -0.05606, shows negative relationship i.e.; with the increase in DFL, ROA decreases. Correlation between ROA and DOL is 0.070781, shows positive relationship which means increase in DOL increases the ROA.

HYPOTHESIS TESTING # 03

**Ho:** There is no significant relationship between DFL, DOL and ROI

**Ha:** There is no significant relationship between DFL, DOL and ROI

\[
ROI = \alpha_3 + \beta_3 DFL + \beta_2 DOL + \epsilon_i
\]

\[
ROI = 139.27 - 0.0884 DFL - 68.79 DOL
\]

**ANOVA**

<table>
<thead>
<tr>
<th></th>
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<th>SS</th>
<th>MS</th>
<th>F</th>
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<tr>
<td>Total</td>
<td>47</td>
<td>11399286</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Inference:** Since the calculated significance level 0.715, which is greater than 0.05, the null hypothesis is accepted. Hence, it is concluded that the DFL does not differ significantly.

A unit increase in DFL decreases the ROI by 0.08842 units and a unit increase in DOL decrease the ROI by 68.7939 units.

**Correlation:** ROI and DFL

Correlation between ROE and DFL is 0.000297, shows positive relationship which means;
increase in DFL increases the ROE.
correlation between ROE and DOL is 0.035771, shows positive relationship which means increase in DOL increases the ROE.

correlation between ROI and DFL is -0.09997, shows negative relationship i-e; increase in DFL decreases the ROI.
and correlation between ROI and DOL is -0.06861, shows negative relationship i-e; increase in DOL decreases the ROI.

HYPOTHESIS TESTING# 04

Ho: There is no significant relationship between DFL, DOL and ROE

Ha: There is significant relationship between DFL, DOL and ROE

\[
\text{ROE} = \alpha_2 + \beta_{21} \text{DFL} + \beta_{22} \text{DOL} + U_i \quad -----
\]

\[
\text{ROE} = -11.143 + 0.000224 \text{DFL} + 19.24076 \text{DOL} + 27.17
\]

ANOVA

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<tr>
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<th>SS</th>
<th>MS</th>
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<td>0.97</td>
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http://www.ijmsbr.com
Inference: Since the calculated significance level 0.971, which is greater than 0.05, the null hypothesis is accepted. Hence, it is concluded that the DFL does not differ significantly.

A unit increase in DFL increases the ROE by 0.000224 units and a unit increase in DOL increases ROE by 19.24 units.

Correlation:

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</thead>
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<tr>
<td>Column 3</td>
<td>0.035771</td>
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<td>1</td>
</tr>
</tbody>
</table>

Correlation Analysis
Correlation analysis is an important statistical tool which helps in determining the relationship between two or more variables. The degree of relationship is measured by the correlation co-efficient which is denoted by ‘r’.

Conclusions

It was hypothesized that highly leveraged oil and gas companies have lower profitability. However, this research failed to support the hypothesized positive relationship between financial leverage and both profit measures. It was also hypothesized that highly leveraged companies are riskier in terms of their return on equity and investment. The results indicated that high leveraged firms were less risky in both market-based and accounting-based measures, which is the opposite of hypothesis two. Industry specific variables may help explain these unexpected findings.

Tables:

### ROE

<table>
<thead>
<tr>
<th>Years</th>
<th>1-KESC</th>
<th>2-Mari Gas</th>
<th>3-(OGDC)</th>
<th>4-PSO</th>
<th>5-Shell Gas LPG</th>
<th>6-Shell Pakistan Ltd.</th>
<th>7-Sui Southern</th>
<th>8-Sitara Energy</th>
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<tbody>
<tr>
<td>2004</td>
<td>4.36</td>
<td>0.00</td>
<td>3.70</td>
<td>30.28</td>
<td>118.65</td>
<td>85.75</td>
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http://www.ijmsbr.com
<table>
<thead>
<tr>
<th>Years</th>
<th>1-KESC</th>
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<td>13.30</td>
<td>31.80</td>
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<td>17.50</td>
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### EPS

<table>
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<th>Years</th>
<th>1-KESC</th>
<th>2-Mari Gas</th>
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</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
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<td>3</td>
<td>54</td>
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</table>

DFL = Financial Leverage Ratio = Percent change in EPS / Percent change in EBIT

<table>
<thead>
<tr>
<th>Years</th>
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http://www.ijmsbr.com
DOL  Operating Leverage = Percent change in EBIT / Percent change in sales.

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<th>Years</th>
<th>1- KESC</th>
<th>2-Mari Gas</th>
<th>3- (OGDC)</th>
<th>4-PSO</th>
<th>5- Shell Gas LPG</th>
<th>6-Shell Pakistan Ltd.</th>
<th>7-Sui Southern</th>
<th>8- Sitara Energy</th>
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References:


