THE RELEVANCE OF THE IRRELEVANCE THEORY OF CAPITAL STRUCTURE WITH REFERENCE TO OIL INDIA AND RELIANCE LTD

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Abstract
There are four major theories associated with capital structure. The present study gives emphasis on the "Theory of Irrelevance of Capital Structure" propounded by David Durand. According to this theory the capital structure of the companies do not affect their financial performance. This theory is also known as the net operating income theory. The question always arises as to which the most suitable theory is. Here a horizontal financial analysis has been carried out on two oil exploration and production companies in India. The present study takes in to account four variables for analysis namely return on equity, total debt to equity, interest coverage ratio and debt ratio.
Keywords: Capital structure, Financial Performance, Return on Equity, Total Debt to Equity, Interest Coverage Ratio and Debt Ratio**.**

1.1 Introduction

Capital structure simply refers to the make-up of capitalization of a firm. It is the composition of debt and equity which the company utilizes in order to finance its long term needs. Debt capital is long term borrowings of the company whereas equity can be termed as the long term funds provided by the owners of the company (shareholders). R. H. Wessel has defined capital structure as follows – "The term capital structure is frequently used to indicate the long term sources of funds employed in a business." Capital structure of a firm as a direct effect on the financial risk assumed by the company and also the cost of capital. It also affects the value of the firm and its financial performance. There are a plethora of factors that affect the capital structure of a firm. They can be classified as internal and external factors. Some of the internal factors include profitability, liquidity, flexibility, size and nature of business, regularity of income, desire to retain control etc. the factors over which the management of the company has no control over is termed as external factors. Some of them are conditions in capital market, attitudes of investors, legal and taxation policy, cost of financing and also attitude of management. Actually the decision regarding the capital structure is extremely tricky as there are a number of quantitative and qualitative factors involved in it. Most of the efforts of managers is to obtain an optimal capital structure.

In this study we are trying to analysis the effect of capital structure on the financial performance of the firms. Primary focus has been given to analyzing the NOI theory and whether it holds true in this real life study. We have chosen to study two oil extraction companies. Strength of financial position of a firm is called as financial performance of a firm. Financial analysis can be defined as the process through which the financial strengths and weakness of the firms can be identified by stating the relationship between items that are stated in the balance sheet and profit and loss account. Thusthis paper focus on the "Theory of Irrelevance of Capital Structure" propounded by David Durand

1.2 Review of Literature

There are numerous studies that intend to throw light in to the relationship between financial performance and capital structure. Empirical results have been inconsistent. Modigliani and Miller (1958) said that the capital structure does not effect to the financial performance, but later corrected their stance and said that the financial performance is affected by the financial leverage as the use of debts give tax advantages (1963). A study was conducted to analyze the impact of debt equity ratio with the financial performance which was indicated using the EPS, ROI, Capital turnover, debt to net worth, net profit ratio, return on capital employed and return on equity. The study used the samples from automobile sector, electronic sector and metal industries. With the data available, the researcher made a conclusion that the capital structure of the selected automobile companies has not affected the financial performance, whereas the metal and electronic segment was significantly affected by the capital structure. (Rani, Kavita 2015). Khalifa, M. (2014) targeted to analyse the effect of capital