THE LEVERAGES AND FINANCIAL PERFORMANCE

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ABSTRACT

The possibility of making a profit is mostly linked with risk of losses. High management levels need to understand the risks involved sufficient skills to invest and to utilize knowledge in a good manner. Operating leverage is highest in companies that have a high proportion of fixed operating costs in relation to its variable. Companies with high operating leverage can make more money from each additional sale if they don't have to increase the variable costs when producing more sales. Operating leverage is a measure of how revenue growth translates into operating profit within risky, or volatile operating and financial leverage. Financial Leverage is the strategy of using borrowed money to increase Due Pont return on assets.

A sample of (21) industrial companies of Amman Stock manufacturing sector have been analyzed via simple regression has concluded the followings: (a) no significant statistical impact of operating leverage upon assets turn over the one component of Due Pont System return on asset. (b) The financial leverage is with a negative statistical significant impact on net profit margin as the second Due Pont component. It is well-known that both types of Leverage affects the firm risk as it can magnify earnings both up and down.

Keywords: Operating Leverage, Financial Leverage, Return on Assets

INTRODUCTION

Both investors and companies employ financial and operating leverage when attempting to generate greater returns on their assets. Not realizing each leverage risk and expected return that may be achieved on financial performance leads to the loss of many opportunities. However, using leverage does not guarantee success, and possible excessive losses are more likely from highly leveraged positions.

Despite the high contribution of the industrial sector amounted yearly to 24% of GDP, to be the second largest economic sector after the services sector (Report of the Ministry of Industry and Trade), it is exposed to a set of operational and financial risks that prevent it from playing its expected role in facing economic stagnation and maximizing shareholder wealth. Using borrowed Funding source when investing to expand a firm's asset base is an investment strategy. If a firm is described as highly leveraged, the firm has more debt than equity.

A group of factors represented in the high customs burdens, the costs of production, transportation, energy and raw materials, the intensity of regional and international competition, the shortage of skilled manpower, the difficulty of obtaining financing, currency exchange rate fluctuations and the high cost of financing contribute to increasing operational and financial risks. As a result, this study came to shed more light on the impact of each of the operational and financial leverages as an independent variable on the components of financial performance represented by both the net profit margin and the asset turnover rate the components of the DuPont system.

Differences in the financial structure of companies and the accompanying indebtedness lead to dealing with varying degrees of financial leverage indicators. The high percentage of financial leverage leads to a decrease in the weighted rate of financing costs and thus to a different rate of return on total assets. If a company's variable costs are higher than its fixed costs, the company is using less operating leverage. How a business makes sales is also a factor in how

Citation Information: Kadomi, A.M. (2021). The leverages and financial performance. *Journal of Management Information and Decision Sciences, 24*(S1), 1-11.

much leverage it employs. When a firm takes on debt, that debt becomes a liability, and the company must pay interest on it. A company will only take on significant amounts of debt when it believes that return on assets will be higher than the interest on the loan. The biggest risk that arises from high financial leverage occurs when a company's return on return on assets does not exceed the interest on the loan.

At the same time, operating leverage is a cost-accounting formula that measures the degree to which a firm can increase operating income by increasing revenue. It happens if a company is capable to control its variable costs involved in earning its revenues.

Return on sales is a ratio used to evaluate a company's operational efficiency. David Yechiam Aharon & Yossi Yagil (2019) assured that excess return can be explained by risk and the degree of financial leverage. Lenny Mamaro & Tsholofelo Legotlo (2020) confirm that there is no universal theory on the debt to equity choice.

From the researcher point of view, the use of debt which is known by financial leverage joint with operating leverage and reflected in the degree of risk are expected to affect companies performance.

(Nasir al-Din, 2011) illustrated that one of the most important advantages of financial leverage is improving the return on shareholders' equity as a result of the difference between the cost of borrowing and the return on investment, and the owners' ability to improve better control over it due to the creditors voice in the management. Safi & Musa (2009) assumed about the possibility of borrowing money with high purchasing power and returning it with money with less purchasing power in the event of inflation tax, so the required rate of return on debt becomes lower (Nuseirat, 2012).

Operating leverage is associated with the value of fixed costs. If the ratio of fixed to total costs is high, this means that the company is characterized by a high operating leverage with a capital intensity. The high operating leverage means that a small increase in sales produces high operating profits.

Financial management is primarily aiming to maximize the owners wealth by through making decisions that ensure the enhancement of the competitive position, (Ali, 2020).

The operating leverage usually increases with the increase in fixed costs (Brealey et al., 2012. Thus, companies need continuously reduce fixed costs to ensure that more losses are avoided especially in times of crisis.

(Abdul Aziz Abdul Rahman, 2021) demonstrated that the operating leverage represents the degree of profit elasticity in relation to the volume of sales during one year.. High operating leverage leads to the degree of sales sensitivity. A small change in sales leads to a large change in profits which vary from one company to another.

The value of operating leverage is greater at sales levels that immediately follow the break-even quantity. The share of fixed costs in total costs measured at the break-even point will change only when the price or unit variable cost changes (Abdul Aziz Abdul Rahman, 2021). A company that is characterized by a high degree of operating leverage and faces a recession in its sales may be able to lower the price a little, increase its sales and benefit from the significant increase in operating profits resulting from increased sales (Nasir El-Din, 2011).

The Statement of the Problem

A profitable form of financing debt or equity and a tradeoff between variable or fixed costs is essential. The choice of the capital structure and to control variable costs has been a central question in the corporate finance literature. The choice remains unclear. Up to now there is no common acceptable universal theory on financial and operational choice. However, previous studies of this field have not investigated how the capital structure affects the

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companies' financial performance. Still a company has a choice of using debt or equity and a choice of controlling variable against fixed costs. Such choices represent a need to explore how the company's financing mix influences its financial performance. Simply, The problem of the study is to find out the impact of the operational and financial challenges that cast a direct and heavy shadow on the Jordanian industrial companies. Solving this problem may be inferred by calculating each company leverages and each of leverage impact on their financial performance components of the DuPont system, net profit margin and asset turnover rate.

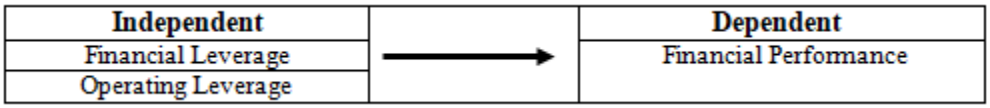

FIGURE 1
STUDY MODEL

Study Hypotheses

The following hypotheses were built:

H1 *There is no statistically significant impact of the operating leverage on the financial performance, as represented by the net profit margin, asset turnover rate and return on assets at the level of significance ($\alpha \leq 0.05$).*

H2 *There is no statistically significant impact of the financial leverage on the financial performance represented by the net profit margin and the asset turnover rate at the level of significance ($\alpha \leq 0.05$).*

REVIEW OF LITERATURE

The successful choice will paid off. Capital structure one choice may affect the company positively or negatively. The second choice is the size of a company borrowed debt with expectations of its repayment ability (Kajirwa, 2015) is an alternative for raising additional funds to meet the day-to-day needs. The third choice is the company ability of balancing role between returns and risks. This choice determines the company tolerance toward risks and has its own effect on maximizing the market value of the company. However, this study focuses on the impact of debt financing and operating leverage on the performance of companies listed on Amman Stock Exchange of Jordan. (Tauseef et al., 2015; Kajananthan, 2012) assured that each choice may affect the company positively or negatively. Debt resources borrowed with expectations of repayment (Kajirwa, 2015), is an alternative mode for raising additional funds to meet the day-to-day needs of a given organization.

(Nasir al-Din, 2011) notified that one of the most important advantages of financial leverage is improving the return on shareholders' equity if the cost of borrowing is less than the return on investment, and with a sufficient control over its variable cost. Creditors are preferred due to not with voting right and do not participate in the profits, and tax exempt advantages. In line with the previous study, Ebaid (2009) found that the capital structure choice has no impact on the financial performance of listed companies from 1997 to 2005 in Egypt. In addition, (Abdul Aziz Abdul Rahman et al., 2020) examined the impact of capital structure on earnings per share. The results show a statistically significant relationship of leverage ratios on the profitability of the organizations.

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Iorpev & Kwanum (2012) examined the impact of capital structure on the performance of manufacturing companies in Nigeria. The annual financial statements of 15 manufacturing companies from 2005 to 2009. The results show that total debt to equity is positively related with ROA and negatively related with profit margin.

Taking in consideration that high level management is primarily aiming to maximize the wealth of owners under conditions that ensuring the enhancement of the competitive position, (Brealey et al., 2012; Ali, 2020), companies need to face the challenges of finding the necessary funding, especially in light of the limited financial resources and the various costs of obtaining it, and continually align profit maximization with risks (Perinpanathan, 2014). Companies need to operate with a capital structure and fixed costs (Brealey et al., 2012; Ali, 2020).

The greater the dependence on external sources of financing is ended by the higher degree of financial leverage, its effectiveness depends upon the ability to invest the borrowed funds at a rate of return that exceeds the cost of the borrowed funds (Khanfar, 2006).

When the value of fixed to total costs ratio is high, the company is characterized by a high operating leverage, a small increase in sales produces high operating profits and the loss is magnified in the event of decreasing in sales.

High ratio of fixed to total costs implies capital intensity, a small increase in sales produces high operating profits. The operating leverage represents the degree of profit elasticity in relation to the volume of sales. The concept of a lever means the ability to lift a heavy mass using a relatively small force.

One advantages of operating leverage depend on the nature of the economic conditions of the company and the market in which it operates. Nasir El-Din (2011) displayed advantages of operating leverage due to commodity pricing policies. A company that is characterized by a high degree and faces a recession in its sales may be able to lower the price a little to improve sales.

Previously, Daves & Brigham (2007) pointed that the company will not have an operational lift if the ratio of fixed costs to total costs is zero. This means that fixed costs are responsible for increasing the operating leverage, (Khanfar, 2006).

THEORETICAL FRAMEWORK

Modigliani & Miller (1958) questioned ways on improving performance. They proposed in their theory that debt or equity financing does not i matter. However, the theory imposed by Modigliani & Miller (1963) stated that the cost of capital affects whether to use debt or equity financing. The market value of the company is not affected by the formulation of the financing structure nor by changes in the leverage ratio, but rather determined by the profits that it is obtained by various assets (Berk, 2014).

Cost and Benefit Trade-Off Theory

Assured that an increase in the level of debt causes an increase in the risk of bankruptcy, financial problems, agency costs and thus a decrease in the value of the company. Therefore, it is possible to determine an optimal capital structure through a balance between tax benefits versus the costs of bankruptcy and financial crises, (Nasih, 2014).

Nguyen (2013) characterizes the trade-off hypothesis as the choice of financing. It proposes that a company should not utilize excessive debt. The most benefits of the trade-off theory raising the issue of a well-defined optimal level of debt financing. However, debt financing is recommended as the most appropriate financing opposed to equity financing due to tax benefits on interest cost.

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The pecking order theory by Myers & Majluf (1984) is driven by the desire to enhance financial performance. The theory prefers debt financing over equity financing, (Gitman, 2012). However, the pecking order theory does not own a well-defined optimal level of debt. It assured that in the presence of information asymmetry, a company prefers internal finance and external funding such as long-term debt or equity if internal funds are exhausted, (Chen & Chen, 2011). Market Timing Theory is based on choosing the appropriate source of funding. It assumed that the company relies on equity funds to finance its cash needs at times when the prices of its shares are valued at or above their real value, while the company resorts to borrowing in cases where the company's shares are valued at less than their real value (Ramadan, 2011) agency cost theory involves the separation of ownership and management. It reveals that high level management of the company always act on behalf of the owners or shareholders. The main problem arises because conflicting interest on whether to finance the company with debt or equity. Because of that, financial structure does may is not built up not to influence financial performance, (Nguyen, 2013).

The researcher added few studies aliened to this one. Nasir Al-Din (2011) revealed the absence of a statistically significant impact of any of the operational and financial leverages on the profitability of the common share.

Al-Hamdouni & Al-Subaihi (2012) study achieved a test of the relationship between financial leverage and stock returns for a sample that included (262) public shareholding companies operating in the industrial and services sectors listed on the Amman Stock Exchange for the period (2005-2009), the study reached several results. The most important is a positive relationship between financial leverage and systemic risks. The two researchers assured that the relationship is strong and positive between financial leverage and earnings per share. Al-Subaie (2012) found a positive statistically significant relationship between the financial leverage ratio and the return on investment.

Al-Qudah (2013) study, exposed the relationship between financial and operational leverage and financial risks on the one hand, and the value of the company on the other hand, for a sample of (35) public shareholding industrial companies listed on the Amman Stock Exchange for the period (2002-2010), and the results showed a positive and statistically significant effect between operational leverage and the company's value, and a negative impact between financial leverage and systemic risks on the company's value.

Al-Barakat (2014) study, assured the impact of financial and operational leverage on return on assets, return on ownership, share of profits and regulatory risks for a sample of industrial companies listed on the Amman Stock Exchange for the period (2000-2011). Anton (2016) study, showed a positive and statistically significant effect of financial leverage on the growth of companies, and profitability. Mamaro & Legotlo (2020) investigated the impact of debt financing on financial performance of retail firms, concluded that lagged return on equity, total debt to total asset and growth in sales strongly influence financial performance of return on equity.

RESEARCH METHODOLOGY

Based upon the philosophy of knowledge of how to know. the methods that can be used to understand better. In a positivist view, science is the way to get at truth. Scientists follow specific procedures to assure that observations are verifiable, accurate and consistent. It is required to employ secondary data, measure variables, analyze and apply the quantitative research approach. Both of descriptive statistical analysis and regression analysis has been used.

The researcher used the following equations to measure the independent and dependent variables of the study:

1- Financial Leverage=Total Liabilities/Total Assets

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2- Operating Leverage=Total Fixed Assets/Total Assets
3- Asset Turnover=Sales/Total Assets
4- Net Profit Margin=Net Profit/Sales

The study variables were measured by using the branched simple linear regression model from the statistical program (SPSS) to test the study hypotheses.

Simple regression model is stated as follows: Yi,t=αi+β Xi,t+εi,t (1) where i and t represent the cross-sectional and time series dimension of the data, respectively, while α and β denote constant and regression coefficients, respectively. As Y i,t represents the dependent variable exogenous variables of company I time t, and e measures the error term regression equation is stated as follows: Yi,t =αi+βXi,t+εi,t (1) where the subscripts i and t represent the cross-sectional and time series dimension of the data, respectively, while α and β denote constant and regression coefficients, respectively. As Y i,t represents the dependent variable, X i,t represents the set of exogenous variables of firm I time t, and e measures the error term.

Table 1
ARITHMETIC AVERAGES OF THE INDEPENDENT VARIABLES OF THE STUDY SAMPLE

No.	Company name	Operating leverage	Financial leverage
Pharmaceutical and medical industries			
1	Dar Al-Dawa	0.32	0.433
2	Al Hayat	0.36	0.117
3	Philadelphia	0.258	0.25
Arithmetic mean		0.313	0.267
Pharmaceutical and medical industries			
4	Agricultural Commercial Industrial (Production)	0.447	0.35
5	Jordan Chemical Industries	0.333	0.585
6	Arab Company for the manufacture of pesticides and veterinary drugs	0.208	0.319
Arithmetic mean		0.329	0.418
Paper, cardboard, printing and packaging industries			
7	Al-Eqbal	0.394	0.316
Food and Beverage Industries			
8	The Jordanian Poultry Processing and Marketing Co	0.763	0.727
9	Jordanian dairy	0.309	0.228
10	public investment	0.26	0.102
11	Modern International for Vegetable Oil Industry	0.099	0.117
12	National Poultry	0.458	0.147
13	Jordanian vegetable oil factories	0.156	0.182
14	Siniora Food Industries	0.481	0.438
Arithmetic mean		0.361	0.277
Tobacco and cigarette industries			
15	investment turnout	0.178	0.319
16	Union factories for the production of tobacco and cigarettes	0.296	0.587
Arithmetic mean		0.237	0.453

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Engineering and construction industries			
17	Ready mix concrete and construction supplies	0.254	0.404
18	Arabia for the manufacture of metal pipes	0.238	0.225
19	Jerusalem Concrete Industries	0.312	0.239
Arithmetic mean		0.268	0.289
Electrical Industries			
20	United Cable Factories	0.338	0.201
Garment, leather and textile industries			
21	Jordan's Wormwood Factories	0.006	0.04
The arithmetic mean of the manufacturing sector as a whole		0.308	0.301
The standard deviation of the manufacturing sector as a whole		0.156	0.178
highest value		0.732	0.727
lowest value		0.045	0.04
Range		0.687	0.687

Descriptive Statistics for Independent Variables

The data in the above table (1) indicates the followings:

1- Total arithmetic mean of the operating leverage variable for the sample of companies operating in the various manufacturing industries during the study period was (0.308), indicating a low ratio of fixed to total assets. The low standard deviation of the operating leverage of (0.156) indicates the relative discrepancy in the values of operating leverages between companies of different activities, and management policies in the use of asset, fixed and variable costs.

2- The total arithmetic average of the financial leverage (0.301), indicating a low relying on debt financing to run their operational and investment activities. The standard deviation of financial leverage of (0.178) indicates the difference in the degree of dependence on financial leverage between different manufacturing industries activities, and this can be linked to different financing and investment policies between companies operating in different activities of the manufacturing sector and the resulting variation in the level of credit rating and difficulties in obtaining additional financing sources that effect On the company's ability to expand by purchasing new fixed assets or financing other projects.

Table 2
ARITHMETIC AVERAGES OF THE DEPENDENT VARIABLES OF THE STUDY SAMPLE

No.	The Company's name	net profit margin	Asset turnover	Return on Assets
Pharmaceutical and medical industries				
1	Dar Al Dawaa	0.083	0.613	0.05
2	Al Hayat	0.216	0.598	0.129
3	Philadelphia	0.199	0.962	0.21
Arithmetic mean		0.166	0.724	0.13
Chemical industries				
4	Agricultural Commercial Industrial (Production)	0.028	0.738	0.024
5	Jordan Chemical Industries	0.043	0.719	0.031
6	Arab Company	0.122	0.696	0.085
Arithmetic mean		0.064	0.718	0.047
Paper, cardboard, printing and packaging industries				

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7	Al-Eqbal	0.049	1.043	0.051
Food and Beverage Industries				
8	Jordanian processing	0.029	0.564	0.017
9	Jordanian dairy	0.063	1.397	0.09
10	Public investment	0.196	0.326	0.064
11	Modern International for Vegetable Oil Industry	0.06	1.534	0.091
12	National Poultry	0.019	0.967	0.022
13	Jordanian vegetable oil factories	0.073	0.828	0.061
14	Siniora Food Industries	0.095	0.919	0.089
Arithmetic mean		0.076	0.934	0.062
Industries and cigarettes				
15	Investment turnout	0.261	1.087	0.284
16	Union factories for the production of tobacco	0.013	0.494	0.008
Arithmetic mean		0.137	0.791	0.146
Engineering and construction industries				
17	Ready mix concrete	0.077	0.722	0.056
18	Arabia for the manufacture of metal pipes	0.032	0.517	0.018
19	Jerusalem Concrete Industries	0.029	0.657	0.018
Arithmetic mean		0.046	0.632	0.031
Electrical Industries				
20	United Cable Factories	0.018	0.533	0.01
Garment, leather and textile industries				
21	Jordan's Wormwood Factories	0.576	0.11	0.063
Arithmetic mean of the manufacturing sector as a whole		0.109	0.763	0.07
The standard deviation of the manufacturing sector as a whole		0.129	0.332	0.068
Highest value		0.576	1.534	0.284
Lowest value		0.013	0.11	0.008
Range		0.563	1.424	0.276

The above data in table (2) indicates the followings:

1- The total arithmetic average of net profit margin for a sample of companies operating in the various manufacturing sectors for the study period was (0.109), while the total arithmetic average of the asset turnover rate was (0.763), indicating that the strategy of these companies in maximizing the return on assets depends on the high turnover rate. The standard deviation for each of them are (0.129, 0.332), respectively, indicate the relative variance in the values of each of the net profit margin and the asset turnover rate between the different manufacturing sectors are relatively low.

2- The total arithmetic mean of return on assets for the sample of the different manufacturing industrial sectors for the study period was (0.070), indicating the low efficiency of the use of assets in generating sales and achieving profits for companies operating in the various manufacturing sectors, and the standard deviation rates indicate the existence of varying values of return on assets.

Hypothesis Testing

The researcher used a simple regression to test the hypotheses of the study, according to the following decision rule: The null hypothesis is rejected and the alternative hypothesis is

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accepted if the significance level is (sig) less or equal to (0.05) and vice versa. In the following tables, the results are presented:

H1 *There is no statistically significant effect of the operating leverage on the financial performance either the net profit margin or asset turnover rate and return on assets. at the level of significance ($\alpha \leq 0.05$).*

Table 3
TESTING THE FIRST HYPOTHESIS (IMPACT OF OPERATIONAL LEVERAGE ON FINANCIAL PERFORMANCE)

Test result	Significance Level (Sig)	Calculated (T) value	correlation coefficient (R)	alterable
Reject	0	-5.414	0.513	net profit margin
accept	0.957	-0.054	0.006	Asset turnover
Reject	0.007	-2.758	0.291	return on assets
Statistically significant ($\alpha \leq 0.05$)				

By reviewing the above data in table (3), we note the following:

1- The results of the level of significance related to both the asset turnover rate and the operational leverage are greater than the reference test of (0.05), which requires acceptance of the hypothesis, meaning that there is no statistically significant effect of the operating leverage.

2- The results of the significance level associated with each of the operating leverage on the one hand and the net profit margin and return on assets on the other hand, are less than the reference level of the test which is (0.05). In the sense that there is a statistically significant effect of the operating leverage on each of them. The correlation coefficient indicates the average ability of the operating leverage to explain the change associated with it. The negative sign of the calculated (T) value indicates that the relationship is inverse between them.

Table 4
TESTING THE SECOND HYPOTHESIS
(LEVERAGE IMPACT ON FINANCIAL PERFORMANCE)

test	significance level	Calculated (T)	correlation coefficient	alterable
Reject	0	-4.064	0.409	net profit
Accept	0.612	-0.508	0.056	Asset
Accept	0.112	-1.607	0.175	return on
Statistically significant ($\alpha \leq 0.05$)				

H2 *There is no statistically significant effect of the financial leverage on the performance represented by the net profit margin, asset turnover rate and return on assets of the Jordanian industrial manufacturing companies at the level of significance ($\alpha \leq 0.05$).*

By reviewing the analysis in the above table (4), we note the following:

3- The results of the significance level associated with the net profit margin are less than the reference level test of (0.05), which implies rejecting the hypothesis, meaning that there is a statistically significant effect of the operating leverage on the net profit margin. The correlation coefficient indicates the average ability of the operating leverage to explain the change associated with it. The negative sign of the calculated (t) value indicates the nature of the inverse relationship.

4- The results of the significance level related to each of the asset turnover rate and the return on assets are greater than the reference level of the test (0.05), which requires acceptance of the hypothesis, meaning that there is no statistically significant effect of the financial leverage on each of them.

RESULTS

The results of the study lead to the following:-

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1- There is no statistically significant impact of the operating leverage on the asset turnover rate. This can be explained by the presence of "idled" fixed assets that are not sufficiently exploited and do not add new economic value in generating sales and maximizing returns.
2- There is a statistically significant adverse effect of the operating leverage on the net profit margin, and this can be explained by the low productivity of fixed assets in generating profits, and this may be due to its antiquity and the need to update and maintain it.
3- There is no statistically significant effect of the operating leverage on the return on assets. This can be explained by the insufficient investment of assets in operational operations and the low ability to generate sufficient cash flows to move the operating cycle of companies.
4- There is no statistically significant effect of financial leverage on both the return on assets and the turnover rate of assets, and this can be explained by not employing enough external financing to purchase new assets that contribute to generating more sales and making profits. This result does not contradict the results of the previous operating leverage, which confirms the lack of optimal use of assets in generating revenues.
5- There is a statistically significant adverse effect of financial leverage on the net profit margin. The increase in financial leverage and what this represents from the increase in borrowing leads to a decrease in the profit margin. It indicates not benefiting from loans in maximizing the profit margin of one unit of currency from sales, and this leads to companies not benefiting from financial leverage.
6- An additional result was reached from the analysis of the study data represented in the dependence of the Jordanian industrial companies in their sales policies on increasing the market share represented in the high turnover of assets at the expense of the net profit margin, and this can be explained by the high intensity of competition that Jordanian industrial companies face within their traditional markets in light of the decline in national exports due to the political and economic events that the region is witnessing.

RECOMMENDATIONS

In light of the results that have been reached, the researcher recommends the following:

1- Exploiting the assets owned by companies to increase the operational capacity to higher levels, as it is the source of revenue and profit generation, due to many idle and untapped assets that may be due to their old ones.
2- Benefiting from using more debt to modernize assets with low productivity, in the hope that this will lead to improving production and profits, as this becomes possible as a result of the decrease in the indebtedness ratio in companies below 30%.
3- Exerting more efforts in the field of training employees to make the best use of assets in achieving revenues.
4- Work to achieve returns on assets higher than the cost of interest on loans, and this requires not to implement projects that are not economically viable.
5- Work to reduce costs of all kinds as much as possible and increase the productivity of assets in order to maximize profits.

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Citation Information: Kadomi, A.M. (2021). The leverages and financial performance. *Journal of Management Information and Decision Sciences, 24*(S1), 1-11.