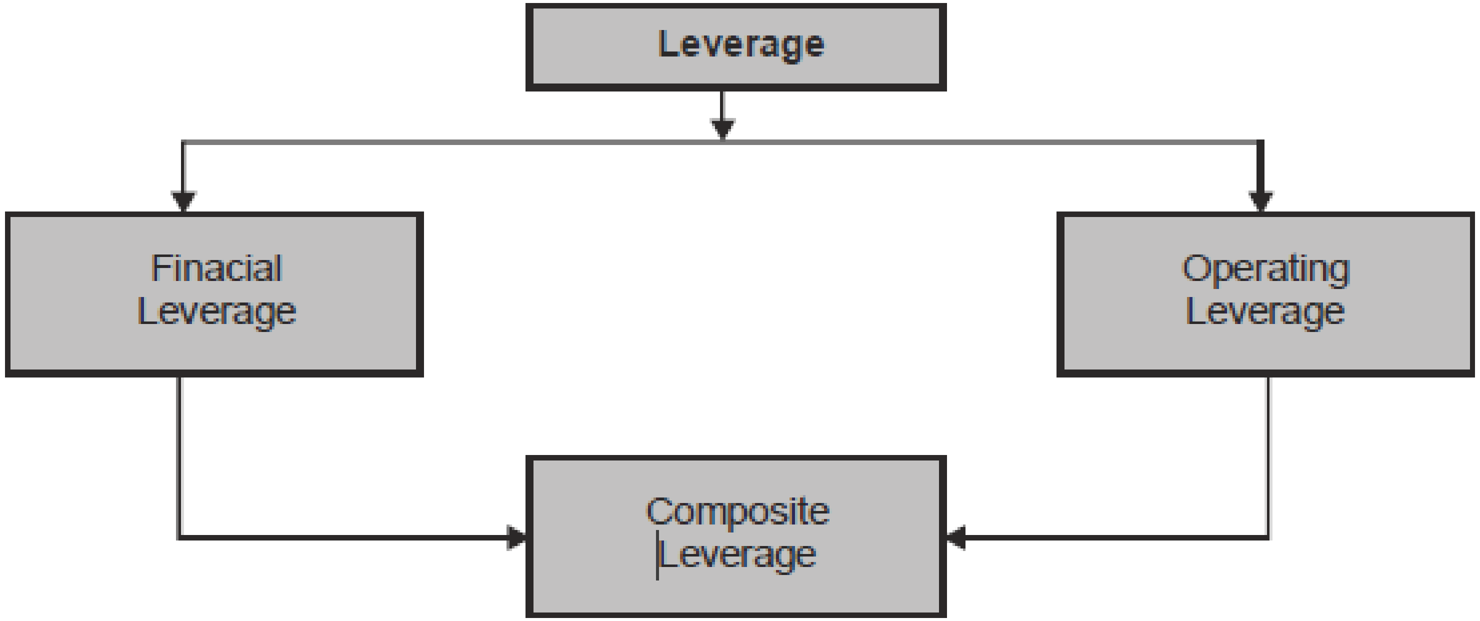
FINANCIAL MANAGEMENT

MS. DEEPALI GUPTA SHIVHARE

LEVERAGE

- leverage refers to furnish the ability to use fixed cost assets or funds to increasethe return to its shareholders.



Financial Leverage

- Leverage activities with financing activities is called financial leverage.
- “The use of long-term fixed interest bearing debt and preference share capital along with share capital is called financial leverage or trading on equity”.
- Financial leverage can be calculated with the help of the following formula:
- FL = OP / PBT
- The Financial leverage (FL) measures the relationship between the EBIT and the Earning Per Share and it reflects the effects of change in EBIT on the level of EPS. Thus, It is concerned with the effect of changes in EBIT on the earnings available to equity share holders.
- FL = % change in EPS / % change in EBIT
- OR
- FL = EBIT / PBT

Operating leverage

- When the sales level increases or decreases, the EBIT [Earning Before Interest and Tax] also changes.
- The operating leverage measures the relationship between the sales revenue and the EBIT.
- The operating leverage is calculated by dividing the % change in EBIT by the % change in sales revenue.
- Operating leverage = % change in EBIT / % change in Sales
- O.L. = Contribution/ EBIT
- Sales Revenue - Variable Cost = Contribution — Fixed Cost = EBIT

Operating leverage

- The operating leverage may be defined as the firm’s ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes.
- The operating costs of a firm fall into three categories. i) fixed cost ii) variable cost iii) sem-variable costs are fixed over a certain range of sales volume and increase to higher levels for higher sales volumes.

Combined Leverage

- A firm has to look into the overall risk or total risk of the firm, which is business risk plus the financial risk. Therefore, a financial manager should consider both the operating leverage and the financial leverage.
- Thus combined leverage is a product of the operating leverage and the financial leverage. The combined leverage be defined as the % change in EPS for a given % change in the sales level.
- CL = % change in EBIT/% change in Sales* % change in EPS / % change in EBIT

= % change in EPS / % change in Sales

- CL = OL × FL