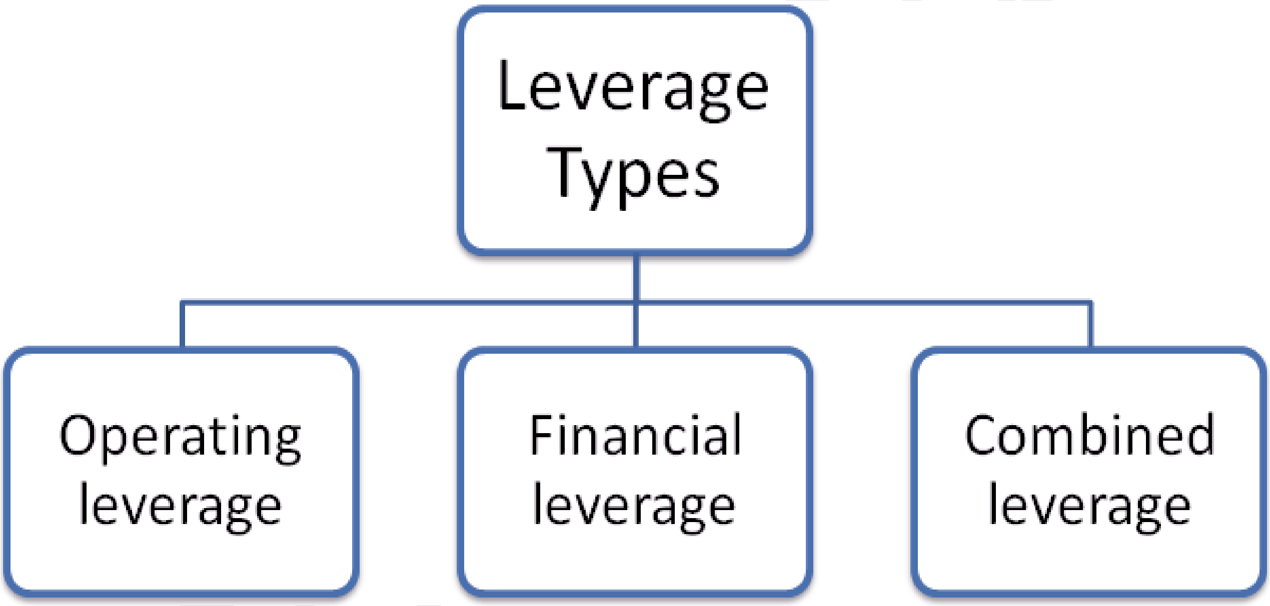
SES'S L.S.RAHEJA COLLEGE OF ARTS AND COMMERCE

Course: Financial Management - II Unit: IV Prepared by: Raju D. Gole

Leverages

Meaning:

Leverage is an investment strategy of using borrowed money—specifically, the use of various financial instruments or borrowed capital—to increase the potential return of an investment. **Leverage** can also refer to the amount of debt a firm uses to finance assets.



1. **Operating Leverage:**

Operating leverage refers to the use of fixed operating costs such as depreciation, insurance of assets, repairs and maintenance, property taxes etc. in the operations of a firm. But it does not include interest on debt capital. Higher the proportion of fixed operating cost as compared to variable cost, higher is the operating leverage, and vice versa.

Operating leverage may be defined as the "firm's ability to use fixed operating cost to magnify effects of changes in sales on its earnings before interest and taxes."

Operating Leverage = Contribution / EBIT

2. Financial Leverage:

Financial leverage is primarily concerned with the financial activities which involve raising of funds from the sources for which a firm has to bear fixed charges such as interest expenses, loan fees etc. These sources include long-term debt (i.e., debentures, bonds etc.) and preference share capital.

Long term debt capital carries a contractual fixed rate of interest and its payment is obligatory irrespective of the fact whether the firm earns a profit or not.

According to Gitman financial leverage is “the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on firm’s earnings per share”. In other words, financial leverage involves the use of funds obtained at a fixed cost in the hope of increasing the return to the equity shareholders.

Financial Leverage = EBIT / EBT

3. Combined Leverage:

Operating leverage shows the operating risk and is measured by the percentage change in EBIT due to percentage change in sales. The financial leverage shows the financial risk and is measured by the percentage change in EPS due to percentage change in EBIT.

Both operating and financial leverages are closely concerned with ascertaining the firm’s ability to cover fixed costs or fixed rate of interest obligation, if we combine them, the result is total leverage and the risk associated with combined leverage is known as total risk. It measures the effect of a percentage change in sales on percentage change in EPS.

Combined Leverage = Contribution / EBT

EBIT = Earnings before Interest & Tax
EBT = Earnings before ax

Income statement format:

Particulars	**Amount**
Sales	×××
Less – Variable Cost	×××
Contribution	×××
Less – Fixed Cost	×××
EBIT	×××
Less – Interest	×××
EBT	×××
Less – Tax	×××
EAT	×××

Strategic Financial Management

Strategic financial management means not only managing a company's finances but managing them with the intention to succeed—that is, to attain the company's goals and objectives and maximize shareholder value over time. However, before a company can manage itself strategically, it first needs to define its objectives precisely, identify and quantify its available and potential resources, and devise a specific plan to use its finances and other capital resources toward achieving its goals.

Strategic financial management is about creating profit for the business and ensuring an acceptable return on investment (ROI). Financial management is accomplished through business financial plans, setting up financial controls, and financial decision making.

NOTE: ABOVE MENTIONED POINTS ARE INDICATIVE AND NOT EXHAUSTIVE. PLEASE EXPLAIN THE ANSWERS IN DEATAIL WITH PROPER EXAMPLES WHEREVER NECESSARY. ALSO REFER NOTES & BOOK(S) FOR THE SAME.

Important Questions

a. Compute different leverages from the following information

Particulars	**Rs.**
Interest	22,000
Sales (2,200 Units)	2,20,000
Variable Cost	1,10,000
Fixed Cost	66,000

Prepare Cash Budget for the period from April to June for M/S ZED Ltd

b. Compute different leverages from the following information

Firms	A	B	C
Sales (Rs.)	3,60,000	7,50,000	1,00,000
Variable Cost p.u.	20	150	2
Fixed Cost (Rs.)	72,000	1,40,000	15,000
Output (units)	6,000	1,500	10,000
Interest	40,000	80,000	NIL

c. Calculate the operating leverage, financial leverage and combined leverage from the following data under situation I and II and Financial plan A and B.

Installed capacity 4,000 units
Actual production and sales 75% of the capacity
Selling price Rs.30 per unit
Variable cost Rs.15 per unit
Fixed Cost:
Under Situation I Rs.15,000
Under Situation II Rs.20,000

Capital Structure:

Particulars	Financial Plan	
	A (Rs.)	**B (Rs.)**
Equity	10,000	15,000
Debt (Rate of Interest at 20%)	10,000	5,000

d. Write short notes
1. Types of leverages
2. Return on Investment
3. Methods of financing Business
4. Importance of leverages