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E-content

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LEVERAGE

Leverage is a term drawn from the science of engineering which indicates mechanical advantage or effectiveness gain by the action of a lever . The concept of leverage is used to assess the risks associated with 'high fixed cost' or with a 'high debt-equity ratio' . Operating a business with a high degree of leverage either by using high fixed cost assets or by inducting more debt in the capital structure increases risk , because of the heavy burden of meeting 'fixed cost' or of 'fixed interest payment obligations .' Nevertheless , operating a business with a high degree of leverage also provides an opportunity to a profitable firm to increase its Return on Investment (ROI).

DEFINITION

According to Prof.S.C.Kuchchal, “Leverage may be defined as meeting a fixed cost or paying a fixed return for employing resources or funds.”

According to Solomon Ezra, “Leverage is the ratio of the rate of return on shareholders equity and the rate of return on total capitalisation.”

Leverage serves as a tool which cuts both way. In case the volume of operations is kept at a high point , so as to enable the firm to earn adequation income, a high leverage boosts up returns to the equity shareholders.

LEVERAGES ARE OF THREE KIND

- *Operating
Leverage*
- *(OL)*

- *Financial
Leverage*
- *(FL)*

- *Combined
Leverage*
- *(CL)*

OPERATING LEVERAGE

According to E.F.Brigham, “IF a high percentage of a firm’s total costs are fixed costs, then the firm is said to have a high degree of operating leverage.” Use of high fixed operating costs does magnify a change in profits relative to a given change in sales. In other words, it can be said that when operating leverage is high a slight favourable or unfavourable change in sales will cause a much more favourable or unfavourable change in operating profit (OP) or earnings before interest and tax (EBIT) of the firm.

In the words of Solomon Ezra, “operating Leverage is the tendency of the operating profit to vary disproportionately with sales.”

DEGREE OF OPERATING LEVERAGE

The degree of operating leverage measures more precisely the extent of impact on operating profit of a given change in sales. In other words, it is the percentage change in OP or EBIT which results from a given percentage change in sales. It can be measured as follows:

$$\text{Degree of operating Leverage} = \frac{\% \text{ Change in operating Profit (OP) or EBIT}}{\% \text{ Change in sales}}$$

Or

$$\text{Operating Leverage (OL)} = \frac{\text{Contribution}}{\text{Operating profit (OP) or EBIT}}$$

$$= \frac{N (SP - VC)}{N (SP - VC) - FC}$$

FINANCIAL LEVERAGE

Financial leverage indicates the impact of debt- financing on the earnings of the firm. High financial financial leverage represents a higher proportion of borrowed funds in the total capitalisation of the company. Capital structure with a high degree of financial leverage (FL) creates a heavy fixed burden on the profits which can be sustained till sales earnings are adequate . Financial leverage can be computed as follows:

$$FL = \frac{EBIT}{EBIT-INT} = \frac{EBIT}{PBT}$$

$$DFL = \frac{\% \text{ Change in PBT}}{\% \text{ Change in EBIT}}$$

COMBINED LEVERAGE

Both these leverages exercise a combined impact on the earning of a firm. Operating leverage causes considerable accelerating or decelerating impact on the rate of return on overall investment in relation to change in the size of sales; which involves business risk Operating leverage (OL) is mainly concerned with the assets side of the Balance Sheet and is the result of assets-mix in a firm . On the contrary, financial leverage (FL) is the result of capital-mix of a firm and is mainly concerned with the liabilities side of the balance sheet of the firm.

Degree of Combined Leverage

$$DCL = \frac{S - VC}{(S - VC) - FC} \times \frac{(S - VC) - FC}{S - VC - FC - Int.}$$

$$= \frac{C}{EBIT} \times \frac{EBIT}{PBT} = \frac{C}{PBT}$$

QUESTIONS

LONG ANSWER TYPE QUESTIONS

- 1. What is meant by leverage ? What are the various types of leverages ? Explain clearly.*

Short Answer Type Questions

- 1. Explain the concept of leverage.*
- 2. What is operating leverage .*

REFERENCE

- *Dr. Sharma F.C.*
- *PUBLICATION- SBPD Publication Edition
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THANK YOU