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Financial Management
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Financial Management

Financial Management mainly involves, rising of funds and their effective utilization with the objectives of maximising shareholders wealth. Joseph and Massie has told about financial Management as "Financial management" is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations".

In the words of Van Horne – "Financial Management is concerned with the acquisition financing and management of assets with some overall goal in mind."

Above definitions of thinkers are telling the same concept that financial management is concerned with the acquisition and use of funds by a business firm.

Financial management can be understood in detail by the study of its two approaches Traditional approach and modern approach.

Under traditional approach financial management has been related to the procurement of funds and limited to finish time to time the essential activities viz., sources of funds, Institutional sources and current practices of business firm. Under the traditional approach financial management has been concerned with the promotion of company securities, capital Market, Reconstruction / Reorganisation amalgamation, Absorption etc.

Under Modern Approach – Financial Management has become inseparable part of business management which is related to the internal operation of the business. In Modern approach the analytical aspects of financial Management has been emphasised. Under Modern approach financial management is concerned with the financial planning, evaluation of alternative uses of funds, capital budgeting, determination of the criteria of the financial success of the business, cost of capital and the management of working capital.

The study of both approaches has concluded that the financial management has become an inseparable part of the business management. It is the key role of business management. It is related to arrange the funds and to judicious utilisation. This is the day to day administrative function of business management so that goods of the enterprise can be cherished.

Nature of financial Management

Following points are enough to speak about the nature of financial management as per the concept, approaches and the expertise of financial experts:-

1. An indispensable organ of Business Management: - Financial manager plays important role in the modern business management. Financial

manager play key role in every activities of business of and in the basic role in the decision making of business.

2. Continuous Administrative function: - Traditionally financial management was the periodic function but in modern days it has become a continuous and administrative function for the successful operation of funds and to make the business more profitable.

3. Analytical and wider form – Financial management is more analytical and wider concept in the modern days. Financial management pays proper attention in the internal and external activities of business.

4. Measure of performance – Finance decision affects the volume of income and the business risk both. On the basis of financial results the performance of business can be evaluated.

5. Centralised Nature – Financial management is centralised in all scopes/areas of business management. Financial management can be centralized to coordinate and control all the activities and departments in the marketing and production in modern industrial enterprise.

6. Business –co-ordination- Financial management establishes co-ordination with all departments and units of business.

7. Helpful in Decision of Top Management – Financial Management helps the top management of business to take decision of business.

Functions / Importance of financial Management

Finance Management is indeed the key to successful business operations without proper administration and effective utilization of finance, no business enterprise can utilize its potentials for growth and expansion.

Financial management is concerned with the acquisition, financing and management of assets with some overall goals in mind. As mentioned in the contents of modern approach, the discussions on financial management can be divided into three major decisions viz (i) investment decision (ii) Dividend decision. A firm takes these decisions simultaneously and continuously in the normal course of its business. Firm may not take these decisions in a sequence but decisions have to be taken with the objective of maximising shareholder wealth.

1. Investment decision- It is most important than the other two decisions. It begins with a determination of the total amount of assets needed to be held by the firm. In other words, Investment decisions relates to the selections of assets – long term assets and short term assets, - Long term assets and short term assets, that a firm will invest funds on financial management helps to manage the funds properly on fixed capital and working capital so that business can be operated successfully in future without any barrier.

2. Financing Decision - After estimation of the amount required and the assets that require purchasing, comes the next financing decision into the picture. Here financial Manager is concerned with making of the right hand side of the balance sheet. It is related to the Financing mix or capital structure or leverage and he has to determine the proportion of debt and equity. It should be optimum financing mix which maximizes shareholders wealth. A proper balance will have to be struck between risk and return. Debt involves fixed cost (interest) which may help in increasing the return on equity along with an increasing in risk. Rising of funds by issue of equity shares is one permanent source, but the shareholders except higher rates of earnings. The capital structure theories and determination of optimum capital structure.

3. Dividend decision – This is the 3rd most important function of financial management. It is related to dividend policy. Dividend is a part of profit that is available for distribution to equity shareholders payment of dividends should be analysed in relation to the financial decision of a firm. There are two options available in dealing with the net profits of a firm viz, distribution of profits as dividends to the ordinary shareholders where there is no need of retention of earnings or they can be retained in the firm itself if they require, for financing of any business activity. But distribution of dividends or retaining should be determined in terms of its impact on the shareholders wealth. The financial managers should determine optimum dividend policy which maximizes market value of the share there by market value of the firm. Considering the factors to be considered while determining dividends is another aspect of dividend policy.

Goals / Objectives of financial Management-

The objectives of financial management can be broadly classified into two categories:-

I Basic objectives: Traditionally, the basic objectives of financial management have been (A) Maintenance of liquid assets and (B) Maximization of profitability of the firm. However these days, there is a greater emphasis on (C) shareholders wealth maximisation rather than on profit maximization.

(A) Maintenance of Liquid Assets: Financial Management aims at maintenance of adequate liquid assets with the firm to meet its obligations at all times. However, investment in liquid assets has to be adequate neither too low nor too excessive. The finance manager has to maintain a balance between liquidity and profitability.

(B) Maximization of profit: "Profit maximisation" is a term which denotes the maximum profit to be earned by an organisation in a given time period. The profit maximisation goal implies that the investment. Financing and dividend policy decision of the enterprise should be oriented to profit maximisation.

The term "profit" can be used in two sense – first as the owner oriented concept and the second, as the operational concept refers to the net profit, which goes in the form of dividend to the shareholders. Profit as the operational concept means profitability which is an indicator of economic efficiency of the enterprise.

Profitability – maximisation implies that the enterprise should select assets, projects and decisions that are profitable and reject the non-profitable ones. It is in this sense that the term – profit, maximisation is used in financial management.

(C) Wealth Maximisation: It is now widely and universally accepted that the objective of the enterprise should suitable and operationally feasible, precise and clear cut and should give weightage to the time value and risk factors. Owing to the various drawbacks of the profit maximisation objective, Professor Ezar Solomon rejected it as inappropriate and unsuitable and suggested the adoption of wealth-maximisation objective which removes all the drawbacks of the profit maximisation objective.

Wealth maximisation is also called value maximisation. The wealth or 'net present worth' of a course of action is the difference between gross present worth and the amount of capital investment required to achieve the benefits. Gross present – worth represents the present value of expected cash benefits.

Wealth maximisation cares more for the economic welfare of the shareholders, cannot forget the others who directly or indirectly work for the over-all development of the company. Thus wealth maximisation takes care of

1. Lenders or creditors
2. Workers or employees
3. Public or society
4. Management or employer

II Other Objectives: Besides the above basic objectives, the following are the other objectives of financial management.

(i) Ensuring a fair return to shareholders.
(ii) Building up reserves for growth and expansion.
(iii) Ensuring maximum operational efficiency by efficient and effective utilization

II **Leverages**

A firm can raise its required finance either equity or debt or both the sources. While construction capital structure, a firm can use fixed cost bearing securities for maximisation of shareholders wealth. Leverage has been defined as, the action of a lever and mathematical advantage gained by it. In other words leverage allows accomplishing certain things that are otherwise not possible. The concept is valid in business also. From the financial management point of view, the term leverage is commonly used to describe the firm's ability to use fixed cost assets or sources of funds to magnify the returns to its owners. According to James Holmes, "Leverage is the employment of an assets or sources of funds for which the firm has to pay a fixed cost or fixed return." Here fixed cost (operating cost) or fixed returns (financial cost) remains constant irrespective of the level of output.

Types of Leverage

There are two types of leverages, such as

(i) Operating Leverage

(ii) Financial Leverage

1. Operating Leverage –

Operating Leverage is present any time, a firm has operating costs regardless of the level of production. These fixed cost do not vary with sales. They must be paid regardless of the amount of revenue available. Hence, operating leverage may be defined as the firm's ability to use operating costs to magnify the effects of changes in sales on its earning before interest and taxes. Operating leverage is associated with investment activities. Hence, operating leverage results from the present fixed operating expenses with in firm's income stream. The operating costs are categorised into three: one – fixed costs which do not vary with the level of production. They must be paid regardless of the amount of revenue available. Example – depreciation on plant and machinery, building, furniture, etc. second variable costs that vary directly with the level of production. Example – raw materials, direct labour costs, etc. Third – semi-variable costs, which partly vary and is partly fixed.

The degree of operating leverage may be defined as the change in the percentage of operating income (EBIT). For the change in percentage of sales revenue. The degree of operating leverage at any level of output is arrived at by dividing the percentage change in EBIT with percentage in sales.

That is

Degree of Operating Leverage =

$$\frac{\text{Percentage in change in EBIT}}{\text{Percentage in change in sales}}$$

Operating leverage may be favourable or unfavourable. High degree of operating leverage indicates high degree of risk. It is good when revenues are rising and bad when they are falling. Operating risk (Business risk) is the risk of the firm not being able to cover its fixed operating costs. The larger the magnitude, the larger is the volume of sales required to cover all fixed costs.

2. Financial Leverage –

A firm need long-term funds for long term activities like expansion, diversification, modernisation etc. The financial manager's job is to compose funds. The required funds may be raised by two sources to compose capital is known as financial structure. The use of fixed charges sources of funds such as debt and preferences share capital along with the equity share capital in capital structure is described as financial leverage. According to Lawrence – "Financial Leverage is the ability of the firm to use fixed financial charges to magnify the effects of changes in EBIT on the firm's earnings per share. In other words, Financial Leverage may be defined as the payment of fixed rate of interest for the use of fixed interest bearing securities to magnify the rate of return as equity shares. It is also known as "Trading on equity". Hence, financial leverage results from the presence of fixed financial charges in the income statement. Financial leverage associate with financing activities. The fixed charges do not vary with firm's EBIT. They must be paid regardless of the amount of EBIT available to the firm. It indicates the effects on EBIT created by the use of fixed charges securities in the Capital structure of a firm. Financial leverage is computed by the following of formula.

$$\text{Financial Leverage} = \frac{EBIT}{PBT}$$

E = Earning
B = Before
I = Interest
T = Tax

P = Profit
B = Before
T = Tax

A financial leverage may be positive or negative. Favourable leverage occurs when the firm earns more on the assets purchased with the funds than the fixed cost of their use and vice versa. High financial risk. The financial risk refers to the risk of the firm not being able to cover its fixed financial costs. Hence, the financial manager should take into consideration, the level of EBIT and fixed charges while preparing the financial plan.

III Calculate financial (average and operating leverage from the following data :

	Rs.
Sales 200000 units @ Rs. 2.00 per unit	400000
Variable cost per unit @ Rs. 20.70 per unit	-
Fixed cost	200000
Interest charges on Debt. Capital	7336

Financial leverage $= \frac{EBIT}{PBT}$

EBIT = 4, 00,000 – (200000 x .70 + 200000)

= 4, 00,000 – 3, 40,000

= 60000

PBT = 60000 – 7336

= 52664

$\therefore$ Financial leverage $= \frac{60000}{52664} = 1.14$

Operating leverage $= \frac{C}{EBIT}$

C = Sales – Variable cost

= 400000 – 140000

= 260000

EBIT = 60000

$\therefore$ Operating Leverage $= \frac{260000}{60000} = 4.33$

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

$= \frac{C}{PBT}$

$= \frac{260000}{52664}$

= 4.94

IV **<u>Capital Structure:-</u>**

The term capital structure refers to the mix of long term sources of funds such as equity share capital, reserves and surplus. Debentures. Long-term debt from outside sources and preference share capital. It is actually that part of financial structure, which represents long – term sources. The term capital structure is generally defined to include only long-term debt and total stock older investment. Bogen has defined capital structure in his own words “Capital structure may consists of a single class of stock or it may be complicated by several issues of bonds and preferred stock, the characteristics of which may vary considerably.” In simple words, capital structure refers to the composition of capitalisation, i.e, to the proportion between debt and equity that make up capitalisation. Capital structure indicated by the following equation –

Capital structure = Long term Debt + Preferred Stock + net worth

Features of Capital Structure

Construction of optimum capital structure is very important for a firm, since the firm's value is depending on the capital structure. Hence, financial manager or the concerned person should develop an appropriate capital structure, which is helpful to maximise shareholders wealth. This can be done entry when all those factors which are relevant to the company's capital structure decision are properly analysed and balanced. Capital structure should be planned generally keeping in view the interest of ordinary shareholders because they are the ultimate owners of a business enterprise and have the right to select the directors. However, the interest of the other groups, such as, employees, customers, creditors, Society and Government should also receive reasonable consideration. An appropriate capital structure should have the following features.

(i) Profitability/ Return:

As we have seen in the above discussion that the appropriate capital structure is one which is most advantageous with the constraints, maximum use of leverage at a minimum cost should be made. In other words, it should generate maximum returns to the owners without adding additional cost.

(ii) Solvency/risk:

The use of more or exercise debt threatens the solvency of the firm. Debt should be used till the point where debt does not add significant risk, otherwise use of debt should be avoided.

(iii) Flexibility:

Flexible capital structure means it should allow the existing capital structure to change according to the changing conditions without increasing cost. It should also be possible for the firm to provide funds whenever needed to finance its possible activities. Firm should also repay the funds in not required.

(iv) Conservation/Capacity :

Capital should be conservative in the sense that the debt capacity of a firm should not be exceeded. In other word the capital structure should be determined within the debt capacity of the firm and not beyond firm's capacity. The debt capacity of a firm depends on its ability to generate future cash inflows. It should have enough cash to pay its fixed charges and principal sum.

(v) Control :

Use of more equity may lead to lose the control on company. The owners of competitors from (closely held firms) are very particular concerned about the dilution of control. Hence, construction of capital structure should not involve the risk of loss of control on the firm.

V **Overcapitalisation:-**

A company is said to be over-capitalised when its actual earnings or profits are not sufficient to pay dividend at proper rate to the shareholders. In short when the actual capitals action of a company arrived at, by adding up the par value of paid up value of share capital, reserves and surplus, debentures and other long-term borrowings is more than the proper capitalisation i.e., the capitalisation determined on the basis of either the cost approach or the earnings approach. When the earnings or profits of the company are lower than the general expected return in the company. In short term there is a fall in the earning capacity of the company. In overcapitalisation there is a fall in the rats of dividend declared by the company over a long period. It is true to say that a company is said to be overcapitalised if the rate of dividend of this company falls continuously over a long period.

Effects of over –capitalisation

Over capitalisation affects the different contributories of a company in the following ways.

1. Adverse effect – Effects of over capitalisation on the shareholders.
   (i) Over – Capitalisation results in a fall in the rate of dividends to the shareholders.
   (ii) Over- Capitalisation will result in a fall in the market values or market prices of the shares held by the shareholders.
   (iii) On account of the fall in the market values of the shares, resulting from over-capitalisation, the holdings of the shareholders will have lesses value as securities for raising loans.

(iv) The shareholders of an over-capitalised company may find it difficult to dispose of their shares. Even if they are able to dispose of their shares, at a loss.

2. Adverse effects of over – capitalisation on the consumers :

(i) An over-capitalised company is forced to raise the prices of its products so as to increase its earnings. The rise in the prices of the products will be determined to the consumer.

(ii) An over- capitalised company may not be able to keep us the quality of its products. The fall in the quality of the products will be harmful to the consumers.

(iii) An over- capitalised company is unable to face competition and survive in the market. The result is its liquidation. The consumers will be affected adversely by the stoppage of the production by the liquidated company.

3. Adverse effects of over-capitalisation on the society :

(i) An overcapitalised company may find it difficult to pay the wages of the workers on time. This will affect the morale of the workers and will lead to strained industrial relations.

(ii) If an over-capitalised company resorts to wages cuts to reduce its costs and to improve its earnings there will be resentment amongst the workers. As a result, the industrial relations will be strained.

(iii) An – overcapitalised company with a large amount of debenture issue may an account of debenture issue may an account of its lower earning capacity, find it difficult to pay the fixed interest on its debentures.

This will affect the interest of debenture Hoders adversely.

(iv) An- overcapitalised company on accounts of its lower earning capacity, find it difficult to repay the creditors and the debenture holders.

(v) Over- capitalised will lead to misappropriation and wastage of the resources of the society.

(vi) Over – capitalised will lead to a fall in the market values of the shares of an over-capitalisation company may encourage speculation in the share and affect the climate of investment adversely.

(vii) An over-capitalised company is unable to face competition and survive in the market. The result is its liquidation. The liquidation or closure of the over-capitalised company will affect the interests of the creditors and the labourers adversely.

VI Capital Budgeting

Capital Budgeting refers to planning the deployment of available capital for the purpose of maximising the long term profitability of the firm. It is the firm's decision to invest its current funds most efficiently in long activities in the anticipation of flow of future benefits over a series of years.

In other words, Capital budget may be defined as the firm's decision to invest its current funds most efficiently in the long-term assets in anticipation of an expected flow of benefits over a series of years. Therefore, it involves a current outlay or series of outlay of cash resources in return for an anticipated flow of future benefits. Capital budgeting is the process to identify, analysis and select investment projects, whose returns (Cash flows) are expected to extend beyond one year. Firm's investment decisions would generally include expansion, acquisition, modernisation, replacement of fixed assets or long – term assets.

Process of Capital Budgeting

The processes of capital budgeting may be discussed in the following manner:-

1. Planning/Idea generation :-

   Idea is the first step in capital budgeting process. In other words the planning phase of a firm's capital budgeting process is concerned with articulation of its broad investment strategy and the generation and preliminary search of project proposals. Identifying a new worthwhile project is a complex problem. It involves a careful study from many different angles. Ideas can be generated from the sources like, performance

Analysis of existing industries, examination of input and output of various industries, review of important export data, study plans outlays and government guidelines, looking at the suggestions of financial institutions and development agencies, study of new technological developments etc.

2. Evaluation/Analysis –

In the preliminary screening, when a project proposal suggests that the project is prima facie worthwhile, then it is required to go for evaluation /analysis. Analysis has to consider aspects like, marketing, technical, financial, economic and ecological analysis.

3. Selection –

Selection or rejection follows the analysis phases if the project is worthwhile after using a wide range of evaluation techniques, which are divided into traditional non-discounted and modern/discounted. Selection and rejection of a project depend on the technique used to evaluate and its rule of acceptance.

4. Financing of the project –

After the selection of the project, the next step is financing. Generally the amount required is known after the selection of the project. Under this phase financing arrangement share to be made. There are two broader sources available such as equity and debt.

5. Execution/Implementation –

Planning of a paper work and implementation of the selected project. Implantation of an industrial project involves the stages, project and engineering designs negotiations and contracting, construction training and plant commissioning. Adequate formulation of project, use of the principle of responsibility accounting and use of network techniques i.e., PERT and CPM are very much helpful for the implementation of a project at reasonable cost.

6. Review of the project –

Once the project is converted from paper work to concrete work. Then there is need to review the project. Performance review should be done periodically. Under this performance review, actual performance is compared with the predetermined or projected performance.

Payback Period

Payback period is one of the traditional techniques of Capital Budgeting. It is most popular and widely recognised technique of evaluating investment proposals. Payback period may be defined as that period required, to recover the original cash outflow invested in a project. In other words it is the minimum required number of years to recover the original cash outlay invested in a project. The cash flow after taxes is used to compute payback period.

Payback period can be calculated in two ways (i) using formula (ii) using cumulative cash flow method. The first method can be applied when the cash flows stream of each year is equal/annuity in all the year's or projects fife, i.e., uniform cash flows for all the years. In this situation the following formula is used to calculate payback period, or

Initial Investment (Cash outlay)

$$\text{Payback period} = \frac{Initial\ \ Investment(Cash\ outlay)}{Annual\ Cash\ inflow}$$

The second method is applied when the cash flows after taxes are unequal or not uniform over the projects life period. In this situation, payback period is calculated through the process of cumulative cash flows, cumulative process goes up to the period where cumulative cash flows equals to the actual cash outflows.

Advantages of Payback period

(i) It is very simple and easy to understand.

(ii) Cost involvement in calculating payback period is very less as compared to sophisticated methods.

Disadvantages of Payback period

(i) It ignores cash flows after payback period.

(ii) It is not an appropriate method of measuring the profitability of an investment, as it does not consider all cash inflows yielded by the investment.

(iii) It does not take into consideration time value of money.

(iv) There is no rational basis for setting a minimum payback period.

(v) It is not consistent with the objective of maximising shareholders wealth share value does not depend on payback period of investment projects.

(vi)

Determinants of Capital Structure

Capital Structure may be determined at the time of promotion of the firm or during the latter stages. But determining optional capital structure at the time of promotion is very carefully. The following determinants are discussed as under:-

1. Tax benefit of Debt :-

   Debt is the cheapest source of long term finance when compared with other sources equity, because the interest on debt finance is a tax-deductible expenses. Hence, debt can be accepted as a tax sheltered sources of finance, which helps in shareholders wealth maximisation.

2. Flexibility :-

   Flexibility is one of the most important and serious factors, which is considered in determining capital structure. Flexibility is the firm's ability to adopt its capital structure to the needs of changing conditions. Changing conditions may be need of more funds for investments or having substantial funds that are already raised.

3. Control :-

   The equity shareholders have voting right to elect the directors of the company. Raising funds by way lead to less of control. If the management wants to have total control on the firm then, it may require to raise funds through non-voting right instruments that is debt source of finance.

4. Industry Leverage Ratio :-

   The industry standard provide benchmark. Firm can use industry leverage ratio as standard for construction of capital structure. Because industry standard may be appropriate to the firm. It does not mean that all firms in the industry are having optimum capital structure.

5. Seasonal variations :-

   Use of more or less financial leverage depends on the seasonal variations of the business. Low degree of financial leverage(less debt) capital in their capital structure.

6. Degree of competition :-

   Competition in the industry also determines the capital structure. When , there is no or less competition then, the firms can use less equity or more debt in their capital structure, since they can sell more products at higher prices.

7. Industry Life cycle :-

The industry life cycle consists of introduction stage: growth stage: maturity stage and declining stage. The industry in infancy should use less debt capital or more equity capital in capital structure, since the profit earning capacity is less due to less sales whereas when a firm is in its growing stages and having more profits, it can go for more debt or less equity that helps to maximise shareholder wealth.

8. Agency Cost :-

Agency cost arise when there is a conflict of interest among owners, debenture holders and the management. Conflict may arise due to the transferring of wealth to debt holders in their favour. The agency problem is handled through monitoring and restrictive covenants, which involves costs that are called agency costs.

9. Company characteristics :-

Characteristics like size and credit standing among other companies (within or outside company). Small firm's ability to raise funds from outside is limited when compared to large firms. Small firms have to depend on owners fund for financing activities.

10. Timing of public Issue :-

Timing for public offer is also one of the most important factors considered while planning the capital structure. Public offering should be made at a time when, that state of the economy as well as capital market is ideal to provide the funds.

11. Requirement of Investors :-

Before going to issue a particular instrument to the public or investors to raise funds, there is a need to know the investors requirements. Investors may be institutional investors (LIC, GIC, UTI) as well as individual investors.

12. Period of finance :-

Period of also plays a crucial role in determining the capital structure. A firm can issue redeemable debentures or preference shares when the finance is required for a limited period.

13. Purpose of finance :-

Debt source of finance is suitable when a firm is planning to invest in productive purpose.

14. Legal Requirements :-

There are some guidelines on shares and debentures issued by the governments that are very important for the construction of the capital structure.

Effects of operating Leverage on Profit/Incomes

As indicated earlier, operating Leverage affected the business risk which may be viewed as uncertainty inherent in the estimate of future operating income. A company using high technology accompanied by fixed costs but low variable costs would have high degree of operating leverage, its break-even. Point will relatively be higher and thus changes in the sales level might have a magnified effect on profits. Thus, higher the degree of operating leverage the greater will be the fluctuations in profit as response to change in sales/output volume. Besides, the degree of operating leverage has implications for a variety of business and financial policy decisions; such as:

(i) High degree of operating leverage may suggest that the volume may be increased to gain a step rise in profits

(ii) High degree of operating leverage may also suggested that profits will swing widely as volume fluctuates.

Effect of financial Leverage on Profit/Incomes:-

The effects of financial leverage is measured through returns on equity or Through returns on equity or through 'earnings per share'. Earnings per share'. Earnings per share is obtained by dividing earnings after interest and taxes by total number of equity shares. If there are preference shares in the company capital structure, net equity earnings will be arrived at after deducting interest, taxes and preference shares dividends. It may be noted that the effects of financial leverage are not always clear and identical in various states of profitability and debt proportion in capital structure.

(i) Financial leverage in general is favourable when the return on assets exceeds the cost of debt capital.

(ii) At zero debt-level, the after tax return on total assets is likely to be equal to the after tax return on equity.

(iii) When the return on asset is high, both net return on equity and earnings per share increase with a rise in debt ratio.

(iv) While higher amounts of leverage improve equity returns and EPS, they produce a higher degree of volatility also in such returns.

(v) Financial Leverage magnifies the volatility of returns whether measured by net income or return on equity or earnings per share.

Effects of Combined leverage on profit/incomes

The extent of risk and uncertainty can be determined on the basis of combined effects operating and financial leverages. If operating leverage is 3 and financial leverage is 4, then combined leverage will be 3*4=12. Thus the extent of its being favourable or unfavourable will be 12 times in such a situation, a definite percentage increase in sales will cause increases 12 times in EBT. But a definite percentage decline in sales will equally cause a fall in EBT 12 times. This significant that the credit/goodwill of such company will increase in the market in good years because the market value of its equity shares will unexpectedly rise due to maximisation of profit and dividend. On the other hand, the volume of profit may be too poor in bad years to bear with interest burden. As a result its equity shares may be issued only at discount.

If both the operating leverage and financial leverage of a company are very low the risk will be too low which may indicate that the company is very cautious in raising the finances and its applications.

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