Leverage

Meaning

Financial leverage means employment of funds obtained at a fixed charge. Thus, financial leverage may be defined as the ratio of long-term debt to total funds employed.

Leverage is introduced in a Company in anticipation of earning more on the funds than what it would cost which in consequence would improve income of the stockholders.

This principle of leverage is very popular. The management employs this principle, more often than not, to increase the company's return on equity capital and more so when it is impossible to improve operating efficiency of the company and increasing the return on total investment.

Leverage, in business terminology, really just means debt. It's the borrowing of funds to finance the purchase of inventory, equipment, and other company assets. Business owners can use either debt or equity to finance or buy company assets. Using debt increases the company's risk of bankruptcy but can also increase the company's profits and returns; specifically its return on equity. If debt financing is used rather than equity financing, the owner's equity is not diluted by issuing more shares of stock.

Leverage occurs in varying degrees. The higher the degree of leverage, the higher is the risk involved in meeting fixed payment obligations i.e., operating fixed costs and cost of debt capital. But, at the same time, higher risk profile increases the possibility of higher rate of return to the shareholders.

Factors Affecting Financial Leverage

Financial leverage is more about the borrowings from external sources and needs to be repaid sooner or later. To understand more about financial leverage, let us go through the following factors:

- **Second Stage Leverage**: The financial leverage is considered as second stage leverage because it is dependent upon the degree of operating leverage. If the operating risk is high, the company will plan for low financial leverage and vice-versa.

- **Financial Liability**: The borrowings in the form of debts create financial liability on the company.

- **Financing Decision**: The financial leverage decision is a part of the company's financing strategy planned by the directors.

- **Interest Rates**: These borrowings are usually payable with interest which is quite high.

- **Stability of the Firm**: The most important factor considered by the management while taking the financing decision is the firm's position and balance, to bear the risk.

- **Return on Assets**: The returns which the additional capital needs to be estimated to find out whether the company will be able to generate higher profits on the capital employed or not.

- **Fixed Financial Cost**: The debts create a fixed financial burden in the form of interest over the company.

Significance of Leverage

Leverage refers to the use of fixed costs in an attempt to increase the profitability. Leverage affects the level and variability of the firm's after tax earnings and hence, the firm's overall risk and return. The study of leverage is significant due to the following reasons.

(I) Measurement of Operating Risk

Operating risk refers to the risk of the firm not being able to cover its fixed operating costs. Since operating leverage depends on fixed operating costs, larger fixed operating costs indicates higher degree of operating leverage and thus, higher operating risk of the firm. High operating leverage is good when sales are rising but bad when they are falling.

(II) Measurement of Financial Risk

Financial risk refers to the risk of the firm not being able to cover its fixed financial costs. Since financial leverage depends on fixed financial cost, high fixed financial costs indicates higher degree of operating leverage and thus, high financial risk. High financial leverage is good when operating profit is rising and bad when it is falling.

(III) Managing Risk

Relationship between operating leverage and financial leverage is multiplicative rather than additive. Operating leverage and financial leverage can be combined in a number of different ways to obtain a desirable degree of total leverage and level of total firm risk.

(IV) Designing Appropriate Capital Structure Mix

To design an appropriate capital structure mix or financial plan, the amount of EBIT under various financial plans, should be related to earning per share. One widely used means of examining the effect of leverage to analyze the relationship between EBIT and earning per share.

(v) Increase Profitability

Leverage is an effort or attempt by which a firm tries to show high result or more benefit by using fixed costs assets and fixed return sources of capital. It insures maximum utilization of capital and fixed assets in order to increase the profitability of a firm, it helps to know the reasons not having more profit by a company.

Limitations of Financial Leverage

There are certain drawbacks of the financial leverage which are mainly related to borrowings through debts. These are as follows:

- **High Risk**: There is always a risk of loss or failure in generating the expected returns along with the burden of paying interest on debts.
- **Adverse Results**: The outcome of such borrowings may be harmful at times if the business plan goes wrong.
- **Restrictions from Financial Institutions**: The lending financial institution usually restricts and controls the business operations to some extent.

- **High Rate of Interest**: The interest rates on the borrowed sum is generally high, which creates a burden on the company.

- **Benefits Limited to Stable Companies**: The financial leverage is a suitable option for only those companies which are stable and possess a sound financial position.

- **May Lead to Bankruptcy**: In case of unexpected loss or poor returns and huge debts or liabilities, the company may face the situation of bankruptcy.