LESSON - 7

FINANCIAL LEVERAGE AND COMBINED LEVERAGE

Objectives

The main objectives of this lesson are to explain

- * the concept of finanacial leverage, its measurement and importance
- the EBIT-EPS analysis
- * the point of indifference
- * the meaning and measurement of composite leverage

STRUCTURE :

- 7.1 Meaning of Financial Leverage
- 7.2 Measurement of Financial Leverage
- 7.3 Financial Leverage and EBIT EPS Analysis
- 7.4 Calculation of Point of Indifference
- 7.5 Combined Leverage Meaning and Measurement
- 7.6 Importance of Financial and Operating Leverages
- 7.7 Summary
- 7.8 Key Words
- 7.9 Self Assessment Questions
- 7.10 Further Readings

7.1 Meaning of Financial Leverage :

The composition of different sources of long-term funds mobilised by a firm is known as capital structure of that firm. These sources include debt, preference capital, equity and retained earnings. The use of fixed income bearing debt and preference share capital along with equity for the benefit of owners of the firm (equity shareholders) is called financial leverage or trading on equity. Since the cost of these funds is fixed and cheaper when compared to cost of equity, their use magnifies the earnings to the equity shareholders.

Favourable and Unfavourable Financial Leverage : Financial leverage can be favourable or unfavourable. Debt capital involves payment of interest at a fixed rate irrespective of the fact that the firm makes profit or not. The preference dividend, however, is payable out of after-tax income. If there is no profit during any particular year, the preference dividend is not payable. The equity shareholders are entitled to the residual income. A firm is said to have a favourable financial leverage, if its earnings are more than the cost of debt and preference capital. On the contrary, if it does not earn as much as these costs, the leverage is unfavourable.

Financial Leverage and Trading on Equity : Financial leverage and trading on equity are generally synonymously used. However, there is a slight difference to be shown in their use. Trading on equity refers to the employment of fixed income - bearing sources of funds for the benefit of equity shareholders. Hence, the term trading on equity should be used for financial leverage only when it is favourable. The firm resorts to trading on equity with the objective of giving the equity shareholders a higher rate of return than the general rate of return on the capital employed in the firm, so that it may compensate the risk they bear.

For example, if a firm borrows debt capital at 15% and earns 20% on its capital, the difference of 5% after payment of interest belongs to equity shareholders making their total return 25% (20+5). On the other hand, if the firm earns only 12% on its capital, there will be a loss of 3% after payment of interest, which makes the rate of return available to equity shareholders lower at 9% (12-3). Thus, financial leverage is a duoble-edged sowrd, which has the potentiality of increased return as well as increased risk to equity shareholders.

7.2 Measurement of Financial Leverage

Degree of Financial Leverage can be calculated with the following formula :

Degree of Financial Leverage =
$$\frac{EBIT}{EBT} = \frac{EBIT}{EBIT - I}$$

Where,

EBIT = Operating profit or Earnings before interest and tax

EBT = Earnings before tax

1 = Annual Interest on debt capital

Illustration 1

Calculate the financial leverage for the following financial planEquity capital= Rs. 2,00,000Debt= Rs. 2,00,000Operating profit= Rs. 40,000(EBIT)Interest at 10% on debt capital.

Solution :

EBIT		= Rs.	40,000
Less Interest @10% or	n deb	t = Rs.	20,000
EBT		= Rs,	20,000
Degree of Financial Leverage		EBIT _	Rs.40000
Degree of Financial Leverage	dig.	EBT	Rs.40000 - 20000
		40,	000 _ 2
		= 20,	$\overline{000} = 2$

Alternative Definition of Financial Leverage : One of the objectives of planning an appropriate capital structure is to maximise the return on equity shareholders' funds or maximise the earnings per share (EPS). Some authorities have used the term, "Financial Leverage" in the context that it defines the relationship between EBIT and EPS. 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 the firm's earnings per share. Therefore, financial leverage indicates the percentage change in EPS in relation to a percentage change in EBIT.

As per the above definition the degree of financial leverage can be calculated as below :

Percentage Change in EPS

Degree of Financial Leverage = Percentage change in EBIT

It is implied that there will be no financial leverage, if the quotient according to the above formula does not exceed one.

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Illustration 2

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EPS =

A company has the following capital structure :	
10,000 Equity shares of Rs. 10 each	Rs. 1,00,000
2,000 10% Preference shares of Rs. 100 each:	Rs. 2,00,000
2,000 10% Debentures of Rs. 100 each :	Rs. 2,00,000
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Calculate the EPS for each of the levels of EBIT as : i) Rs. 1,00,000 and ii) Rs. 1,4

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Also calculate the financial leverage taking EBIT level under base (i). Tax rate is 50%

Solution : Computation of Earnings per share

		(1)		(11)	
EBIT	Rs. 1,0	00,000	Rs.	1,40,000	•
Less : Interest on debentures		20,000		<u>20,000</u>	
EBT	u _e is and it? 8	80,000		1,20,000	
Less Tax @50%	4	40,000		<u>60,000</u>	
EAT	4	40,000		60,000	
Less : Preference dividend		20,000		20,000	
	1			×	
Earnings available to equity shareholders		20,000		40,000	
Earnings per share		Rs. 2		Rs. 4	

Earnings available to equity shareholders No. of equity shares

Degree of financial leverage = $\frac{Percentage \ Change \ in \ EPS}{Percentage \ change \ in \ EBIT} = \frac{100\%}{40\%} = 2.5$

7.3 Financial Leverage and EBIT - EPS Analysis

Financial leverage is used to magnify the shareholder's earnings. It is based on the assumption that cost of fixed charge funds is lower than the firm's rate of return on its assets. An analysis of EBIT - EPS relationships helps in designing the capital structure of a firm. It is a widely' used technique to design an appropriate capital structure which will be determined on the basis of EPS. It will help to determine the appropriate financial plan from among various alternative financial plans, when EBIT is constant and is varying. This EBIT - EPS can be explained with the following illustrations :

7.3.1 Analysing Alternative Financial Plans - Constant EBIT : The effect of financial leverage on EPS under various alternative financial plans can be illustrated as below.

Illustration 3

ABC Ltd. has an equity share capital of Rs. 10,00,000 divided into shares of Rs. 100 each. The company plans to raise further Rs. 5,00,000 for expansion-cum-modernisation. The company has the following financial plans :

Plan I :	All common stock
Plan II :	Rs. two lakh in equity and Rs. 3 lakh in 8% debt.
Plan III :	All debt financed at 8% p.a.
Plan IV :	Rs 2 lakh in equity and Rs. 3 lakh in 8% preference share capital.

 (7.4	Financial Leverage

The Company's present earnings before interest and tax (EBIT) are Rs. 3,00,000. The corporate tax rate is 50%.

You are required to calculate the earnings per share in each plan and comment on the implications of financial leverage.

Solution :

1. 自动 _医 , 一方 通路运行规模 医动脉管膜		Different PLA	ANS		
· · · · · · · · · · · · · · · · · · ·	I I I	and the second s	III	IV	
	(Rs.)	(Rs.)	(Rs.)	(Rs.)	: 1
Earnings before interest and taxes (EBIT)	3,00,000	3,00,000	3,00,000	3,00,000	
Less : Interest @ 8%	2 20 <u>2</u> 0	24,000	40,000		
EBT	3,00,000	2,76,000	2,60,000	3,00,000	
Less : Tax@ 50%	1,50,000	1,38,000	1,30,000	1,50,000	
EAT	1,50,000	1,38,000	1,30,000	1,50,000	•
Less : Preference dividend@ 8%		- 	a da seci l ita	24,000	
Earnings available to equity shareholders	1,50,000	1,38,000	1,30,000	1,26,000	
No. of equity shares	15,000	12,000	10,000	12,000	
Earnings per share (EPS)	Rs. 10	Rs. 11.50	Rs. 13	Rs. 10.50	

Comments :

Of all the above financial plans, plan III, the most leveraged is the best plan as its EPS is the highest at Rs. 13. Plan II is the next best plan where the EPS is Rs. 11.50. In this case, Rs. 3 Lakh are mobilised in the form of debt capital. Even plan IV, where preference Capital is mobilised, is better than plan I which is all-equity financed.

Thus, through EBIT-EPS analysis, alternative financial plans can be assessed.

7.3.2 Analysing Alternative Financial Plans - Varying EBIT

In practice, EBIT for any firm is subject to various influences. As a result, EBIT varies. In the given period, the actual EBIT of the firm may be more or less than the expected. It is therefore useful to analyse the impact of financial leverage on EPS for possible fluctuations in EBIT. It is illustrated below :

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Illustration 4

A firm is considering two financial plans for an investment of Rs. 5,00,000

		Plan I	Plan II	Net i sa sin dit
	Debt (at 10% interest)	Rs. 4,00,000	Rs. 1,00,000	
	Equity share capital (Rs. 10 each)	Rs. 1,00,000	Rs. 4,00,000	a an
Nel je Grain	Total Capital	Rs. 5,00,000	Rs. 5,00,000	
	No. of equity shares	10,000	40,000	

Find out the effect of financial leverage on EPS, if EBIT expected is i) Rs. 50,000, ii) Rs. 75,000, and iii) Rs. 1,25,000. The corporate tax rate is 50%.

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Solution :	la Kulonetekad		h, he to the
Effect on EPS under Plan I			
	Rs.	Rs.	Rs.
EBIT	50,000	75,000	1,25,000
Less : Interest on debt	40,000	40,000	40,000
Earnings before tax :	10,000	35,000	85,000
Less : tax @ 50%	5,000	17,500	42,500
Earnings after tax :	5,000	17,500	42,500
No. of equity shares	10,000	10,000	10,000
Earnings per share :	0.50	1.75	4.25
Effect on EPS under Plan II	Rs.	Rs.	Rs.
EBIT	50,000	75,000	1,25,000
Less : Interest	10,000	10,000	10,000
EBT	40,000	65,000	1,15,000
Less Tax@ 50%	20,000	32,500	57,500
EAT	20,000	32,500	57,500
No. of coulty shares t		40,000	40.000
no. of equity snares :	40,000	40,000	40,000
Earnings per share (EPS)	0.50	0.81	1.44

Comment :

1) Plan I more leveraged than plan II. Plan I has 80% of debt while plan II has only 20% of debt capital.

2) Under plan I, the effect of change in EBIT on EPS is more when campared to plan II, because financial leverage is higher in plan I.

7.4 Calculation of Indifference point

The point of indifference refers to that level of earnings before interest and taxes (EBIT), at which earnings per share (EPS) remains the same irrespective of different alternatives of debt-equity mix. At this level of EBIT, the rate of return on capital employed is equal to the cost of debt. This is also known as break-even level of EBIT for alternative financial plans.

At the level of indifference EBIT (EBIT*) alternative financial plans with result in the same EPS. For example

a) Under all equity (100%) plan, EPS is equal to

EBIT (1-T)

Na

EPS_a = ------ Where EBIT = Earning Before Interest and Taxes.

T = corporate tax rate

N = Number of shares

b) Under Debt - Equity plan, EPS is equal to

(EBIT - I) (1-T)

EPS_b = ------ Where I = annual interest

c) Under Debt - Equity - preference capital plan EPS is equal to

Financial Leverage.. Financial Management . 7.6 (EBIT - I) (I-T) - Dp Where Dp = Preference Dividend EPS = N If we wish to find the indifference level of EBIT between plan a (all equity) and plan b (Debt - Equity), since EPS under both plans would to equal at Indifference level of EBIT, EBIT * can be worked out by the following procedure Since $EPS_{\mu} = EPS_{\mu}$ (EBIT - I) (1-T) EBIT (1-T) then =N i) number of shares under both the plans (H) Given ii) interest on debt (I) iii) carporate tax rate (T) We can solve EBIT which is the indifference level of EBIT (EBIT *) Similarly between financial plan d and c the following equation can be used. Given i) Interest under both plans (I) ii) Tax rate (T) iii) Number of shares under both plans iv) Preference dividend under plan c (DP) we can solve EBIT by using the following equation. EBIT - Ib) (1-T) (EBIT - Ie) (1-T)-Dp _____ and the second Nb Nc 7.4.1. EBIT - EPS Analysis - Graphical Presentation : We know that (EBIT - I) (1-T) - Dp EPS =_____ IN if the equation is rearranged $EPS = \frac{(1-T)EBIT}{N} - \frac{(1-T)I}{N} - \frac{DP}{N}$ EPS = $\frac{-(1-T)I}{N} - \frac{DP}{N} + \frac{(1-T)}{N} EBIT$

When the level of leverage, corporate the rate and dividend on preference Capital are coustant.

$$\left[\frac{(1-T)I}{N} + \frac{DP}{N}\right]$$
 is a constant

Then EBIT is a changing variable and is represented by 'x'

$$EPS = -\left[\frac{(1-T)I}{N} + \frac{DP}{N}\right] + \left[\frac{1-T}{N}\right] EBIT$$

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if EPS is represented by y

then y = a+bx

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Therefore EPS is a linear function of EBIT.

If H₀ ERIT - EPS relationship is platted on a graph the line takes the shape of a straight line

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from the graphical view of EBIT - EPS analysis the following observations can be made.

The line be come steeper and steeper with more and more debt in the capital structure

* Steeper the line, the more the profit potential to the sharehders

* Point of intersection (E) is the indifference point. It is the level of EBIT at which EPS under various alternative financil plans is equal. It is the point where rate of

Below the indifference point, the line shifts more and more towerds the righ when the level of leverage increases, indicating Unfavourable effect of leverage.

* The line beyond point E Shifts towards left as the leverage increases indicating favourable effect of leverage.

If the actual EBIT of the campany is

* Lower than EBIT*	1	Equite financing is preferable		
* equal to EBIT *	and Rock of	all plans are equally preferable		

* Morethan EBIT* - Debt financing is preferable

These situations arise because of the difference between rate of refurn on assets (r) and rate of interest an debt (i)

r is less than i	-	EPS decreases with every increase in debt
r is equal to i	-	EPS remains the same with any level of debt
r is more than i	-	EPS increases with increasing debt

Illustration 5:

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A new project under consideration of a company requires an investment of capital of Rs. 150 lakhs. Interest on term loan is 12% and the tax rate is 50%. If the debt equity ratio insisted by the financing agencies is 2:1, calculate the point of indifference for the project.

7.8

Solution :

In case of this project, the financing agencies insisted on debt - equity ratio of 2:1. Hence, there are two alternative plans they are :

1) Raising the entire amount of Rs. 150 lakhs by the issue of equity shares, so that there is no debt.

2) Raising debt capital of Rs. 100 lakhs and equity capital of Rs. 50 lakhs.

Calculation of point of indifference :

$$\frac{(X-I_1)(I-T)-D_p}{N_1} = \frac{(X-I_2)(I-T)-D_p}{N_2}$$
$$\frac{(X-0)(1-.5)-0}{150 \ lakhs} = \frac{(X-12 \ lakhs)(1-.5)-0}{50 \ lakhs}$$
or
$$\frac{.5x}{150} = \frac{.5x-6}{50}$$
or
$$25x = 75 \ x - 900$$
or
$$50x = -900$$
or
$$50x = -900$$
or
$$x = \frac{900}{50} = Rs.18 \ lakhs$$

Thus, EBIT at point of indifference is Rs. 18 lakns. At uns level of EBIT, the earnings per share (EPS) will be the same under both the plans.

Illustration 6 :

ABC Co. Ltd is considering three plans for which the key information is as below :

a) Total investment to be raised Rs. 4,00,000.

b) Plans of financing proportion :

Plans	Equity	Debt	Preference capital	
А	100%	-		
В	50%	50%		
C	50%		50%	

c) Cost of debt is 8% and rate of preference dividend is 8%.

d) Equity shares of Rs 10 each will be issued at a premium of Rs. 10 per share

e) The expected EBIT is Rs. 1,60,000 and the tax rate is 50%.

Determine for each plan :

i) Earnings per share (EPS)

ii)/the EBIT range among the plans for point of indifference.

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Sollution :			hin Strager L
i) computation of EPS for each plan	Miller (Millerpress) of the s General Sciences and Loss Sciences		
and the second second second second	Plan A	Plan B	Plan C
	(Rs.)	(Rs.)	(Rs.)
EBIT	1,60,000	1,60,000	1,60,000
Less : Interest@8%	a for sind the local	16,000	
EBT	1,60,000	1,44,000	1,60,000
Less Tax @ 50%	80,000	72,000	80,000
Earnings after tax	80,000	72,000	80,000
Less : Preference dividend 8%	· · ·		16,000
Earnings available to	80,000	72,000	64,000
equity shareholders			
No. of equity shares	20,000	10,000	10,000
Earnings per share	Rs. 4.00	Rs . 7.20	Rs. 6.40

ii)

Computation of EBIT range among the plans for point of indifference.

a) Point of indifference between plan A and B :

$$\frac{X-I_1(1-T) - D_p}{N_1} = \frac{(X-I_2)(1-T) - PD}{N_2}$$

Where,

(

X = EBIT at point of indifference

 $I_1 =$ Interest under plan 1

 $I_2 =$ Interest under plan 2

T = Tax rate

 $D_p =$ Preference dividend

 $N_1 =$ Number of equity shares under plan 1

N₂ - Number of equity shares under Plan 2

$$\frac{(X-0) (1-.5) - 0}{20,000} = \frac{(X-16,000) (1-.5) - 0}{10,000}$$

or
$$\frac{.5x}{20,000} = \frac{.5x - 8000}{10,000}$$

or
$$10,000 (.5x) = 20,000 (.5x - 8000)$$

or
$$.5x = 2 (.5x - 8000)$$

or
$$.5x = x - 16,000$$

or
$$.5x = 16,000$$

$$\therefore x = \frac{16,000}{5} = Rs.32,000$$

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Thus, point of difference between plan A and Plan B is Rs. 32,000.

b) Between plan A and C

 $\frac{(X-0) (1-.5) - 0}{20,000} = \frac{(X-0) (1-.5) - 16,000}{10,000}$

or

 $\frac{.5x}{20,000} = \frac{.5x - 16,000}{10,000}$ or .5x = 2 (.5x - 16,000)or .5x = x - 32,000or .5x = 32,000 $\therefore x = \frac{32,000}{.5} = Rs. 64,000$

c) Between plan B and C

$$\frac{(x-16,000) (1-.5)-0}{10,000} = \frac{(x-0) (1-.5)-16000}{10,000}$$

.5x - 8000 = .5x - 16,000

Thus, there is no point of indifference between plan B and C

7.5 Combined Leverage - Meaning and measurement

As discussed earlier, operating leveage measures the effect of a change in sales on EBIT. It explains the degree of operating risk. Financial leverge measures the effect of a change in operating EBIT or EPS. Thus, it explains the degree of financial risk. When these two leverages are combined it indicates the effect of change in sales on EPS. This combined leverage or composite leverage can be computed as follows :

Degree of Composite leverage = Operating Leverage x Financial Leverage

=- Sales - VC	= <u>Contribution</u>
EBIT	EBIT
= <u>EBIT</u> =	EBIT
EBT	EBIT - Interest ondehi
Contribution x El	BIT
EBIT E	BT
	$= \frac{Sales - VC}{EBIT}$ $= \frac{EBIT}{EBT}$ $\frac{Contribution}{EBIT} \times \frac{EH}{EB}$

= <u>Contribution</u>sales - <u>Variable operating Cost</u> EBT EBIT - Interest an debt The degree of combined or composite leverage can also be calculated as follows :

Degree of combined leverage = <u>Percentage change in EPS</u> Percentage change in sales

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Illustration 7

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ABC Ltd, has sales of Rs. 10,00,000; Variable cost of Rs. 4,00,000 and fixed costs of Rs. 2,00,000. It has a long term debt of Rs. 20,00,000 at 10% rate of interest. Calculate the operating, financial and combined leverages.

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Solution :

Sales :		Rs. 1	10,00,000	
Less Variable Cost :		Rs.	4,00,000	
Contribution :			6,00,000	
Less : Fixed Cost		ж ¹ ,	2,00,000	
EBIT			4,00,000	
Less Interest@10%			2;00,000	
EBT	· · · ·		2,00,000	
(1) APR 1, PALSE & PLAN 1, D. 1999 (1999)				

~		Contribution	$\frac{6,00,000}{-1.5}$
1)	Operating Leverage =	EBIT	$=\frac{1.5}{4,00,000}$

ii) Financial Leverage =
$$\frac{EBT}{EBT} = \frac{4,00,000}{2,00,000} = 2$$

iii) Composite Leverage = DOL x \cup FL = 1.5 x 2 = 3

 $\frac{Contribution}{EBT} = \frac{6,00,000}{2,00,000} = 3$

Illustration 8

or

A firm has sales of Rs. 20,00,000; variable cost of Rs. 14,00,000 and fixed costs of Rs. 4,00,000 and debt of Rs. 10,00,000 at 10% rate of interest. What are operating, financial and composite leverages? If the firm wants to double its EBIT, how much of a percentage rise would be needed?

Solution :

Rs.
20,00,000
14,00,000
6,00,000
4,00,000
2,00,000
1,00,000
1,00,000

	Contribution	$-\frac{6,00,000}{-3}$
a) Operating Leverage =	EBIT	$-\frac{1}{2,00,000}$

b) Financial Leverage = $\frac{EBIT}{EBT} = \frac{2,00,000}{1,00,000} = 2$

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c) Combined leverage = Operating leverage x Financial leverage = $3 \times 2 = 6$

Percentage rise in sales needed to double the EBIT :

As the operating leverage is 3, if sales increase by 100% EBIT will increase by 300%. So, if sales increase by 33 1/3%, EBIT will increase by 100%, i.e. EBIT will double.

7.12

Verification :

Sales (after 33 1/3 increase) (20,00,000+6,66,667)		26,66,667
Less : vairable cost (at 70% of sales)		18,66,667
Contribution :		8,00,000
Less : Fixed Cost		4,00,000
EBIT		4,00,000

7.6 Importance of Financial and Operating Leverages

The two important quantitative tools used by the financial experts to measure the return to equity shareholders and the market pirce of equity shares are the operating and financial leverages. Of these two tools, the financial leverage is considered to be superior, because it focusses the attention on the earnings of the shareholders and the market price of the shares.

A firm resorts to financial leverage or trading on equity to magnify the earnings of equity shareholders. Financial leverage is significant in the following two ways :

i) Planning of capital structure : The capital structure is concerned with the debt - equity ratio. It helps in selecting the optimum capital structure which gives the highest EPS.

ii) **Profit planning :** The earnings per share is affected by the degree of financial leverage. In case the profitablity of the firm is increasing, the fixed cost funds will help in increasing the availability of profits for equity shareholders. Thus, financial leverage is important for profit planning.

However, a firm cannot continue to increase debt capital to magnify shareholders' earnings because financial leverage has the risk of adversely affecting the earnings which is known as financial risk. If a firm employs more and more debt capital, it increases the financial risk. Moreover, a firm with widely fluctuating earnings cannot afford to employ more debt capital.

A company should try to have a balance of the two leverages because they got tremendous acceleration or deceleration effect on EBIT and EPS. A proper cambination of both operating and financial leverages is of great advantage to the firm's growth, while on inappropriate combination may prove to be a curse as explained below :

i) A very high degree of operating as well as financial leverages will make the position of a firm very risky. When both the leverages are high, it implies that the firm has high fixed operating cost and fixed interest charges. As a result, the carnings of shareholders widely fluctuate.

ii) If a firm has a high operating leverage, it should not have a high financial leverage. It should have a low financial leverage.

iii) In the same way, firm with a low operating leverage will get the benefit by having a high financial leverage, provided it has enough profitable opportunities for the borrowed funds.

iv) If both the leverages are low, it means that the management of the firm is adopting a very cautious attitude. It results in losing a good no. of investment opportunities.

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Of all the above cases, low operating leverage and high financial leverage is the ideal situation for making maximum profits with minimum of risk. So the management of the firm should properly combine both the leverages to get the maximum advantage.

7.7. Summary

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The use of fixed income - bearing debt and preference shares along with equity, for the benefit of owners of the firm is called financial leverage or trading on equity. Financial leverage has both favourable and adverse effect on shareholders' earnings. The degree of financial leverage is computed with the following formulae :

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

or DFL = $\frac{Percentage change in EPS}{Percentage change in Sales}$

The EBIT - EPS analysis helps in identifying the most appropriate financial plan from among various alternative financial plans. It helps in designing proper capital structure for a firm. The point of indifference refers to that level of earnings before interest and tax (EBIT) at which EPS remains the same, irrespective of different alternatives of debt - equity mix. This point is also known as break -even level of EBIT for alternative financial plans.

A company should try to have a balance of both operating and financial leverages, because they got tremendous acceleration or decelaration effect on EBIT and EPS. A proper combination of these leverages is of great advantage to the firm's growth.

7.8 Key words

Financial Leverage : It refers to the employment of fixed - income bearing securities in capital structure. Trading on Equity : Employment of debt capital for the benefit of equity shareholders.

Indifference point : It refers to that level of EBIT at which the EPS is the same for two Financial plans.

Composite Leverage : It is the combined effect of both financial and operating leverages.

EBIT-EPS analysis: It is an important tool which shows the effect of financial leverage on earnings per share.

7.9 Self - Assessment Questions

- What is meant by financial leverage? Explain how it magnifies the revenue available to equity 1. shareholders.
- 2. What is leverage? Distinguish between operating and financial leverages.
- 3. Explain the significance of operating and financial leverages.
- 4. Explain the following :
 - i) Financial leverage ii) Trading on equity

iii) Composite leverage

7.10 Suggested Readings

- 1. James C. Van Horne : Financial Management
- 2. Khan and Jain : Financial Management
- 3. Pandey I.M. : Financial Management