Leverage

Leverage refers to the employment of assets or sources of fund bearing fixed payment to magnify EBIT or EPS respectively. So it may be associated with investment activities or financing activities.

Mainly two types of leverages:

1. Operating leverage and

2. Financial leverage.

It is to be noted here that these two leverages are not independent of each other; rather they form a part of the whole process. So we want to know the combined effect of both investment and financing decisions. The combined effect of operating and financial leverage is measured with the help of combined leverage.

1. Operating Leverage:

Operating leverage is concerned with the investment activities of the firm. It relates to the incurrence of fixed operating costs in the firm's income stream. The operating cost of a firm is classified into three types: Fixed cost, variable cost and semi-variable or semi-fixed cost. Fixed cost is a contractual cost and is a function of time. So it does not change with the change in sales and is paid regardless of the sales volume.

2. Financial Leverage:

Financial leverage is mainly related to the mix of debt and equity in the capital structure of a firm. It exists due to the existence of fixed financial charges that do not depend on the operating profits of the firm. Various sources from which funds are used in financing of a business can be categorized into funds having fixed financial charges and funds with no fixed financial charges. Debentures, bonds, long-term loans and preference shares are included in the first category and equity shares are included in the second category.

3. Combined Leverage:

A firm incurs total fixed charges in the form of fixed operating cost and fixed financial charges. Operating leverage is concerned with operating risk and is expressed quantitatively by DOL. Financial leverage is associated with financial risk and is expressed quantitatively by DFL. Both the leverages are concerned with fixed charges. If we combine these two we will get the total risk of a firm that is associated with total leverage or combined leverage of the firm. Combined leverage is mainly related with the risk of not being able to cover total fixed charges.