RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM V SEM.

SUBJECT: FUNDAMANTAL TO FINANCIAL MANAGEMENT

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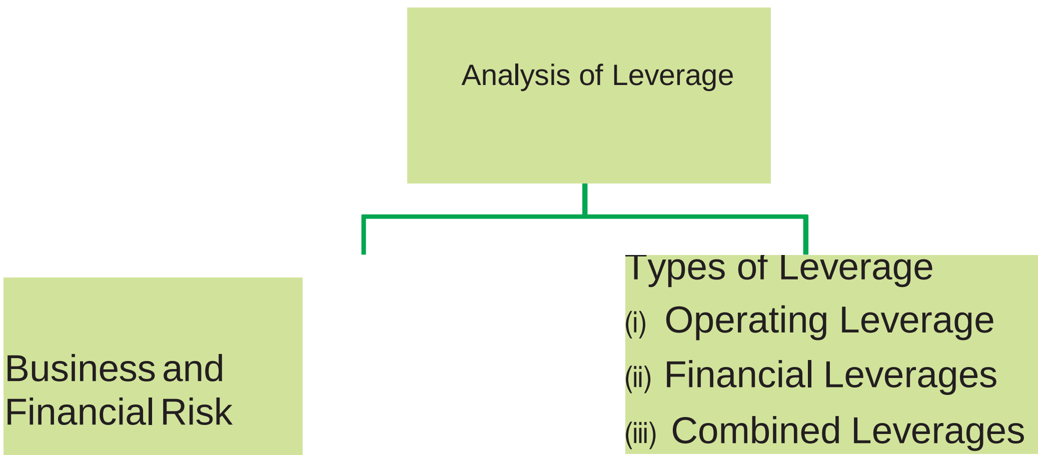
LECTURE: 25

NAME OF FACULTY: DR. PALASH BAIRAGI

LECTURE-25

FINANCIAL DECISION – LEVERAGE



A firm can finance its operations through common and preference shares, with retained earnings, or with debt. Usually a firm uses a combination of these financing instruments. Capital structure refers to a firm's debt-to-equity ratio, which provides insight into how risky a company is Capital structure decisions by firms will have an effect on the expected profitability of the firm, the risks faced by debt holders and shareholders, the probability of failure, the cost of capital and the market value of the firm.

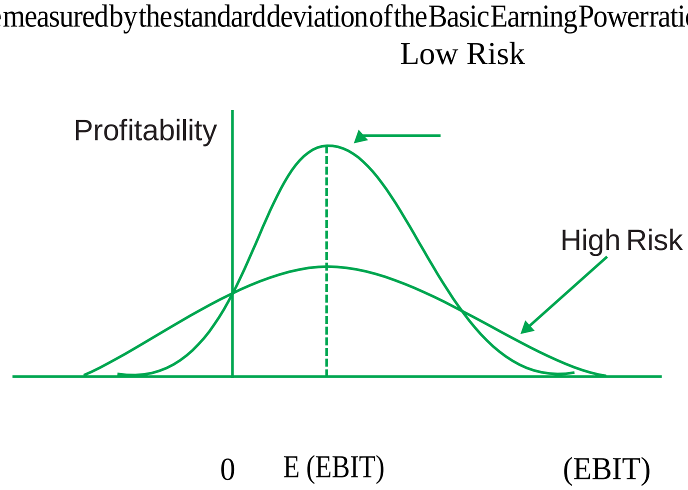
Business Risk and Financial Risk

Risk facing the common shareholders is of two types, namely business risk and financial risk. Therefore, the risk faced by common shareholders is a function of these two risks,

i.e. {Business Risk, Financial Risk}

Business Risk:- It refers to the risk associated with the firm's operations. It is the uncertainty about the future operating income (EBIT), i.e. how well can the operating incomes be predicted?

Business risk can be measured by the standard deviation of the Basic Earning Power ratio.



Financial Risk:- It refers to the additional risk placed on the firm's shareholders as a result of debt use i.e. the additional risk a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.

DEBT VERSUS EQUITY FINANCING

Financing a business through borrowing is cheaper than using equity. This is because:

- Lenders require a lower rate of return than ordinary shareholders. Debt financial securities present a lower risk than shares for the finance providers because they have prior claims on annual income and liquidation.
- A profitable business effectively pays less for debt capital than equity for another reason: the debt interest can be offset against pre-tax profits before the calculation of the corporate tax, thus reducing the tax paid.
- Issuing and transaction costs associated with raising and servicing debt are generally less than for ordinary shares.

These are some benefits from financing a firm with debt. Still firms tend to avoid very high gearing levels.

One reason is financial distress risk. This could be induced by the requirement to pay interest regardless of the cash flow of the business. If the firm goes through a rough period in its business activities it may have trouble paying its bondholders, bankers and other creditors their entitlement.

The relationship between Expected return (Earnings per share) and the level of gearing can be represented as: