

# Degree of operating leverage

Business, Company



### Operating Leverage:

Operating Leverage is the term that describes the impact on operating income of a change in the level of output. Brigham says that " If a high percentage of a firm's costs are fixed, and hence do not decline when demand decreases, this increases the company's business risk. This factor is called operating leverage. If a high percentage of a firm's total costs are fixed, the firm is said to have a high degree of operating leverage. The degree of operating leverage (DOL) is defined as the percentage change in operating income (or EBIT) that results from a given percentage change in sales.... In effect, the DOL is an index number which measures the effect of a change in sales [number of units] on operating income, or EBIT."

### Autron:

Generally, the higher the operating leverage, the more a company's income is affected by fluctuation in sales volume. The higher income vs. sales ratio results from a smaller portion of variable costs, which means the Company does not have to pay as much additional money for each unit produced or sold. The more significant the volume of sales, the more beneficial the investment in fixed costs becomes. Applying this principle the operating leverage of Autron is in a good position and any change in sales volume will not violently affect the income of this company.

### Ambertech:

The position of this company with respect to the Operating Leverage is not advantageous to the company as the ratio is high. It signifies that the fixed

costs are at a higher level. This means that any small change in sales volume will adversely affect the profitability of the company.

### Degree of Financial Leverage

#### Company

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#### Financial Leverage:

‘ Financial leverage’ is the term used to describe the impact on returns of a change to the extent to which the firm’s assets are financed with borrowed money. In their 1997 article Buccino and Mckinley define operating leverage as the impact of a change in revenue on profit or cash flow. It arises, they say, whenever a firm can increase its revenues without a proportionate increase in operating expenses. Cash allocated to increasing revenue, such as marketing and business development expenditures, are quickly " consumed by high fixed expenses."

#### Autron:

The degree to which a business is utilizing borrowed money. Companies that are highly leveraged may be at risk of bankruptcy if they are unable to make payments on their debt; they may also be unable to find new lenders in the future. Financial leverage is not always bad, however; it can increase the shareholders return on their investment and often there are tax advantages associated with borrowing. Applying this basic principle, with a low financial leverage, this company is utlising very lower level of borrowed funds. The

interest burden on the company will naturally be less and the company is financing its operations from its own sources.

Ambertech:

As against the company Autron, this company has high financial leverage which implies that the borrowings are more for this company and the company is running the risk of higher interest payments and meeting their debt commitments on dates.

Combined Leverage:

A leverage ratio that summarizes the combined effect the degree of operating leverage (DOL), and the degree of financial leverage has on earnings per share (EPS), given a particular change in sales. This ratio can be used to help determine the most optimal level of financial and operating leverage to use in any firm. This ratio can be very useful, as it summarizes the effects of combining both financial and operating leverage, and what effect this combination, or variations of this combination, has on the corporation's earnings

Autron:

It should be noted that a firm with a relatively high level of combined leverage is seen as riskier than a firm with less combined leverage, as the high leverage means more fixed costs to the firm. On the basis of the combined leverage ratio, it can be stated that the company Autron is less riskier as the leverage ratio of – 4. 296 is highly advantageous to the firm signifying a lower level of fixed costs and better profitability. As we have

seen in the Operating Leverage for this Company, any change in sales volume will result in more profits.

Ambertech:

In contrast to the company Autron, this company has a higher operating and financial leverage which has resulted in a higher combined leverage. This situation implies that the company's fixed costs are very high leading to lower profitability. Any change in sales volume will adversely affect the earnings of the company.

References:

1. Brigham, Eugene F., Fundamentals of Financial Management (1995).
2. Buccino, Gerald P. and Kraig S. McKinley, " The Importance of Operating Leverage in a Turnaround," Secured Lender (Sept./Oct. 1997), p. 64-68.