CHAPTER – 1

INTRODUCTION

1.1 ACCOUNTING

Accounting has evolved and emerged as a field in response to the social and economic needs of society. Accounting framework or methodology provide a technical means to measure, evaluate and communicate information of an economic and financial nature. Accounting is now related to a complex set of allocations and valuations pertaining to the operational activities of a business enterprise. The concept of accountancy or accounting is now broad enough to include the description of the recording, processing, classifying, evaluating, interpreting and supplying of economic-financial information for financial statement presentation and decision-making purpose. In its task, accounting has been successful technically and methodologically. Accounting as a subject has been evolving continuously ever since its inception. It has been through a rigorous and eventful procedure of invention, innovation and individualization.

The modern accounting, therefore, is not merely concerned with record keeping but also with a whole range of activities involving planning, control, decision-making, problem solving, performance measurement and evaluation, coordinating and directing, auditing, tax determination and planning, cost and management accounting and all such activities have to be carried out in way that are congruent with the needs and requirements of the society. After all, accountancy is meant for the larger good of the society.

1.2 SOCIAL RESPONSIBILITY AND ROLES

Accounting aims at designing a satisfactory information system, which may fulfil informational needs of different users and decision-makers. A business organization is regarded as an open system, which has a dynamic interplay with its environment from which it draws resources and to which it consigns its products and services. Business enterprises are an integral part of a nation. The enterprise must fulfil its obligations towards society in return for the rights and facilities that the society or the government gives them. As a result, their effect on society of that region is tremendous. The company executives know that their work has a notable effect on welfare of the society. Therefore, they give this information in their Annual Reports.
The stakeholders of the company, viz. shareholders, creditors, suppliers, managers, employees, tax authorities and others, are interested in broadly knowing about how the firm is doing and what is its financial condition. Of course, their concerns may differ. Trade creditors and short-term lenders are interested primarily in the short-term liquidity of the company and its ability to pay its dues in the next twelve months or so. Term lending institutions and debenture holders have a relatively longer time horizon and are concerned about the ability of the firm to service its debt over the next five to ten years. Long-term shareholders and managers who want to make a career with the company are interested in the profitability and growth of the company over an extended period of time.

1.3 RATIONALE FOR THE SELECTION OF THE PROBLEM & SIGNIFICANCE OF THE STUDY

When a company makes a financing decision, it has to consider all possible ways to fulfil its financial requirements. The decision to employ a particular source of finance is greatly influenced by the type of project to be financed, nature of capital requirement; the company’s earning capacity as also its debt repayment capacity and the prevailing market conditions among many other factors.

The management of a company goes through many brainstorming sessions before deciding on a particular capital structure- Equity dominated or Debt-dominated or trade-off between the two etc. Needless to say, the main purpose is to maximize the market value of the share and to fetch decent returns to the investors.

For the investors, Equity is a risky avenue for investment when compared with Debt funds. The returns on Equity Share Capital largely depend on the financial performance of the company, dividend policy of the company etc. and therefore the returns are not guaranteed. Whereas the debt fund gives assured returns and also ensures safety of investment.

For a company, Equity Shares is the least risky of all sources of finance. Distribution of equity dividend is always subject to company’s financial position and its future growth plans. However, debt fund or leverage when employed also entails regular payment of servicing charges (interest) and redemption of capital.
The dictionary meaning of the word leverage is ‘the power to control’ or ‘augmentation’ or ‘dominance’. In terms of business finance, the leverage is employment of debt fund or borrowed capital. Although leverage is purely a financial tool, it is used immensely by managers involved in the decision-making processes related to capital structuring decisions, mergers and acquisitions, ascertainment of cost of capital etc.

In today’s market conditions when the expectations of the Equity shareholders are rising, a company has to be able to determine a judicious mix of debt funds and owned funds. It has to verify whether the employment of debt fund to a certain degree helps, the company realise the cherished goals or not. After all, leverage is a very powerful phenomenon affecting a company’s profitability and liquidity and overall financial performance.

When a company involves debt in its capital structure, it invariably results in fixed charges that have to be paid to service the debt. This is a significant event because the company has to use these funds to augment its profitability. If such debt funds are not gainfully utilized, their use will prove to be counterproductive. In other words, the employment of debt in the capital structure has a deep impact on the profitability of the company. On the other hand, the liquidity of a company is also impacted by leverage. The greater the degree of debt funds employed, the greater will be outflow of cash in terms of cost of servicing the debt. That does affect the cash profit earned by a company. Moreover, debt funds also have to be redeemed after certain duration of time. That is major cash out flow for the company. However, if a company’s capital structure is dominated by equity alone, the advantage of tax shield will not be available. In order to fulfil expectations of high number of equity shareholders, the company has to distribute a greater portion of profit as dividend to equity shareholders. As long as the rate of earning is higher than the cost of borrowing, leverage is beneficial. However, if there is a possibility of a decline in the rate of earnings, the company should try to dispose of debt fund to the extent permitted by availability of sufficient funds or earnings generation or disposable short-term investments. Thus, the impact of leverage on the profitability and liquidity that a company enjoys presents a wide, comprehensive and interesting scope for research and analysis.
Several Indian industries have written success stories that have made India proud today. Several companies from the leading industries have employed debt funds, which in some cases exceed 50% of total corporate funding. The data published by RBI and SEBI reveals that incidence of debt capital as compared to Equity funds has been consistently high since 1995. In spite of having fix-charge bearing securities in their capital structure, many companies have lavishly rewarded their shareholders and at the same time, they have pumped huge funds into R & D without displeasing the investor. That by itself is a commendable feat. The incidence of sickness in those industries has been much less, almost non-existent.

TABLE – 1.1

GROWTH OF STOCK EXCHANGES

<table>
<thead>
<tr>
<th>Sr.</th>
<th>On 31st Dec</th>
<th>1946</th>
<th>61</th>
<th>71</th>
<th>80</th>
<th>91</th>
<th>95</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No. Of St. Exchanges</td>
<td>7</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>20</td>
<td>22</td>
</tr>
<tr>
<td>2</td>
<td>No. Of Listed Companies</td>
<td>1125</td>
<td>1203</td>
<td>1599</td>
<td>2265</td>
<td>6229</td>
<td>8593</td>
</tr>
<tr>
<td>3</td>
<td>No. Of Securities issued by listed companies</td>
<td>1506</td>
<td>2111</td>
<td>2838</td>
<td>3697</td>
<td>8947</td>
<td>11784</td>
</tr>
<tr>
<td>4</td>
<td>Capital of listed companies CIRI (Crore Rs.)</td>
<td>270</td>
<td>753</td>
<td>1812</td>
<td>3973</td>
<td>32041</td>
<td>59583</td>
</tr>
<tr>
<td>5</td>
<td>Market value of capital of listed companies (Crore Rs.)</td>
<td>971</td>
<td>1292</td>
<td>2675</td>
<td>6750</td>
<td>110279</td>
<td>478121</td>
</tr>
</tbody>
</table>

Source: RBI Handbook Page No. 339-342

In the above exhibit, it can be conferred that the number of stock exchanges has risen from 7 in 1946 to 23 in 2009. There is humungous growth seen the number of companies registered, in that in the year 1946, only 1125 companies were registered which grew to a whopping 10575 in the year 2009. The amount of capital registered has shown exponential growth in that in the year 1946 the total capital formation of the registered companies was Rs. 270 crores which snowballed to a staggering 93,297 crores in the year 2009. This clearly shows that Indian corporate clearly stands apart when it comes to phenomenal growth. It is interesting to observe the pattern of finance adopted by the companies and the underlying considerations for selection of particular type or types of securities to raise finance.
### TABLE – 1.2
**CAPITAL FORMATION BY NON-GOVERNMENT COMPANIES**

<table>
<thead>
<tr>
<th>Sr.</th>
<th>Year</th>
<th>Amount (Rs. In Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2005-06</td>
<td>21154.00</td>
</tr>
<tr>
<td>2</td>
<td>2006-07</td>
<td>31600.00</td>
</tr>
<tr>
<td>3</td>
<td>2007-08</td>
<td>43737.59</td>
</tr>
<tr>
<td>4</td>
<td>2008-09</td>
<td>14670.59</td>
</tr>
</tbody>
</table>

Source: RBI Handbook Page No. 339-342

The above table shows the amount of capital formation by corporates which bear a testimony to the growing contribution and dominance of corporates.

### TABLE – 1.3
**PERCENTAGE OF DEBT FUND TO TOTAL FUNDS**

<table>
<thead>
<tr>
<th>Sr.</th>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1995-96</td>
<td>56.60</td>
</tr>
<tr>
<td>2</td>
<td>1996-97</td>
<td>73.10</td>
</tr>
<tr>
<td>3</td>
<td>1997-98</td>
<td>94.50</td>
</tr>
<tr>
<td>4</td>
<td>1998-99</td>
<td>98.20</td>
</tr>
<tr>
<td>5</td>
<td>1999-2000</td>
<td>93.40</td>
</tr>
<tr>
<td>6</td>
<td>2000-01</td>
<td>95.40</td>
</tr>
<tr>
<td>7</td>
<td>2001-02</td>
<td>98.20</td>
</tr>
<tr>
<td>8</td>
<td>2002-03</td>
<td>97.90</td>
</tr>
<tr>
<td>9</td>
<td>2003-04</td>
<td>78.30</td>
</tr>
<tr>
<td>10</td>
<td>2004-05</td>
<td>78.20</td>
</tr>
<tr>
<td>11</td>
<td>2005-06</td>
<td>77.90</td>
</tr>
<tr>
<td>12</td>
<td>2006-07</td>
<td>81.70</td>
</tr>
<tr>
<td>13</td>
<td>2007-08</td>
<td>73.40</td>
</tr>
<tr>
<td>14</td>
<td>2008-09</td>
<td>93.50</td>
</tr>
</tbody>
</table>

Source: RBI Annual Statistics
Growing dominance of debt funds can be understood from the above exhibit. Of the total capital raised in the year, 1995-96 only 56.60% constituted debt funds. But over the last decade, debt as component in the total capital raised has grown steadily and in the year 2008-2009 it constituted about 93.50% of the total funds raised by the corporates. It shows that debt as an instrument of finance is very popular with corporates and the magnitude and importance of debt funds again justifies a thorough research on the impact of financial leverage on the financial performance of selected Indian industries.

<table>
<thead>
<tr>
<th>Sr.</th>
<th>Year</th>
<th>No. Of Stock Exchanges</th>
<th>Listed Companies on BSE</th>
<th>Market Capitalization (BSE) (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1993</td>
<td>21</td>
<td>2861</td>
<td>21.7</td>
</tr>
<tr>
<td>2</td>
<td>1994</td>
<td>22</td>
<td>3585</td>
<td>36.2</td>
</tr>
<tr>
<td>3</td>
<td>1995</td>
<td>22</td>
<td>04702</td>
<td>36.5</td>
</tr>
<tr>
<td>4</td>
<td>1996</td>
<td>22</td>
<td>5603</td>
<td>38.2</td>
</tr>
<tr>
<td>5</td>
<td>1997</td>
<td>22</td>
<td>5832</td>
<td>36.6</td>
</tr>
<tr>
<td>6</td>
<td>1998</td>
<td>22</td>
<td>5835</td>
<td>41.3</td>
</tr>
<tr>
<td>7</td>
<td>1999</td>
<td>23</td>
<td>5849</td>
<td>35.4</td>
</tr>
<tr>
<td>8</td>
<td>2000</td>
<td>23</td>
<td>5815</td>
<td>46.8</td>
</tr>
<tr>
<td>9</td>
<td>2001</td>
<td>23</td>
<td>5869</td>
<td>29.3</td>
</tr>
<tr>
<td>10</td>
<td>2002</td>
<td>23</td>
<td>5762</td>
<td>26.9</td>
</tr>
<tr>
<td>11</td>
<td>2003</td>
<td>23</td>
<td>5650</td>
<td>23.3</td>
</tr>
<tr>
<td>12</td>
<td>2004</td>
<td>23</td>
<td>5528</td>
<td>43.6</td>
</tr>
<tr>
<td>13</td>
<td>2005</td>
<td>22</td>
<td>4731</td>
<td>52.4</td>
</tr>
<tr>
<td>14</td>
<td>2006</td>
<td>22</td>
<td>4781</td>
<td>81.8</td>
</tr>
<tr>
<td>15</td>
<td>2007</td>
<td>21</td>
<td>4821</td>
<td>82.6</td>
</tr>
<tr>
<td>16</td>
<td>2008</td>
<td>19</td>
<td>4887</td>
<td>103</td>
</tr>
<tr>
<td>17</td>
<td>2009</td>
<td>19</td>
<td>4929</td>
<td>55.3</td>
</tr>
<tr>
<td>18</td>
<td>2010</td>
<td>19</td>
<td>4875</td>
<td>94.1</td>
</tr>
<tr>
<td>19</td>
<td>2011</td>
<td>19</td>
<td>5067</td>
<td>86.3</td>
</tr>
</tbody>
</table>
The number of listed companies has risen from 2861 in the year 1993 to 5067 in the year 2011. The number of listed companies has almost doubled in last twenty years. The role of Bombay Stock Exchange has been growing not just in size but in terms of its impact on the overall economy of the country also. More details have been pencilled out in the following chapters.

### TABLE – 1.5

**RESOURCE MOBILISATION BY CORPORATE SECTOR**

<table>
<thead>
<tr>
<th>Issues</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Securities</td>
<td>2235161</td>
<td>3847256</td>
<td>2726653</td>
<td>43870</td>
<td>85229</td>
<td>61067</td>
</tr>
<tr>
<td>Domestic Issues</td>
<td>2187281</td>
<td>3687586</td>
<td>2632243</td>
<td>42930</td>
<td>81692</td>
<td>58953</td>
</tr>
<tr>
<td>Public Issues</td>
<td>146710</td>
<td>254790</td>
<td>248300</td>
<td>2879</td>
<td>5644</td>
<td>5561</td>
</tr>
<tr>
<td>Private Placement</td>
<td>2040571</td>
<td>3432796</td>
<td>2383943</td>
<td>40050</td>
<td>76048</td>
<td>53392</td>
</tr>
<tr>
<td>Euro Issues</td>
<td>47880</td>
<td>159670</td>
<td>94410</td>
<td>940</td>
<td>3537</td>
<td>2114</td>
</tr>
<tr>
<td>Government securities</td>
<td>4366880</td>
<td>6236190</td>
<td>5835210</td>
<td>85709</td>
<td>138152</td>
<td>130688</td>
</tr>
<tr>
<td>Central Government</td>
<td>3185500</td>
<td>4924970</td>
<td>4794820</td>
<td>62522</td>
<td>109104</td>
<td>107387</td>
</tr>
<tr>
<td>State Government</td>
<td>1181380</td>
<td>1311220</td>
<td>1040390</td>
<td>2187</td>
<td>29048</td>
<td>23301</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>6602041</td>
<td>10083446</td>
<td>8561863</td>
<td>129579</td>
<td>223382</td>
<td>191755</td>
</tr>
</tbody>
</table>

As can be observed in the above table, there is humongous growth in the resources mobilised by the corporate sector as well as government sector. This provides an interesting opportunity to analyse and interpret the modes through which industries raise finance and how judiciously they utilise the same. All these factors pose a fruitful scenario to investigate the impact of financial leverage on the financial performance of the selected companies belonging to selected industries.

Financial performance largely influenced by the composition of capital structure. Capital-structure management is of paramount importance for the financial success of any company.
1.4 CAPITAL STRUCTURE – MEANING & TYPES

For any firm there are two principal sources of finance available to it - equity and debt. The capital structure is a term that refers to the sources of finance that a firm has employed to fulfil its capital requirements. It is a bouquet of securities issued or sources employed for capital formation. It is also known as a financing-mix of debt and equity.

The choice of a particular capital structure goes a long way in influencing the market value of a firm. It has a significant impact on the expected earnings of a firm or cost of capital and in some circumstances both.

Capital structure is essentially a mix of various sources of finance. These sources are Equity Share Capital, Retained Earnings, Preference Share Capital and Debt funds including debentures.

A non-leveraged firm has a distinct capital structure which is marked by complete absence of borrowed funds, where as a leveraged firm has a capital structure which has some element of debt in it. Let us take both i.e. a non-leveraged base and a leveraged base as the basis for studying the impact of leverage on capital structure.

1.4.1 NON-LEVERED BASE:

When a firm has no leverage in its capital structure, it may have prominently issued Equity Share Capital as a major source of finance. Retained earnings are also a source of finance. So the capital structure can include Retained earnings apart from Equity Share Capital. Let us study the characteristics, benefits and limitations arising from such capital structure.

1.4.1.1 TYPE 1- EQUITY SHARES ALONE:

When a company funds its capital requirement only through issue of Equity shares or ordinary shares, it is known as Equity-centric capital structure.
CHARACTERISTICS:

(1) There is no element of debt in this type of capital structure and hence all the advantages of employing debt are forgone at once.
(2) Equity share-holders are real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run.
(3) Dividend payment on such securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay dividends.

BENEFITS:

(1) The main benefit is that there is no fixed-charge on such securities. There is no legal obligation to pay dividend.
(2) Secondly, such securities are not to be redeemed until it goes into liquidation. So there is no need for the company to make any financial provision.
(3) All the decisions made by the board of directors have the approval of the shareholders because it is the equity shareholders who dominate the proceedings in such company.
(4) To an extent, risk is avoided because borrowed funds always entail fixed-charges which can be a huge financial burden when the company is not able to earn sufficiently or its earnings are fluctuating and uncertain.

Obviously, this is not always a good idea to issue only equity shares alone for such capital structure suffers from limitations.

LIMITATIONS:

(1) The first major limitation is that all the tax benefits of employing debt funds are sacrificed.
(2) The control over management is also diluted because the equity shareholders have a right to attend and participate in all meetings and decision making process. They are also endowed with voting powers.
(3) Besides, the floating cost of such shares is higher than that of debt fund.
(4) Equity shareholders also come last when it comes to staking a claim to the company’s assets at the time of liquidation. Generally, the claims of ordinary shareholders remain unpaid.
The shareholders do expect the normal rate of return on their investment plus capital gain commensurate with risk involved. These expectations of shareholders have to be largely fulfilled. Otherwise it can demoralise such investors and in future when the requirement for funds arises, they may not rally behind the company.

1.4.1.2 TYPE 2 – EQUITY SHARES WITH RETAINED EARNINGS:

The term “retained earnings” refers to the accumulated net income that has been retained for reinvestment in the firm rather than being paid out in the form of dividends to shareholders. It can also be called internal equity. Net income that is retained in the business can be used to acquire additional income-earning assets that result in increased income in future years. The same can be used to finance expansion plans.

CHARACTERISTICS:

(1) Such capital structure has Equity share capital as well as retained earnings.
(2) There is no element of debt in this type of capital structure and hence all the advantages of employing debt are forgone at once.
(3) It is believed that both are cost free sources of funds. They don’t carry any explicit financial cost.
(4) Retained earnings are that portion of income which is not distributed as dividend.
(5) Retained earnings are also ploughing back of profit.
(6) Equity share-holders are real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run
(7) Dividend payment on such securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay dividends.

Now lets us examine the BENEFITS accruing from it:

(1) The main benefit is that there is no fixed-charge on such securities. There is no legal obligation to pay dividend.
(2) Secondly, such securities are not to be redeemed until it goes into liquidation. So there is no need for the company to make any financial provision.
(3) All the decisions made by the board of directors have the approval of the shareholders because it is the equity shareholders who dominate the proceedings in such company.

(4) To an extent, risk is avoided because borrowed funds always entail fixed-charges which can be a huge financial burden when the company is not able to earn sufficiently or its earnings are fluctuating and uncertain.

(5) Retained earnings do not entail any financial obligation for the company and are readily available for use.

(6) Retained earnings are also a cost effective way of raising finance. Because if new shares are issued, it may have to incur floatation cost. But in case of retained earnings, there is no such cost.

Clearly, this combination also suffers from some LIMITATIONS:

(1) The first major limitation is that all the tax benefits of employing debt funds are sacrificed.

(2) The control over management is also diluted because the equity shareholders have a right to attend and participate in all meetings and decision making process. They are also endowed with voting powers.

(3) Besides, the floating cost of such shares is higher than that of debt fund. Retained earnings, however, do not entail such cost.

(4) Equity shareholders also come last when it comes to staking a claim to the company’s assets at the time of liquidation. Generally, the claims of ordinary share-holders remain unpaid.

(5) The shareholders do expect the normal rate of return on their investments and also the retained part of profit apart from a capital gain commensurate with risk involved. These expectations of shareholders have to be largely fulfilled. Otherwise it can demoralise such investors and in future when the requirement for funds arises, they may not rally behind the company.

(6) The opportunity cost involved in case of Equity shares and Retained earnings cannot be ignored by the company. So the general belief that both are cost-free sources of funds does not hold true in reality.
1.4.2 LEVERED BASE:

When a company uses debt in its capital structure along with Equity Share Capital, it can be said to be a levered company. Preference shares are also known as hybrid security. Use of leverage offers many advantages if used in favourable conditions. In unfavourable conditions, use of leverage can prove to be inimical and detrimental to the financial health of the company. This shall be explained later on.

1.4.2.1 TYPE 1 – EQUITY SHARES WITH PREFERENCE SHARE CAPITAL:

When a company issues Preference Share Capital apart from Equity share capital, to fulfil its financial requirements, its Capital Structure has both Equity shares on which dividend payment is not mandatory as well as Preference Shares on which, dividend payment is required if the company posts profit or in case of loss, dividend can be carried forward.

CHARACTERISTICS:

(1) Preference shares have features of both Equity shares and Debenture. So dividend payment can be deferred despite being an obligation.

(2) In the presence of Preference shares, the Equity shares play a second fiddle, in that Preference shares have a priority over Equity shares when it comes to dividend payment.

(3) Preference dividend is not tax deductible. It offers no tax benefits.

(4) In such a capital structure, there is no pure debt which results in zero tax benefit in terms of reduced tax liability.

(5) The rate of preference dividend is fixed and preference shareholders also have claims on income and assets prior to common shareholders.

(6) Equity share-holders are real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run.

(7) Dividend payment on common securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay equity dividends.
BENEFITS:

(1) Combination of Equity and Preference presents a riskless leverage in that non-payment of preference dividend will not enforce insolvency upon company.

(2) The preference shareholders have no voting rights. So the control over the management is not diluted.

(3) Preference shares are a clever way to undermine the dominance of Equity shareholders.

(4) Preference dividend can be postponed and Equity dividend is of course not mandatory. Hence, in both the cases, the company can schedule dividend payment to suit company’s financial convenience.

(5) Combination of Equity share capital and Preference share capital presents more flexibility and imposes fewer burdens.

(6) There is also an option to convert preference shares into equity shares which takes care of issue of redemption of Preference share capital.

LIMITATIONS:

(1) The first major limitation is that all the tax benefits of employing debt funds are sacrificed. Preference dividend offers no tax shield.

(2) The control over management may also be diluted because certain types of preference shares do have limited voting rights.

(3) Besides, the floating cost of both the types of shares is higher than that of debt fund.

(4) Equity shareholders also come last when it comes to Staking a claim to the company’s assets at the time of liquidation. Generally, the claims of ordinary shareholders remain unpaid. Preference shareholders have priority claims on incomes and assets which may demoralise the ordinary shareholders.

(5) The equity shareholders do expect the normal rate of return on their investments and also the retained part of profit apart from a capital gain commensurate with risk involved. In a scenario where preference shareholders are paid the dividend but the equity shareholders are not, it can have inimical impact on the faith of equity shareholders in the company and in future when the requirement for funds arises, they may not rally behind the company.
(6) The opportunity cost involved in case of Equity shares cannot be ignored by the company.

(7) Preference dividend only be deferred and not negated to the shareholders. There is no escaping the financial outgo.

1.4.2.2 TYPE2 – EQUITY SHARES WITH DEBT:

When a company also uses debt in its capital structure, it also imbibes the element of leverage in it. Debt includes debentures, bonds and long term loans. They are all long-term sources of finance and they are the financiers or creditors of the company. This also means that the firm has to pay interest on the debentures or term loans or bonds. It is a legal obligation and has to be fulfilled. Beside, such securities also come with redemption clause. They have to be redeemed or retired after a specified period of time. Interest on debentures has to be paid before any dividends are disbursed. Upon the failure to do so, a company can be forced into bankruptcy. Such creditors also have a claim on the assets of the company and are pegged ahead of ordinary shareholders. Here the company has to carefully tread between the cost of raising such debts on the one hand and the rate return on its net assets on the other hand.

CHARACTERISTICS:

(1) Inclusion of debt results in payment of interest on the amount borrowed which is a liability.

(2) The interest paid on the debt is tax-deductible and therefore provides the benefit of tax-shield.

(3) Debenture holder or debt holders are merely providers of finance and they have no voting rights. This will not dilute the control over management.

(4) Creditors or financiers have no claim to the assets of the company.

(5) Unlike Equity share capital, such debt or debentures have to be redeemed after a certain period of time and that calls for special provision of finance.

(6) Floating of debt can be a success or failure depending on the market conditions, firms own ability to make use of it and stability of the company’s earnings.
BENEFITS:

(1) Interest paid on the debt being a tax-shield reduces tax liability of the company.
(2) Debt holders of are financiers or creditors of the company with no voting rights and hence the control over management is not diluted.
(3) Under favourable market conditions, it can enhance the company’s earnings without posing significant amount of financial risk.
(4) Debt or debentures are a redeemable source of finance so when the company has enough finance to dispose its debt it can do so and can become debt-free.
(5) The rate of interest on debt provides a benchmark rate of return to the company. The funds borrowed have to be invested such as to generate at least as much as to service the debt.
(6) Those firms whose rate or earnings are consistently high can take full advantage of such debt.
(7) Judicious use of debt funds can increase the Earnings Per Share (EPS) available to the shareholders.
(8) Floatation cost of debt fund is the least as compared with that of other securities.

LIMITATIONS:

(1) Under highly volatile market conditions, use of debt can be disadvantageous.
(2) Use of debt can be advantageous only if actual rate of earnings is higher than the rate paid on borrowing. It is a double-edged sword.
(3) Borrowed funds if not used wisely can erode the earnings of the company and it may lose confidence of the investors and shareholders apart from facing adverse financial implications.
(4) Use of debt is a purely risk-laden leverage and not a risk-free leverage offered by Preference share capital.
(5) Interest on debt has to be paid by any means. So a company may have to borrow even more to service its debt, if circumstance so demand.

1.4.2.3 TYPE 3- EQUITY, DEBT AND PREFERENCE:

In this combination apart from Equity shares and debt funds, the company also issues preference shares also known as a hybrid security. As preference shareholders have a priority with respect to claims on income and assets over equity shareholders, it is
considered less risky for investors. From the company’s point of view, there is no legal obligation to pay the preference dividends subject to conditions and its non-payment also does not force the company to go into bankruptcy. But if the company pays equity dividend, it has to pay preference dividend first. Again, like equity dividend the preference dividend is not tax-deductible, so it does not provide tax-shield. But inclusion of debt in the capital structure overcomes this lacuna. However, the rate of preference dividend is fixed. Preference shareholders also have no voting rights and any say in the management of the company. This financing-mix will reduce the profit available to equity shareholders in the form of EPS or Equity dividend. Debt provides the benefit of tax shied and the providers of finance are mere financiers of the company and not owners. They have no voting rights and control over management.

CHARACTERISTICS:

(1) Inclusion of debt results in payment of interest on the amount borrowed which is a liability. That is not true in case of Preference share capital or Equity share capital.

(2) The interest paid on the debt is tax-deductible and therefore provides the benefit of tax-shield. No such benefit in case of preference or equity dividend.

(3) Debenture holder or debt providers are merely providers of finance and they have no voting rights. This will not dilute the control over management.

(4) Unlike equity shareholders, creditors or financiers of debt have no claim to the assets of the company.

(5) Unlike Equity share capital, such debt or debentures have to be redeemed after a certain period of time and that calls for special provision of finance.

(6) Floating of debt can be a success or failure depending on the market conditions, firm’s own ability to make use of it and stability of the company’s earnings.

(7) Preference shares have features of both Equity shares and Debenture.

(8) So dividend payment can be deferred despite being an obligation.

(9) In the presence of Preference shares, the Equity shares play a second fiddle, in that Preference shares have a priority over Equity shares when it comes to dividend payment.

(10) The rate of preference dividend is fixed and preference shareholders also have claims on income and assets prior to common shareholders.
(11) Equity share-holders are the real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run.

(12) Dividend payment on common securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay equity dividend.

BENEFITS:

(1) Interest paid on the debt being a tax-shield reduces tax liability of the company. This compensates the non-availability of such benefits from Preference share capital.

(2) Debt holders of are financiers or creditors of the company with no voting rights and hence the control over management is not diluted.

(3) Under favourable market conditions, debt can enhance the company’s earnings without posing significant amount of financial risk.

(4) Debt or debentures are a redeemable source of finance so when the company has enough finance to dispose its debt it can do so and can become debt-free.

(5) The rate of interest on debt provides a benchmark rate of return to the company. The funds borrowed have to be invested such as to generate at least as much as to service the debt.

(6) Those firms whose rate or earnings are consistently high can take full advantage of such debt.

(7) Judicious use of debt funds can increase the Earnings Per Share (EPS) available to the shareholders.

(8) Floatation cost of debt fund is the least as compared with that of the other securities.

(9) Preference shares have features of both Equity shares and Debenture. So Preference dividend payment can be deferred despite being an obligation.

(10) Such a capital structure offers the benefits of both pure risk leverage (debt) and risk-free leverage (Preference share capital).

(11) The rate of preference dividend is fixed and preference shareholders also have claims on income and assets prior to common shareholders.
(12) Equity share-holders are real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run.

(13) Dividend payment on common securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay equity dividends. This can off-load the financial burden from the company.

LIMITATIONS:

(1) Under highly volatile market conditions, use of debt can be disadvantageous.

(2) Use of debt can be advantageous only if actual rate of earnings is higher than the rate paid on borrowing. It is a double-edged sword.

(3) Borrowed funds if not used wisely can erode the earnings of the company and it may lose confidence of the investors and shareholders apart from facing adverse financial implications.

(4) Interest on debt has to be paid by any means. So a company may have to borrow even more to service its debt, if circumstance so demand.

(5) Total floating cost of raising finance increases with the presence of Equity share capital and Preference share capital. Debt involves least floatation cost.

(6) Interest on debt and preference dividend can significantly reduce the profit available to Equity share holder. The shareholders do expect the normal rate of return on their investments and also the retained part of profit apart from a capital gain commensurate with risk involved. These expectations of shareholders have to be largely fulfilled. Otherwise it can demoralise such investors and in future when the requirement for funds arises, they may not rally behind the company.

(7) In such a capital structure, the cost of servicing the debt is double-fold. Preference dividend can only be deferred and not negated to the shareholders. There is no escaping the financial outgo. Again, interest on debt is mandatory-profit or no profit.

1.4.2.4 TYPE 4-EQUITY, DEBT, PREFERENCE AND RETAINED EARNINGS:

In such a financial make-up of the company, the company has features, advantages and disadvantages of both – levered as well as non-levered capital structure. Retained
earnings are a reliable source of long term financing. In simple words, it is the use of internal accruals and as mentioned earlier it is also an internal equity. Unlike Equity shares or preference shares, to raise funds through retained earnings are easy as no formal and legal procedures are required as also shareholders’ approval. It is also not a debt, so it does not entail fixed charges unlike debentures or preference shares. It is advantageous to the company as there is no floatation cost involved in it. Most important of all is that the board of directors also don’t dilute their control over the company with the use of retained earnings.

CHARACTERISTICS:

(1) Preference shares have features of both Equity shares and Debenture. So dividend payment can be deferred despite being an obligation.

(2) Preference shares have a priority over Equity shares when it comes to dividend payment.

(3) Preference dividend is not tax deductible. It offers no tax benefits, which is compensated by issuance of debt.

(4) In such a capital structure there is pure debt which results in zero tax benefit in terms of reduced tax liability and there is risk-free debt i.e. preference shares.

(5) Retained earnings are purported to be cost free but there are other costs it involves.

(6) The rate of preference dividend is fixed and preference shareholders also have claims on income and assets prior to common shareholders.

(7) Equity share-holders are real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run.

(8) Dividend payment on common securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay equity dividends. Debt interest has to be paid whether the company is earning profit or incurring loss.

(9) Retained earnings are that portion of income which is not distributed as dividend.

(10) Retained earnings are also ploughing back of profit with no explicit cost like interest on debentures or dividend on preference shares.
BENEFITS:

(1) Interest paid on the debt being a tax-shield reduces tax liability of the company. This compensates the non-availability of such benefits from Preference share capital.

(2) Equity shares and Retained earnings both are cost-free funds.

(3) Debt holders are financiers or creditors of the company with no voting rights and hence the control over management is not diluted.

(4) Under favourable market conditions, debt can enhance the company’s earnings without posing significant amount of financial risk.

(5) Debt or debentures are a redeemable source of finance so when the company has enough finance to dispose its debt it can do so and can become debt-free.

(6) The rate of interest on debt provides a benchmark rate of return to the company. The funds borrowed have to be invested such as to generate at least as much as to service the debt. There is no such binding in case of Equity shares or retained earnings.

(7) Those firms whose rate or earnings are consistently high can take full advantage of such debt.

(8) Judicious use of debt funds can increase the Earnings Per Share (EPS) available to the shareholders who have provided not just initial capital but also a part of undistributed dividends in the form of retained earnings.

(9) Floatation cost of debt fund is the least as compared with that of the other securities. Again, retained earnings, as a source of finance is cost-free.

(10) Preference dividend payment can be deferred despite being an obligation.

(11) Such a capital structure offers the benefits of both pure risk leverage (debt) and risk-free leverage (Preference share capital).

(12) Equity share-holders are real owners of a company and also the claimants of the residue income, which can be in the form of dividends and retained earning which shall be beneficial in the long-run.

(13) Dividend payment on common securities is left to the discretion of the company’s Board of Directors. There is no legal obligation to pay equity dividends. This can off-load the financial burden from the company.
LIMITATIONS:

1. Under highly volatile market conditions, use of debt can be disadvantageous. A huge portion of finance cannot be raised through retained earnings alone.

2. Use of debt can be advantageous only if the actual rate of earnings is higher than the rate paid on borrowing. It is a double-edged sword.

3. Borrowed funds, if not used wisely, can erode the earnings of the company and it may lose confidence of the investors and shareholders apart from facing adverse financial implications.

4. Interest on debt has to be paid by any means. So a company may have to borrow even more to service its debt, if circumstance so demand.

5. Total floating cost of raising finance increases with the presence of Equity share capital and Preference share capital. Debt involves least floatation cost.

6. Interest on debt and preference dividend can significantly reduce the profit available to Equity shareholders. The shareholders do expect the normal rate of return on their investments and also the retained part of profit apart from a capital gain commensurate with risk involved. These expectations of shareholders have to be largely fulfilled. Otherwise, it can demoralise such investors and in future when the requirement for funds arises, they may not rally behind the company.

7. In such a capital structure, the cost of servicing the debt is double-fold. Preference dividend can only be deferred and not negated to the shareholders. There is no escaping the financial outgo. Again, interest on debt is mandatory-profit or no profit.

1.5 LEVERAGE

Leverage is an important factor having great influence on the financing decision or capital structure decision of a firm. There are several sources at the disposal of a firm to raise capital or fulfill its funding requirements. All these sources of financing entail different costs. In this context, Leverage is of paramount importance. Leverage can be described as an employment of a source of fund which requires the firm to pay the fixed charges or fixed return- e.g. if debentures are employed, interest on debentures has to be paid or if preference shares are employed, dividend has to be paid. There is
no great variation in the way in which eminent experts have defined leverage. But a few of the definitions are as under:

According to M.Y. Khan and P.K. Jain “Leverage may be defined as the employment of an asset or sources of funds for which the firm has to pay a fixed cost or fixed return’’

According to Ravi M. Kishore “Leverage refers to the ability of a firm in employing long term funds having a fixed cost, to enhance returns to the owners”

Prasanna Chandra has defined leverage as the extent to which the firm has fixed operating costs or the extent to which the firm has fixed financing costs arising from the use of debt capital.

1.5.1 TYPES OF LEVERAGE

There are basically two types of Leverage 1) Operating Leverage and 2) Financial Leverage but when a firm resorts to a Leverage which imbibes the elements of both the types of Leverage, a third type of Leverage comes into being which is Combined Leverage.

1.5.2 OPERATING LEVERAGE:

When there are fixed costs or expenses in the firm’s income stream, Operating Leverage results. The firm which employs fixed costs must be able to use the same to magnify the effects of changes in its sales on its earnings before interest and taxes (EBIT). The overriding concern for the firm is that it must be able to meet the fixed costs regardless of volume.

1.5.3 FINANCIAL LEVERAGE:

Financial Leverage pertains to financing activity of a firm. The sources from where a firm can raise its resources can be categorised into two types 1) Those sources which carry a fixed financial charge 2) those sources which do not have involve fixed charges. Financial Leverage is a fall out of employment of fixed-charges bearing securities or sources of finance. The overriding concern of the firm here is to fulfil the contractual obligations and still the changes in the earnings before interest and tax (EBIT) should result in greater Earning Per Share (EPS).
1.5.4   COMBINED LEVERAGE:

When a firm employs fixed costs in its income streams as well as fixed-charge bearing sources of finance, it can be said to have employed Combined Leverage. This entails not only operating risk but also financial risk.

1.5.5   FINANCIAL LEVERAGE – Meaning & Significance:

When a company makes a financing decision, it has to consider all possible ways to fulfil its financial requirements. The decision to employ a particular source of finance is greatly influenced by the type of project to be financed, nature of capital requirement; the company’s earning capacity as also its debt repayment capacity and the prevailing market conditions among many other factors.

The management of a company goes through many brainstorming sessions before deciding on a particular capital structure- Equity dominated or Debt-dominated or trade-off between the two etc. Needless to say, the main purpose is to maximize the market value of the share and to fetch decent returns to the investors.

For the investors, Equity is a risky avenue for investment when compared with Debt funds. The returns on Equity Share Capital largely depend on the financial performance of the company, dividend policy of the company etc. and therefore, the returns are not guaranteed. Whereas the debt fund gives assured returns and also ensures safety of investment.

For a company, Equity Shares is the least risky of all sources of finance. Distribution of equity dividend is always subject to company’s financial position and its future growth plans. But debt fund or leverage when employed also entails regular payment of servicing charges (interest) and redemption of capital.

The dictionary meaning of the word leverage is ‘the power to control’ or ‘augmentation’ or ‘dominance’. In terms of business finance, the leverage is employment of debt fund or borrowed capital. Although leverage is purely a financial tool, it is used immensely by managers involved in the decision-making processes related to capital structuring decisions, mergers and acquisitions, ascertainment of cost of capital etc.
Financial Leverage has a direct bearing on the shape of the capital structure of a company or firm. Capital Structure basically represents various sources that a firm has employed to fulfil its financial requirements. It also reveals the proportion of debt capital and equity capital. When a firm uses debt funds or fixed-charges sources of funds such as preference capital or debentures along with the owners’ funds or equity in the capital structure, it is described as Financial Leverage or trading on equity. The coinage of the term ‘trading on equity’ is due to the fact that it is the owner’s equity that is used by the company to raise debt.

In today’s market conditions when the expectations of the Equity shareholders are rising, a company has to be able to determine a judicious mix of debt funds and owned funds. It has to verify whether the employment of debt fund to a certain degree helps, the company realise the cherished goals or not. After all, leverage is a very powerful phenomenon affecting a company’s profitability and liquidity and overall financial performance.

When a company involves debt in its capital structure, it invariably results in fixed charges that have to be paid to service the debt. This is a significant event because the company has to use these funds to augment its profitability. If such debt funds are not gainfully utilized, their use will prove to be counterproductive. In other words, the employment of debt in the capital structure has a deep impact on the profitability of the company. In this respect, the cost of borrowing assumes significant importance vis-à-vis the rate return on net assets that a firm enjoys.

On the other hand, the liquidity of a company is also impacted by leverage. The greater the degree of debt funds employed, the greater will be outflow of cash in terms of cost of servicing the debt. That does affect the cash profit earned by a company. And debt funds also have to be redeemed after certain duration of time. That is major cash out flow for the company. However, if a company’s capital structure is dominated by equity alone, the advantage of tax shield will not be available. In order to fulfil expectations of high number of equity shareholders, the company has to distribute a greater portion of profit as dividend to equity shareholders.

Financial Leverage also provides tax-shield in that the charges paid to service debt are tax-deductible and therefore they reduce the tax liability of a firm. This also enhances the earnings available to shareholders. This again is beneficial to the firm.
As long as the rate of earning is higher than the cost of borrowing, leverage is beneficial. But if there is a possibility of a decline in the rate of earnings, the company should try to dispose of debt fund to the extent permitted by availability of sufficient funds or earnings generation or disposable short-term investments.

1.5.5.1 EFFECTS OF FINANCIAL LEVERAGE ILLUSTRATED:

Financial Leverage is an important tool in the hands of a financial manager. In today’s highly competitive world where cost of raising finance is a major decisive factor influencing various types of financial decisions, capital structure management plays a pivotal role in a firm’s financial success. It is widely believed that Financial Leverage on one hand can enhance the Earning per share, at the same time it can bring about financial ruin for the company if it is not employed at the right time and in the right dosage. The key word here is right proportion. Right proportion is achieved if a manager can juggle the interplay between firm’s ROI and the average interest rate. The following three situations can arise with respect to ROI and average rate of interest:

1. **ROI is greater than the interest rate:** in this situation, it is advisable to borrow because the firm is generating revenue at a rate greater than the rate of borrowing. If the firm is borrowing at a rate of 10% p.a. and if it’s ROI is 18% p.a. This is a case of **highly favourable leverage.** This is called trading on equity.

2. **ROI equals the interest rate:** In this scenario, leverage is neither favourable nor unfavourable. But if other factors are at play tilting the balance in favour of borrowing, then by all means the manager should employ leverage.

3. **ROI is greater than the interest rate:** Now this is a precarious situation because the rate of earning is not able to keep up with the rate being paid on borrowed funds. It doesn’t make sense to borrow in such a situation. This is called **unfavourable leverage.**

To demonstrate the effects of Financial Leverage in a company’s financial structure, consider four firms- A, B, C and D- each with Rs. 50,00,000 of assets. All the firms earn 12% return on investment. Each firm has issued equity shares of Rs. 10 each. Firm A has issued Rs. 50,00,000 of Equity shares. Firms B, C and D have issued Rs. 30,00,000 of Equity shares and the balance capital amount Rs. 20,00,000 in the form
of debentures carrying interest rates of 8%, 12% and 16% respectively for the three firms.

**TABLE – 1.6**

**FINANCIAL LEVERAGE ILLUSTRATED**

<table>
<thead>
<tr>
<th>Data</th>
<th>FIRM A NO DEBT</th>
<th>FIRM B FAVOURABLE LEVERAGE</th>
<th>FIRM C NO LEVERAGE</th>
<th>FIRM D UNFAVOURABLE LEVERAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROI</td>
<td>12%</td>
<td>12%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>INTEREST RATE</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td>EQUITY</td>
<td>Rs. 50,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
</tr>
<tr>
<td>DEBENTURES</td>
<td>0</td>
<td>Rs. 20,00,000</td>
<td>Rs. 20,00,000</td>
<td>Rs. 20,00,000</td>
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<tr>
<td>Total Assets</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
</tr>
<tr>
<td>EQUITY SHARES</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
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<tr>
<td>TAX RATE</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
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<tr>
<td><strong>CALCULATIONS</strong></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>Rs. 6,00,000</td>
<td>Rs. 6,00,000</td>
<td>Rs. 6,00,000</td>
<td>Rs. 6,00,000</td>
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<tr>
<td>- INTEREST</td>
<td>Nil</td>
<td>Rs. 1,60,000</td>
<td>Rs. 2,40,000</td>
<td>Rs. 3,20,000</td>
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<tr>
<td>Earnings before tax</td>
<td>Rs. 6,00,000</td>
<td>Rs. 4,40,000</td>
<td>Rs. 3,60,000</td>
<td>Rs. 2,80,000</td>
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<tr>
<td>- Taxes</td>
<td>Rs. 3,00,000</td>
<td>Rs. 2,20,000</td>
<td>Rs. 1,80,000</td>
<td>Rs. 1,40,000</td>
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<tr>
<td>Earnings after tax</td>
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<td>Rs. 2,20,000</td>
<td>Rs. 1,80,000</td>
<td>Rs. 1,40,000</td>
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<tr>
<td>Divided by shares</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
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<tr>
<td>Earnings Per Share(EPS)</td>
<td>Rs 00.60</td>
<td>Rs 00.73</td>
<td>Rs.00.60</td>
<td>Rs.00.46</td>
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</table>

The above table 1.6 reveals that if the ROI is 12%, Firm A which has no debt element and Firm C whose borrowing cost is the same as ROI have same EPS. Firm B has favourable leverage, as its interest rate on debt is lower than ROI. It offers the highest EPS to shareholders. The reverse has is true in case of Firm D. Its rate of interest on debt is higher than ROI. As a result, its EPS is the least.
<table>
<thead>
<tr>
<th>Data</th>
<th>FIRM A</th>
<th>FIRM B</th>
<th>FIRM C</th>
<th>FIRM D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NO DEBT</td>
<td>NO LEVERAGE</td>
<td>UNFAVOURABLE LEVERAGE</td>
<td>UNFAVOURABLE LEVERAGE</td>
</tr>
<tr>
<td>ROI</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>INTEREST RATE</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td>EQUITY</td>
<td>Rs. 50,00,000</td>
<td>Rs. 30,000,000</td>
<td>Rs. 30,000,000</td>
<td>Rs. 30,000,000</td>
</tr>
<tr>
<td>DEBENTURES</td>
<td>0</td>
<td>Rs. 20,000,000</td>
<td>Rs. 20,000,000</td>
<td>Rs. 20,000,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,000,000</td>
<td>Rs. 50,000,000</td>
<td>Rs. 50,000,000</td>
</tr>
<tr>
<td>EQUITY SHARES</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>TAX RATE</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>CALCULATIONS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>Rs. 4,00,000</td>
<td>Rs. 4,00,000</td>
<td>Rs. 4,00,000</td>
<td>Rs. 4,00,000</td>
</tr>
<tr>
<td>- INTEREST</td>
<td>Nil</td>
<td>Rs.1,60,000</td>
<td>Rs. 2,40,000</td>
<td>Rs. 3,20,000</td>
</tr>
<tr>
<td>Earnings before tax</td>
<td>Rs. 4,00,000</td>
<td>Rs. 2,40,000</td>
<td>Rs. 1,60,000</td>
<td>Rs. 80,000</td>
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<tr>
<td>- Taxes</td>
<td>Rs. 2,00,000</td>
<td>Rs. 1,20,000</td>
<td>Rs. 80,000</td>
<td>Rs. 40,000</td>
</tr>
<tr>
<td>Earnings after tax</td>
<td>Rs. 2,00,000</td>
<td>Rs. 1,20,000</td>
<td>Rs. 80,000</td>
<td>Rs. 40,000</td>
</tr>
<tr>
<td>Divided by shares</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Earnings Per Share(EPS)</td>
<td>Rs 00.40</td>
<td>Rs 00.40</td>
<td>Rs.00.27</td>
<td>Rs.00.13</td>
</tr>
</tbody>
</table>

In the above table 1.7, it can be seen that when the ROI is 8%, Firm A and Firm B have same Earnings Per Share (EPS). That is because Firm A has no debt funds in its capital structure and Firm B’s rate of interest on borrowing is the same as its ROI. However, Firm C and Firm D both are experiencing the negative impact of Leverage, mainly because their ROI is lower than the rate of interest on borrowed funds. This again drives home the point that Financial Leverage can be beneficial and successful only if the firm is enjoying a higher rate of earnings when compared with the rate of interest to be paid on contracted debt.
### TABLE – 1.8

<table>
<thead>
<tr>
<th>Data</th>
<th>FIRM A</th>
<th>FIRM B</th>
<th>FIRM C</th>
<th>FIRM D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NO DEBT</td>
<td>FAVOURABLE LEVERAGE</td>
<td>FAVOURABLE LEVERAGE</td>
<td>FAVOURABLE LEVERAGE</td>
</tr>
<tr>
<td>ROI</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>INTEREST RATE</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td>EQUITY</td>
<td>Rs. 50,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
</tr>
<tr>
<td>DEBENTURES</td>
<td>0</td>
<td>Rs. 20,00,000</td>
<td>Rs. 20,00,000</td>
<td>Rs. 20,00,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
</tr>
<tr>
<td>EQUITY SHARES</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>TAX RATE</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>CALCULATIONS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
</tr>
<tr>
<td>- INTEREST</td>
<td>Nil</td>
<td>Rs. 1,60,000</td>
<td>Rs. 2,40,000</td>
<td>Rs. 3,20,000</td>
</tr>
<tr>
<td>Earnings before tax</td>
<td>Rs. 9,00,000</td>
<td>Rs. 7,40,000</td>
<td>Rs. 6,60,000</td>
<td>Rs. 5,80,000</td>
</tr>
<tr>
<td>- Taxes</td>
<td>Rs. 4,50,000</td>
<td>Rs. 3,70,000</td>
<td>Rs. 3,30,000</td>
<td>Rs. 2,90,000</td>
</tr>
<tr>
<td>Earnings after tax</td>
<td>Rs. 4,50,000</td>
<td>Rs. 3,70,000</td>
<td>Rs. 3,30,000</td>
<td>Rs. 2,90,000</td>
</tr>
<tr>
<td>Divided by shares</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Earnings Per Share(EPS)</td>
<td>Rs 00.90</td>
<td>Rs 1.23</td>
<td>Rs.1.10</td>
<td>Rs.00.97</td>
</tr>
</tbody>
</table>

In the tables 1.6 and 1.7, Firm A which has no leverage did reasonably well in comparison with other firms because firstly there was no gap between ROI and interest rate in case of Firm C (table 1.6) and Firm B (table 1.7). In table 1.6, Firm B had favourable leverage but when the ROI equals rate of interest, the advantage of leverage is nullified. In addition, when Firm D pays a higher rate of interest than ROI, it can be said to have contracted unfavourable leverage duly reflected in lowest EPS in both table 1.6 and table 1.7. In table 1.8, Firm A has the least EPS because it has forgone the advantage of leverage and therefore it has no tax shield. Very high outgo in the form of taxes and greater no. of equity shares drastically bring down the EPS for equity shareholders. This is an example of what it costs if debt is not included in
the capital structure. Firm B has the least cost of borrowing and its ROI is high at 18 
%, thereby fetching it the highest EPS among all the firms. This again exemplifies 
what a favourable leverage can do to the financial health of a firm. Firms C and D 
both are experiencing effects of favourable leverage because of positive equation 
between ROI and Interest rate.

If Preference shares are issued in place of Debentures, again the advantage of tax 
shield shall not be available as the preference dividend is not tax-deductible. To 
demonstrate this, let us take the same four firms with a different capital structure. The 
same four firms- A, B, C and D- each with Rs. 50,00,000 of assets. All the firms earn 
18% return on investment. Each firm has issued equity shares of Rs. 10 each. Firm A 
has issued Rs. 50,00,000 of Equity shares. Firms B, C and D have issued Rs. 
30,00,000 of Equity shares and the balance capital amount Rs. 20,00,000 in the form 
of preference shares carrying dividend rates of 8%, 12% and 16% respectively for the 
three firms.

TABLE – 1.9

<table>
<thead>
<tr>
<th>Data</th>
<th>FIRM A</th>
<th>FIRM B</th>
<th>FIRM C</th>
<th>FIRM D</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROI</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>DIVIDEND RATE</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td>EQUITY</td>
<td>Rs. 50,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
</tr>
<tr>
<td>PREFERENCE</td>
<td>0</td>
<td>Rs. 20,00,000</td>
<td>Rs. 20,00,000</td>
<td>Rs. 20,00,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
</tr>
<tr>
<td>EQUITY SHARES</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>TAX RATE</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>CALCULATIONS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
</tr>
<tr>
<td>- INTEREST</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Earnings before tax</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
</tr>
<tr>
<td>- Taxes</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,50,000</td>
</tr>
<tr>
<td>Earnings after tax</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,50,000</td>
</tr>
<tr>
<td>Preference Dividend.</td>
<td>Nil</td>
<td>Rs. 1,60,000</td>
<td>Rs. 2,40,000</td>
<td>Rs. 3,20,000</td>
</tr>
</tbody>
</table>
In table 1.9, it can be observed that the absence of tax-shield has an adverse impact on the EPS of the three firms. As the dividend rate rises from 8% to 12% and then to 16% the EPS of the Firms C and D plummets as can be seen in the table. The Firm A which has no debt at all has an EPS of Rs. 0.90. ROI, in the absence of tax-shield, is subject to direct taxation which clearly brings down the profit after tax (PAT) and then PAT is further reduced by the dividend on preference shares. In such a case for the leverage to be successful, the ROI has to be high enough so that post taxation the NET ROI is even higher than the rate of preference dividend.

If the Firms raise their finance through Debentures as well as Preference shares, such a capital structure can have the advantage of tax-shield provided by debenture interest and this will have positive impact on the EPS of the firms.

Suppose in the above cases, if the Firms B, C and D float debentures and preference shares in equal proportion and the rates of debenture interest are 8%, 12% and 16% respective for the firms and preference dividend rates are also the same for the three firms, the results would appear as under:

**TABLE – 1.10**

<table>
<thead>
<tr>
<th>Data</th>
<th>FIRM A</th>
<th>FIRM B</th>
<th>FIRM C</th>
<th>FIRM D</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROI</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>INTEREST RATE</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td>DIVIDEND RATE</td>
<td>0%</td>
<td>8%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td>EQUITY</td>
<td>Rs. 50,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
<td>Rs. 30,00,000</td>
</tr>
<tr>
<td>DEBENTURES</td>
<td>0</td>
<td>RS. 10,00,000</td>
<td>RS. 10,00,000</td>
<td>RS. 10,00,000</td>
</tr>
<tr>
<td>PREFERENCE</td>
<td>0</td>
<td>Rs. 10,00,000</td>
<td>RS. 10,00,000</td>
<td>RS. 10,00,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
<td>Rs. 50,00,000</td>
</tr>
<tr>
<td>EQUITY SHARES</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>---------------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
</tr>
<tr>
<td>TAX RATE</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>CALCULATIONS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
<td>Rs. 9,00,000</td>
</tr>
<tr>
<td>- INTEREST</td>
<td>Nil</td>
<td>Rs. 80,000</td>
<td>Rs. 1,20,000</td>
<td>Rs. 1,60,000</td>
</tr>
<tr>
<td>Earnings before tax</td>
<td>Rs. 9,00,000</td>
<td>Rs. 8,20,000</td>
<td>Rs. 7,80,000</td>
<td>Rs. 7,40,000</td>
</tr>
<tr>
<td>- Taxes</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,10,000</td>
<td>Rs. 3,90,000</td>
<td>Rs. 3,70,000</td>
</tr>
<tr>
<td>Earnings after tax</td>
<td>Rs. 4,50,000</td>
<td>Rs. 4,10,000</td>
<td>Rs. 3,90,000</td>
<td>Rs. 3,70,000</td>
</tr>
<tr>
<td>Preference Dividend</td>
<td>Nil</td>
<td>Rs. 80,000</td>
<td>Rs. 1,20,000</td>
<td>Rs. 1,60,000</td>
</tr>
<tr>
<td>Profit available for distribution</td>
<td>Rs. 4,50,000</td>
<td>Rs. 3,30,000</td>
<td>Rs. 2,70,000</td>
<td>Rs. 2,10,000</td>
</tr>
<tr>
<td>Divided by shares</td>
<td>5,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Earnings Per Share(EPS)</td>
<td>Rs 00.90</td>
<td>Rs 01.10</td>
<td>Rs.00.90</td>
<td>Rs.00.70</td>
</tr>
</tbody>
</table>

In table 1.10 Firm B has the highest EPS, as the interest rate and dividend rate are lowest among all the firms. As the interest rate and dividend rate rise from 8% to 12% and again to 16%, it can be seen that the EPS of the firms gradually declines. In case of Firm B, the ROI is high and the corresponding rate of interest is very low as also the preference dividend and after deducting the taxes, the PBT is adequate to pay for the preference dividend which is lowest at 8% and therefore it magnifies the EPS for the firm. However, the Firms C and D both have a very high interest rate and preference dividend rate, which reduce not only the tax liability but also the profit available after tax. And again, preference dividend is paid at a very high rate which further reduces the profit available for distribution. This, instead of increasing the EPS, actually reduces the EPS.

Financial Leverage is a double-edged sword which if used judiciously can maximise the shareholders’ return and have a very positive impact on the financial performance of the company but if employed without considering the rate of earning and the cost of debt, it can have a very adverse impact on the financial performance of the company.

Financial performance has many more aspects to it. It is not just confined to Earning Per Share or Rate of Equity Dividend. It has many facets to it, which need to be
analysed and explained in detail. A detailed discussion on financial performance follows.

1.6 FINANCIAL PERFORMANCE- DEFINITION & SIGNIFICANCE

When a company raises finance to provide for the funds required to start the operations, it also becomes responsible to the providers of finance. There is a whole host of providers of finance including shareholders- equity & preference, creditors, customers, public and even government. These stake holders have provided finance with a view to earning good returns on the investments. it is, therefore, imperative that the funds raised are duly utilised so that the financiers and capital-providers could get the expected rate of return on their investments.

Financial performance is a comprehensive term and cannot be convincingly encapsulated in a few lines without compromising with its vastness. But it is an important phenomenon that conveys the financial health of a company. Financial analysts depend on financial statements to diagnose financial performance. They apply several accounting tools and techniques to analyse various aspects of financial performance. After an in-depth analysis of financial statements, much can be learnt about the firm’s short-term and long term liquidity, amount of debt against assets, financial soundness, availability of funds for future expansion, level of efficiency about the allocation of funds etc.

In simple words financial performance pertains to how the finance raised through all resources is invested so that the vital financial parameters show the company up to be enjoying good financial health.

According to Prasanna Chandra, “….financial performance may range from simple analysis of short-term liquidity position of the firm to a comprehensive assessment of the strengths and weaknesses of the firm in various areas. It is also about corporate excellence, judging creditworthiness, forecasting bond ratings, predicting bankruptcy and assessing market risk.”

There are several users of information about a firm’s financial performance. Reporting of Financial performance assists investors, creditors and other financiers in making sound investment decision. After all, investors are always keen to invest in a company that provide the greatest total return with the element of risk that is just
reasonable or acceptable. It is also a mirror that reflects the efficiency with which the management has been utilising the funds and also the attendant accountability. It is a reflection of how diligently the managers of finance have protected the interest of the investors even in the face of adverse economic conditions whether on home front or on foreign shores. This accountability transcends the confines set by the pertinent laws of the country. The significance of financial performance analysis is greatly reflected in the purposes and objectives it serves of various stakeholders.

It is vital that the financial performance be reported to the seekers of financial information so that they can base their decision on the authentic information provided to them.

[1] **Shareholders:**

The shareholders are the prime and foremost users of accounting information. The shareholders could be *existing* (Domestic and Foreign) and *potential* (again Domestic and Foreign). It is the duty of the company to convey accurately the financial position of the company to shareholders so that they have a clear idea about the company’s financial strength and performance. They are generally interested in the earnings, dividend and growth trends of the firm. A company should prepare and maintain its financial reports about business affairs fairly and accurately in compliance with accounting and financial reporting standard. This is very important because shareholders base their decisions regarding share purchase or sale, takeovers and mergers and performance evaluation and risk assessment as also levels of transparency on such information.

[2] **Debenture Holders:**

The debenture holders invest in a company with a view to earning a steady stream of income. Since debentures are a safe investment, it suits the orthodox investors’ fine. However, they are interested to know the long term liquidity of the company. Financial decisions and its implications have to be thoroughly analysed to foresee capital structure changes, earning potential and expansion and growth plans and risk perception and assurance of easy redemption of their investment.
[3] **Creditors:**

The creditors supply financial resources to the company. They are interested in the continuing profitable performance of the company. This will guarantee a regular receipt of interest and repayment of their capital. They would closely investigate and monitor the company's financial and accounting policies to determine the degree of risk they may have to face. They are interested in short term liquidity of the company. They may also analyse past performance of the company in the light of controllable and non-controllable factors to decide their future investment strategy and credit granting decisions and terms of credit.

[4] **Government:**

The government has an interest in financial statements for regulatory purposes. The tax department has an interest in determining the taxable income of the company. The government also determines its subsidy policy and regulatory policy accordingly. The financial reports also affect the govt.'s employment and macroeconomic policies. It would like to ensure that the company conducts its business in a socially and environmentally healthy manner. Its products and services should be eco-friendly and people friendly. Transparency should be achieved through appropriate Corporate Governance practice to promote a particular type of industry or business to ensure proper utilization of resources and thorough implementation of policies framed.

[5] **Employees:**

With the help of financial statements employees and trade unions can bargain for salary, bonus, fringe benefits or better working conditions. They are mainly interested in their social and economic welfare. They can also negotiate the terms of employment and ask for greater job security. If the contribution of employees is immense in the advancement of the company, they can ask for greater remuneration such as ESOPS etc. They may want to be directly involved in all financial matters that concern them if they find from various policies that their concerns and opinions and efforts are not given due weightage.
[6] **Customers:**

The customer in a way directly influences the future of a company. The customers would like to know whether the products or services they are using are perfectly healthy and not hazardous. They would like to know if the product/service will be in adequate supply in future and that they are what the company promises to be. Various ingredients used in the products are sourced from reputed companies. They want to be able to take pride in using the company’s products/services.

[7] **Competitors:**

Financial statements reflect the economic progress of the company. Its profitability and liquidity comes under a close scanner. The competitors are always looking for an opportunity to pick loopholes for

1. Taking competitive advantage
2. Tarnishing the rival’s image by bringing out its flaws and mistakes.

The reporting company should take into account all this while framing financial statements. After all, success is not defined just in terms of profits but also adherence to social and environmental obligations/norms.

[8] **Financial Institutions:**

A co should prepare and maintain its accounts very accurately in accordance with reporting standards and laws and regulations of the country. It should set a standard of ethical behavior both within and without the organization. The reporting should be timely and transparent-revealing all the mandatory information as well as voluntary information. Financial institutions are primarily interested in long term liquidity of the company, expansion plans, sources of finance, and pre-funding, post-funding and refunding changes in financial conditions. They want to assess the company’s debt repaying capacity and the attendant risk of bankruptcy. Their future association with the company depends on it.

[9] **Public:**

The general users too would want to know the financial strength and performance of the company. They can also be potential investors or buyers. The public hold a high
regard and opinion for a company that respects the rule of law i.e. all its operations are in accordance with the law and no financial malpractice is resorted to. The company must fulfill its social responsibility which is reflected in creation of infrastructure and no of employees working in a company, utilization of natural resources, charities and expenditure on public health and education etc. The environmental cost due to company’s operations should be under thorough check.

[10] Analysts:

The job of an analyst is to dissect the financial reports and statements. Hence the company must follow the highest standard of reporting, Investment analysts advise their clients in matters of shares purchase/sale, forecasting future cash flows and liquidity position of the company, risk behavior, profitability trend, dividend policy, general direction the company is heading in, hedging and divestment etc. Thus the financial statements are extremely useful to the analysts and their performance depends on quality of company’s financial reporting.


The last but not the least type of user of financial statements is Academicians. The main purpose of academicians is to analyse the reports thoroughly and study the impact of market and economic conditions on the financial performance of the company. They may want to apply their financial tools and techniques to verify their efficacy. The same can be interpreted and re-reported in a more simple language to knowledge-seekers. The financial reports can also provide basic ground for further research and new theories. It can also be used to test existing concepts, knowledge and body of work.

1.6.1 COMPONENTS OF CORPORATE FINANCIAL PERFORMANCE:

It can be comprehended that there so many users of information relating to corporate financial performance. They all have different purposes to serve. They are interested in financial information for different reasons. They are looking for different sets of information relating to financial performance because their vested interest is not served by the same set of information. Such different sets of information relating to financial performance can be broadly categorised into four major components.
They are

1.6.1.1 PROFITABILITY
1.6.1.2 LIQUIDITY
1.6.1.3 SOLVENCY
1.6.1.4 EFFICIENCY

1.6.1.1 PROFITABILITY:

Profitability is an imperative measure of a company’s efficiency. It reflects the company’s operating efficiency and its ability to generate adequate returns to its shareholders. The owners and the management are keenly interested in the financial performance of the business unit. In fact, the quest for profitability also leads to a pleasant discovery of efficiency. What it implies is that a company can never be satisfactorily profitable unless it is also efficient in using its resources.

MEANING- Profitability is a measure of operating efficiency of a firm and also its ability to generate returns to its shareholders.

DEFINITION- Profitability can be defined as a barometer that measures the efficiency with which a company is operating and its capacity to earn profits so as to dole out decent returns to its investors and repay debt along with interest.

CHARACTERISTICS- The following characteristics encapsulate the concept of profitability:

1. It is a precise measurement
2. It reflects operating efficiency – overall and departmental
3. It also reveals the firm’s ability to generate returns and profits
4. It is an assurance of availability of resources for future expansion plans
5. There are many ratios measuring long & short term profitability
6. It is a result of the firm’s myriad policies and decisions and strategies.

SIGNIFICANCE

Profitability is a tell-all measure that reveals the operating efficiency as well as the firm’s ability to generate adequate returns to the investors. The average investor is interested in knowing how much dividend he is earning for the investments made. It
can also be a major source of relief for the management in that it also provides internal accruals for growth plans. The following are the major profitability ratios

1) Return on capital employed
2) Earnings per share
3) Gross profit margin
4) Net profit margin
5) Return on assets
6) Return on shareholders’ equity.

1.6.1.2 LIQUIDITY:

Liquidity is a significant measure showing the firm’s ability to meet its short-term obligations. A firm may face many vicissitudes but how successfully it overcomes the lean patches, is reflected in its liquidity position. Liquidity is therefore vital to its survival. Excess liquidity or poor liquidity both are danger signals to the management and indicate impending crisis.

MEANING- Liquidity is a measure that reflects the firm’s ability to meet short-term obligations and therefore it’s a prerequisite for the very survival of the firm.

DEFINITION- Liquidity can be defined as the measure that conveys the financial adequacy and strength of a firm to be able to meets its immediate (short-term) obligations.

CHARACTERISTICS- The following attributes capture the concept of liquidity:

1. It is a precise measure
2. It reflects the firm’s ability to meets its short-term obligations
3. It addresses the vital issue of survival of the firm
4. It exposes the firm’s weak decisions with respect to raising and investment of funds
5. Liquidity precedes profitability
6. Overly liquid firm stands to incur opportunity cost and loss
7. Under-liquid firm stands to lose financiers’ confidence and faith and its own reputation.
8. It is a direct result of capital structure decisions made by the firm
SIGNIFICANCE-

Liquidity is an important measure revealing the firm’s ability to make good its short-term debt and in other words, it shows to what extent the funds provided by the investors are safe. It clearly holds the key to a company’s survival. However, the key really lies in maintaining proper balance between excess liquidity and inadequate liquidity. Both are an invitation for financial trouble. The following are the major liquidity ratios:

1) Current ratio
2) Liquid ratio or Quick ratio or Acid test ratio

1.6.1.3 SOLVENCY:

The long-term solvency of a firm depends on its ability to meet all its liabilities including those, which are not to be met immediately. It is reflective of the claim that creditors and shareholders have against the firm’s assets as also fixed interest bearing funds in the capital structure as against the proportion of equity share capital. Excessive liabilities can be a cause for future insolvency.

MEANING & DEFINITION- Solvency as a measure of financial performance reflects the long-term ability of a firm to meet all its obligations including long-term obligations. It is also an indicator of long-term financial stability of a firm. It shows the proportion of debt against total funds raised.

CHARACTERISTICS-

1. It is a precise measure of long-term solvency of a firm
2. It reflects the financial soundness of the firm in the long-run
3. It also takes into account ‘internal-external’ aspect of capital structure
4. It shows the proportion of shareholders’ funds vis-à-vis total assets employed and therefore the extent of control enjoyed by outsiders
5. It also reveals the extent to which a company is geared- highly geared or moderately geared or poorly geared. This has a direct bearing on the shareholders’ dividend earnings
6. Solvency as a measure also helps the financiers to decide whether they are safe in the event of liquidation
SIGNIFICANCE

A company may enjoy a good liquidity position in the short-run but in the long run, it may face financial crisis if it is not properly geared. Therefore, short-term solvency is no guarantee for long-term financial soundness or longevity of the firm. Excess liabilities are detrimental to the financial health of the company, but having no debt at all can also deprive a company of the advantages of trading on equity. There are several accounting ratios to measure this. Too much dependence on the outsiders for funds can endanger a company’s solvency and can significantly erode the confidence of investors. Solvency measures are definitely a tight rope to walk for any firm.

The following ratios can help gauge solvency enjoyed by a firm:

1) Debt-equity ratio
2) Shareholders’ equity ratio
3) Debt-net worth ratio
4) Capital gearing ratio
5) Fixed-assets to long term funds
6) Dividend coverage
7) Interest coverage

1.6.1.4 EFFICIENCY:

In this age of cutthroat competition, it is important for a company to not only achieve its targets but also to exercise efficiency in achieving them. Resources are limited and there may be many claimants to the resources, which are already scarce. Efficiency as a measure tries to ascertain whether the output from a particular process or business activity is in accordance with inputs committed in the form of materials, time and labour, financial investments or other productive resources.

MEANING & DEFINITION- Efficiency is a measure that shows how effectively a company has employed its resources to magnify its earnings resulting from operating efficiency. In other words, how efficient the company is in converting its inputs into targeted outputs within the constraints of time limit, availability of raw materials, labour, finance etc. It is also a measure of level of efficiency achieved by a company in asset management, the speed at which assets are converted into sales, turnover, receivables management etc.