Capital Structure Job Interview Questions And Answers

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Capital Structure Interview Questions And Answers Guide.

Question - 1:
What is Miller's hypothesis with corporate and personal taxes?
Ans:
Miller's hypothesis with corporate and personal taxes : This approach gives important advantage over equity. This ignores bankruptcy and agency costs.
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Question - 2:
What is Trade-off theory?
Ans:
Trade-off theory: costs and benefits of leverage.
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Question - 3:
What is MM hypothesis with and without corporate tax?
Ans:
MM hypothesis with and without corporate tax : This approach tells that firm's value is independent of capital structure. The same return can be received by shareholders with the same risk.
View All Answers

Question - 4:
What is Traditional approach and Net income (NI) approach?
Ans:
Traditional approach and Net income (NI) approach :- this is an approach in which both cost of debt, and equity are independent of capital structure. The components which are involved in it are constant and don't depend on how much debt the firm is using.
View All Answers

Question - 5:
What is Net operating income (NOI)?
Ans:
Net operating income (NOI):- this is an approach in which both value of the firm and weighted average cost are independent of capital structure. Individual holding the debt and equity receives the same cash flows without worrying about the taxes as they are not involved in it.
View All Answers

Question - 6:
Explain Combined Leverage?
Ans:
it is a leverage which refers to high profits due to fixed costs. It includes fixed operating expenses with fixed financial expenses. It indicates leverage benefits and risks which are in fixed quantity. Competitive firms choose high level of degree of combined leverage whereas cooperative firms choose lower level of degree of combined leverage.
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Question - 7:
What is Combined Leverage?
Ans:
it is a leverage which refers to high profits due to fixed costs. It includes fixed operating expenses with fixed financial expenses. It indicates leverage benefits and

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risks which are in fixed quantity. Competitive firms choose high level of degree of combined leverage whereas cooperative firms choose lower level of degree of combined leverage.

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Question - 8:

What is Financial Leverage?

Ans:

It is a leverage which refers to high level of profitability because of high fixed financial expenses. It includes interest on loan and preference dividend. Higher financial leverage indicates higher financial risk as well as higher break points. In this kind the managers have flexibility in choice of capital structure.

View All Answers

Question - 9:

What is Operating Leverage?

Ans:

it is a leverage which refers to the enhancement of profits because there is a fixed operating cost which is involved with each and every component. When the sales increases fixed cost doesn't increase and it results in higher profits. Higher fixed expenses results in higher operating leverage which leads to higher business risk.

View All Answers

Question - 10:

What is Timing Principle?

Ans:

Timing Principle: this principle deals with capital structure which should be able to have market opportunities and which should be able to minimize cost of raising funds and obtain the savings.

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Question - 11:

What is Flexibility Principle?

Ans:

Flexibility Principle: this principle deals with capital structure which can have additional requirements of funds in future.

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Question - 12:

What is Control Principle?

Ans:

Control Principle: this principle deals with the capital structure which is keeping the controlling position of owners. Preference shareholders possesses no voting rights and don't disturb positions.

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Question - 13:

What is Risk Principle?

Ans:

Risk Principle: this principle deals with the capital structure which should not accept high risk. If company issue large amount of preference shares out of the earnings of the company then less amount will be left out for equity shareholders as dividend is paid after the preference shares.

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Question - 14:

What is Cost Principle?

Ans:

Cost Principle: this principle deals with the ideal capital structure which should minimize cost of financing and maximize the earnings per share. The cheaper form of capital structure is debt capital.

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Question - 15:

What is Control Factor?

Ans:

These factors have been considered by the private companies while raising additional funds and planning the capital structure. In this company plans to raise long term funds by issue the equity and preference shares. It doesn't have relation with the borrowed capital.

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Question - 16:

What is Risk factor?

Ans:

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Company raising the capital by borrowed capital, as it accepts the risk in two ways:
(i) Company maintains the payment of interest as well as installments of borrowed capital at predecided rate and time without being concerned about the profits and losses.
(ii) Borrowed capital is secured capital in the case where the company fails to meet the contract done with the lenders of the money.

View All Answers

Question - 17:

What is Cost of capital?

Ans:

it is a process of raising the funds which involves the cost in planning the capital structure, the use of capital should be capable of earning revenue to meet the cost of capital. There are changes in this because of two reasons:
(i) Interest rates are less than dividend rates.
(ii) Interest paid on borrowed capital is an allowable for income tax purposes.

View All Answers

Question - 18:

What are the internal factors affecting capital structure?

Ans:

The internal factors which are affecting capital structure are as follows:-
1) Cost of capital : - it is a process of raising the funds which involves the cost in planning the capital structure, the use of capital should be capable of earning revenue to meet the cost of capital. There are changes in this because of two reasons:
(i) Interest rates are less than dividend rates.
(ii) Interest paid on borrowed capital is an allowable for income tax purposes.
2) Risk factor : Company raising the capital by borrowed capital, as it accepts the risk in two ways:
(i) Company maintains the payment of interest as well as installments of borrowed capital at predecided rate and time without being concerned about the profits and losses.
(ii) Borrowed capital is secured capital in the case where the company fails to meet the contract done with the lenders of the money.
3) Control Factor: These factors have been considered by the private companies while raising additional funds and planning the capital structure. In this company plans to raise long term funds by issue the equity and preference shares. It doesn't have relation with the borrowed capital.

View All Answers

Question - 19:

What are the external factors affecting capital structure?

Ans:

The external factors which are affecting the capital structure are as follows:-
1) Economic Conditions: If the economy is in state of depression, preference is given to equity form of capital which involves less amount of risk but it is avoided in some cases where the investor is not ready to take the risk. In this case company go on with the borrowed capital.
2) Interest Rates level : Form of borrowed capital will be delayed if the funds are available in high rates of interest but raising is not favourable.
3) Lending Policy : If policy is hard to understand and not flexible then it is good to go with the borrowed capital.
4) Taxation Policy: This policy should be viewed from both the sides from individual as well as corporate perspective. From the individual point of view both interest as well as dividend will be taxable in hands of lender.

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Question - 20:

What are the general factors affecting capital structure?

Ans:

The general factors which are affecting the capital structure are as follows:-
1) Company constitution : In companies capital structure is very important as many companies treat it as a different entity. Private companies considers control factor as important whereas public company finds cost factor more important.
2) Company characteristics : Characteristic of the company which describe its infrastructure as size, age and credit plays pivotal role in deciding the capital structure. Smaller or newly started companies depend more on equity capital as they can do limited bargaining. Large companies or having good credit companies are in the position to get funds from the source of their choice.
3) Stability of Earnings : Fluctuations occurs if the sales and earnings of the company are not stable enough over a period of time. Stable company can take the risk.
4) Attitude of the Management: Attitude plays an important role as if the attitude is conservative then control factor gets the importance and if it is liberal then cost factor gets important.

View All Answers

Question - 21:

Compare Component cost and Composite cost?

Ans:

The component cost is the one which comes under the cost of capital and it has three levels:-
(i) Return at zero risk level: which tells about the expected rate of return when there is no risk involved in the project
(ii) Premium for business risk: This tells about the variance in operating profit due to change in sales.
(iii) Premium for financial risk: This tells about the captital structure risk.
It is the decision whether to buy components or services from an outsider or not. It requires understanding the cost associated with building and buying the components.
Composite Capital is also called the weighted average of component cost of common stock, preference shares and debt. In this each of the components is given an importance on its interest rate, risk analysis and management loss of control which is used to compute the composite capital.

View All Answers

Question - 22:

Explain Average cost and Marginal cost?

Ans:

Average cost is also called as unit cost which is equal to the total cost divided by number of goods produced or also equal to the sum of average variable costs and the average fixed costs. This depends on the time period and also has the affect on the supply curve.
Marginal cost is the change in total cost which takes place when there is a change in quantity by one unit. It depends on the change in volume. It includes at each level of the production additional costs which is required to produce the next unit. For example building a building requires building the base then you require extra cost for space and other building material.

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Question - 23:

Explain Explicit cost and Implicit cost?

Ans:

Explicit cost is the cost which is external to the business like wage, rent and materials. It gives clear picture of the cash outflow from business which is used to decrease the end result of profitability. This directly affects the revenue of the company.
Implicit cost is the result of one person who tries to satisfy his needs in search of an activity which gives no reward to him by money or another form of payment. It includes benefits and satisfaction. For example- goodwill. It is not counted in terms of money and it is indirect intangible cost.

View All Answers

Question - 24:

Explain cost of capital and its importance?

Ans:

Cost of the capital is the rate of return which is minimum which has to be earned on investments in order to satisfy the investors of various types who are making investments in the company in the form of shares, debentures and loans. It is used in financial investment which refers to the cost of a company's funds or the shareholders return on the company's existing deals. It is the required rate that a company must achieve to cover the cost of generating funds in the market. By seeing this only the investor invests the money in the company if the company is giving the required rate of return. It is a guideline to measure the profitability of different investments.
The importance of cost of capital is that it is used to evaluate new project of company and allows the calculations to be easy so that it has minimum return that investor expect for providing investment to the company. It has such an importance in financial decision making. It actually used in managerial decision making in certain field such as-
1) Decision on capital budgeting- It is used to measure the investment proposal to choose a project which satisfies return on investment.
2) Used in designing corporate financial structure- it is used to design the market fluctuations and try to achieve the economical capital structure for firm.
3) Top management performance- It evaluates the financial performance of top executives. It involves the comparison of actual profit of the projects and taken projects overall cost.

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Question - 25:

What is How is the cost of capital measured?

Ans:

Cost of capital is measured in terms of weighted average cost of capital. In this the total capital value of a firm without any outstanding warrants and the cost of its debt are included together to calculate the cost of capital.
To calculate the company's weighted cost of capital, first the calculation of the costs of the individual financing sources:
Cost of Debt Cost of Preference Capital, Cost of Equity Capital, and cost of stock capital take place and the formula is given as:-
WACC= Wd (cost of debt) + ws (cost of stock/RE) + wp (cost of pf. Stock)
where WACC= weighted average cost of capital

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Question - 26:

What is Cost of retained earnings?

Ans:

Cost of retained earnings have the opportunity cost associated with it and it can be computed as well without any difficulty. The opportunity cost in this is same as the rate of return of the shareholders which determine the cut off point for the deals. It is also the rate of return which shareholders can get by investing after tax dividends in alternative opportunity.

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Question - 27:

What is Cost of equity shares?

Ans:

Cost of equity shares is the hardest job to calculate and it also raises lots of problem while working on its calculations. Its main motive is to enable the management which is to make the decisions in the best interest of the equity holders. There is a certain amount of equity capital which must be earned on projects before raising any equity funds or acceptance of finance for other projects.

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Question - 28:

What is Cost of preference shares?

Ans:

Costs of preference share are also used to calculate the cost of capital and are the fixed cost bearing securities. In this the rate of dividend is fixed in advance when

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they are issued. It is equal to the ratio of annual dividend income per shares to net proceed. It is not used for taxes and it should not be adjusted for the same. Basically it is larger than the cost of debt.

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Question - 29:

What is Cost of debt?

Ans:

It is used to measure the cost of capital. This is the first thing which should be calculated in the beginning to find out the cost of capital. It includes both contractual cost and imputed cost. It is defined as the required rate of return that an investment which is debt has to yield to protect the shareholder's interest.

View All Answers

Question - 30:

What is composite cost of capital? Explain the process to compute it?

Ans:

Composite cost of capital is also known as weighted average cost of capital which is a measurable unit for it. It also tells about the component costs of common stock, preferred stock, and debt. Each of these components is given weightage on the basis of the associated interest rate and other gains and losses with it. It shows the cost of each additional capital as against the average cost of total capital raised. The process to compute this is first computing the weighted average cost of capital which is the collection of weights of other costs summed together. The formula is given as:-
WACC= Wd (cost of debt) + Ws (cost of stock/RE) + Wp (cost of pf. Stock)
In this the cost of debt is calculated in the beginning and it is used to find out the cost of capital and other weights of cost is been calculated after the calculation each and every individual weight of the component is added and then it gives the final composite cost..

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Question - 31:

What is cost of equity shares? What are the various ways to measure the cost of equity shares?

Ans:

Cost of equity share is the part of cost of capital which allows the payment to only the equity shareholders. In this every shareholders get the shares for getting the return on the shares on which they are investing so much. From company's perspective the company must earn more than cost of equity capital in order to be unaffected by the market value of the shares of its.
To measure the cost of equity shares we have to follow the following ways:-
1) Dividend yield method or Price ratio method
In this the minimum rate of cost of equity shares will be equal to the "present value of future dividend per share with current price of a share".
Cost of equity shares= Dividend per equity/ Market price
For example if there is a company which issues shares of Rs. 200 each a premium of 10%. The company pays 20% dividend to equity shareholders for the past five years and expects to maintain the same in the future also. Compute the cost of equity capital. Will it be different if market price of equity share is Rs. 260?
The solution can be found out by our formula which says
Cost of equity shares= Dividend per equity/ Market price
= 20*100/210
= 9.52%
If the market price of equity share is Rs. 260.
=20* 100/260 = 7.69%

View All Answers

Question - 32:

Explain Earnings Per Share (EPS). How is it calculated? What is its significance?

Ans:

Earning per share (EPS) is the amount of earning per each share of a company's stock. Companies require the EPS for their each income statement which shows about the continuing operations, discontinued operations, net income and outstanding items. EPS doesn't depend on the increase or decrease of the earning power of the company and gets calculated over number of years.
How is it calculated?
Earnings per share ratio (EPS Ratio) is calculated by dividing the net profit after taxes and preference dividend by the total number of equity shares. It is a small variance of return on equity capital ratio. The formula of Earning per share ratio is given as:-
"[Earnings per share (EPS) Ratio = (Net profit after tax - Preference dividend) / No. of equity shares (common shares)]"
What is its significance?
Earnings per share is a measure of profitability and it is viewed as the comparative earnings or the earning power of the respected firms. It is used from last four quarters but it can also be used to estimates the expected earnings of the next quarters as well.

View All Answers

Question - 33:

What is Price Earning Ratio (P/E Ratio)? How is it calculated? What is its significance?

Ans:

Price earnings ratio (P/E Ratio) is the ratio which is between the market price per equity and earning per share. High Price Ratio is used to give suggestion to the investors about their higher earning expected growth in future. It is usually used to compare the two P/E Ratio of different companies which are from the same industry. Investors should carefully note problems that arises with P/E Ratio measure to avoid biasing decision on many company's measure.
How is it calculated?
The P/E Ratio is calculated by dividing Market price per equity share to Earnings per share. This allows the company to estimate the appreciation in value of share of company and is used by investors for decision making on whether or not to buy shares in a particular company.
Following formula is used to calculate price earnings ratio:
"[Price Earnings Ratio = Market price per equity share / Earnings per share]"
For example:
The market price of share is Rs. 30 and earning per share is Rs. 5

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Price Earning Ratio = 30/5 = Rs. 6
This shows that market value of every one Rs. of earning is Rs. 6. It is useful in calculation of financial forecasting and also helps in knowing whether or not the share of company are under or over valued.
What is its significance?
The significance of Price earning Ratio is it helps investor in deciding whether or not to buy the shares of particular company at a particular market price. Higher the P/E better is it for the company. If P/E ratio is low then the management should be more particular in knowing the cause of the fall as it can affect the company's position in the market.

View All Answers

Question - 34:

Explain leverages?

Ans:

Leverage is a general term which is used in financial management and it is used as a technique to multiply the gains and losses. It refers of attainment of more benefits on comparative lower level of investment or lower sales. There are many ways to attain leverage the most common of them all is borrowing money, buying the fixed assets and use of derivatives. Examples of these are as follows:-
1) Public corporation may leverage its equity by borrowing money. The more a company borrows less equity capital it needs so the profits and losses are shared among small group of people.
2) Business Corporation may leverage its revenue by buying fixed assets. This will get more fixed proportion to the company rather than variable cost as change in revenue will result in larger change in operating income.

View All Answers

Question - 35:

What are the different types of leverages computed for financial analysis?

Ans:

Different types of leverage computed for financial analysis and they are as follows:-
1) Operating Leverage : - it is a leverage which refers to the enhancement of profits because there is a fixed operating cost which is involved with each and every component. When the sales increases fixed cost doesn't increase and it results in higher profits. Higher fixed expenses results in higher operating leverage which leads to higher business risk.
2.) Financial Leverage : - It is a leverage which refers to high level of profitability because of high fixed financial expenses. It includes interest on loan and preference dividend. Higher financial leverage indicates higher financial risk as well as higher break points. In this kind the managers have flexibility in choice of capital structure.
3.) Combined Leverage: - it is a leverage which refers to high profits due to fixed costs. It includes fixed operating expenses with fixed financial expenses. It indicates leverage benefits and risks which are in fixed quantity. Competitive firms choose high level of degree of combined leverage whereas cooperative firms choose lower level of degree of combined leverage.

View All Answers

Question - 36:

What does high/low operating leverage indicate?

Ans:

Operating leverage indicate about the company and its future profitability. It also help in assessing the level of risk which has been offered to the investors. Through this investors can estimate the profitability under certain conditions. High operating leverage indicates profits and it tells about the company's more money making policies from each additional sale if the increase cost doesn't increase to produce more sales whereas low operating leverage indicate the declining of profit margins and decreasing in earnings.

View All Answers

Question - 37:

Explain Operating Leverage. How is it computed? What does high/low operating leverage indicate?

Ans:

Operating leverage works on fixed cost as well as variable costs. It analyzes both of the costs and it remains in the company which has the highest proportion of fixed operating cost in relation to variable operating costs. The company uses fixed assets in operation of the company or vice versa. The company which is dealing in high operating leverage makes more money from additional sales if the company's cost doesn't increase to produce more sales. For example the software developing company's cost structure remains fixed and limited to the development and marketing cost. It doesn't matter how many components they sell the cost remain fixed. It helps the investor in dealing with the information on the risk analysis of the company. High operating leverage sometimes helps benefiting companies and sometimes remain vulnerable to sharp economic and business cycle swings.
How is it computed?
Operating leverage is highest in companies which got fixed operating cost in relation to variable operating cost. It tells investor about the companies position and the risk profile of the company. It is measured when a company has fixed costs that are regardless the sales volume. When company has fixed cost then the percentage change in profits due to changes in sales volume is greater than the percentage change in sales. The computation of this is known as degree of operating leverage (DOL) which gives the extent to which operating profits change as sales volume changes. It is given as:-
DOL (Degree of operating leverage) = %age change in income / %age change in sale

View All Answers

Question - 38:

What is combined leverage? How is it calculated?

Ans:

Combined leverage is a leverage which refers to high profits due to fixed costs. It includes fixed operating expenses with fixed financial expenses. It indicates leverage benefits and risks which are in fixed quantity. Competitive firms choose high level of degree of combined leverage whereas conservative firms choose lower level of degree of combined leverage. Degree of combined leverage indicates benefits and risks involved in this particular leverage.
The formula which is used to calculate this is as follows-
Degree of combined leverage = Degree of operating leverage * Degree of financial leverage.

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Question - 39:

Name the theories of capital structure?

Ans:

Capital structure is a term which is referred to be the mix of sources from which the long term funds are required for business purposes which are raised to improve the capital of the company. The theories which are involved in these are as follows:-
1) Net operating income (NOI):- this is an approach in which both value of the firm and weighted average cost are independent of capital structure. Individual holding the debt and equity receives the same cash flows without worrying about the taxes as they are not involved in it.
2) Traditional approach and Net income (NI) approach :- this is an approach in which both cost of debt, and equity are independent of capital structure. The components which are involved in it are constant and don't depend on how much debt the firm is using.
3) MM hypothesis with and without corporate tax : This approach tells that firm's value is independent of capital structure. The same return can be received by shareholders with the same risk.
4) Miller's hypothesis with corporate and personal taxes : This approach gives important advantage over equity. This ignores bankruptcy and agency costs.
5) Trade-off theory: costs and benefits of leverage.

View All Answers

Question - 40:

Explain Net income approach. Who proposed this theory?

Ans:

Net income (NI) approach as this is also called as traditional approach. This is an approach in which both cost of debt, and equity are independent of capital structure. The components which are involved in it are constant and doesn't depend on how much debt the firm is using. This theory was proposed by David Durand. In this change in financial leverage leads to change in overall cost of capital as well as total value of firm. If financial leverage increases, weighted average cost decreases and value of firm and market price of equity increases. If this decreases then weighted average cost of capital increases and value of firm and market price of equity decreases. The assumptions which can be made according to this approach is that there are no taxes involved in this and the use of debt doesn't change the risk factor for the investors and will remain the same throughout.

View All Answers

Question - 41:

What is capital structure? What are the principles of capital structure management?

Ans:

Capital structure is a term which is referred to be the mix of sources from which the long term funds are required for business purposes which are raised to improve the capital of the company. To fund an organization plan this capital structure is required which is the combination of debt and equity. The management ensures the capital structure accesses which are needed to fund future growth and enhance financial performance. The principles of capital structure management which are essentially required are as follows:-
1) Cost Principle
2) Risk Principle
3) Control Principle
4) Flexibility Principle
5) Timing Principle

View All Answers

Question - 42:

Explain Operating income approach. Who proposed this theory?

Ans:

Operating income approach is the approach which suggests the decision of capital structure towards a firm is irrelevant and change in leverage or debt doesn't result in change of total and market price of the firm. It tells that overall cost of capital is independent of degree of leverage. This approach was also proposed by David Durand.

View All Answers

Question - 43:

Explain Traditional approach of capital structure?

Ans:

Traditional approach is also known as Net income approach but it is the simplest form. It is in between the other two theories named as Net income theory and Net operating income theory. This approach has been formulated by Ezta Solomon and Fred Weston. This theory gives the right and correct combination of debt and equity shares and always lead to enhanced market value of the firm. This approach tells about the financial risk which will be undertaken by the equity shareholders. This approach focuses mainly on increasing the cost of equity capital which will be done after a level of debt in the capital structure

View All Answers

Question - 44:

Explain Low operating leverage, low financial leverage?

Ans:

This is also a worst situation where both operating leverage and financial leverage are low which results in undesirable consequences. Low degree of these leverages shows that the amount of fixed costs is very small and proportion of debts in capital is also low. The management in this situation might loose number of profitable opportunities and investments.

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Question - 45:

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Explain Low operating leverage, high financial leverage?

Ans:

If financial leverage is high than the funds are obtained mainly through preference shares, debentures and debts. This makes the base solid by keeping the operating leverage low on scale. The financial decision can be maximized as the management's concern can be earning per share which will favour the debt capital only. This will increase when the rate of interest on debentures is lower than rate of return in business. The decision is based on earning per share without any indication of the risks involved.

View All Answers

Question - 46:

Explain High Operating leverage, low financial leverage?

Ans:

High operating leverage indicates that company is making few sales but with high margins. This shows the risk if a firm incorrectly forecasts future sales. If the future sales have been manipulative forecasted then it create a difference between actual and budgeted cash flow, which affects the company's future operating ability. Low financial leverage indicates that management has adopted a very good approach towards the debt capital. This decreases the management decision making on earning per share. This is the optimum situation.

View All Answers

Question - 47:

Explain High operating leverage, high financial leverage?

Ans:

High operating leverage and high financial leverage indicates the risky investment made by the company's shareholders. This also indicates that company is making few sales but with high margins. This shows the risk if a firm incorrectly forecasts future sales. If the future sales have been manipulative forecasted then it create a difference between actual and budgeted cash flow, which affects the company's future operating ability. The financial leverage poses high risk when a company's return on assets doesn't exceed interest on loan, which lowers down company's return on equity and profitability.

View All Answers

Question - 48:

What does financial leverage indicate? What are its limitations?

Ans:

Financial leverage indicates borrow of funds to raise the capital by issuing shares in the market to meet their business requirements. This also indicates the profitability and return on equity of the company which has taken significant amounts of debt. The financial leverage has many advantages but it possess some limitations as well which has been shown as follows:-
1) When a company borrows funds using financial leverage then this money develops an environment that can either creates lots of profits or a small amount of it.
2) Borrowing constantly creates an image that the company might be on high risk. Which in turn increases the interest rates and some restrictions could be handed over to the borrowing organization.
3) Value of stock also gets affected as it can drop substantially if the stockholders intervene in between.

View All Answers

Question - 49:

What does high/ low financial leverage indicate?

Ans:

High financial leverage indicates the risky investment made by the company's shareholders. Low financial leverage indicates that management has adopted a very good approach towards the debt capital. This decreases the management decision making on earning per share.

View All Answers

Question - 50:

Explain Financial Leverage. How is it calculated? What does high/ low financial leverage indicate?

Ans:

Financial leverage is the leverage in which a company decides to finance majority of its assets by taking on debt. The leverages have been applied by investors and companies to generate more returns on their assets. This employment of leverage doesn't guarantee success and increases the possibility of excessive losses which becomes more great in high leverage positions. Firms use this leverage when they are unable to raise enough capital by issuing shares in the market and unable to meet their business needs. When firm takes on debt it sees that at that time how is the return on assets and for a firm it should be higher than the interest on the loan.
How is it calculated?
The calculation of financial leverage takes place in following steps:-
1) Calculation of total debt is carried out by the company which includes short term debt as well as long term debt.
2) Calculation of total equity takes place in the company by shareholders to find out the equity they multiply number of outstanding shares by stock price. This amount is represented as shareholder equity.
3) To calculate financial leverage ratio divide total debt with total equity.
4) If company has high financial leverage ratio than it could be a sign of financial weakness. This can also lead to bankruptcy if the company is highly leveraged.

View All Answers

Question - 51:

What is Modigliani- Miller (M and M) approach?

Ans:

Modigilani-Miller approach is also known as MM approach which looks similar to Net operating income approach. It is in synchronization with the Net operating income approach and states in acceptance with the approach that cost of capital is independent of degree of leverage. It provides justification for operational and behavioural for constant cost of capital at any degree of leverage as this is not being provided by the Net operating Income approach. It is been assumed in this approach that capital markets are perfect and the investors are investing in the company from the same expectation of the company's net operating income in search of

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evaluating the value of the firm. The propositions of this approach can be mentioned in the following ways and it is as follows:-
1) Company's overall cost of capital and value of the firm is constant at any degree of leverage as it is independent of the capital structure.
2) Capital investment which has the minimum cut-off rate is also independent of project finances.
If this approach has advantages then it has certain limitations associated with it and the limitations are as follows:-
1) Investors find the leverages inconvenient and risk perception of corporate and personal leverage is different.
2) Corporate doesn't exist but it gets removed later.
3) Arbitrary process doesn't have any restrictions and it is also not be affected by transaction cost.

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