31 Lecture - MGT201

Important Subjective

- **What is operating leverage and how does it affect a company's profitability?**
Answer: Operating leverage is a measure of how much a company's fixed costs contribute to its overall cost structure. A company with high operating leverage has a higher proportion of fixed costs, which means that a small change in sales can lead to a larger change in profits. This can work both ways, resulting in higher profits during good times and larger losses during bad times.

- **What is financial leverage and how does it affect a company's risk?**
Answer: Financial leverage refers to the use of borrowed funds to finance a company's operations. This can increase a company's return on equity (ROE) by magnifying the effect of its earnings on shareholders' equity. However, it also increases the company's financial risk, as it must make regular interest payments and repay principal on its debts.

- **How do you calculate the break-even point for a company?**
Answer: The break-even point is the level of sales at which a company's revenues equal its total costs. It can be calculated by dividing the company's fixed costs by its contribution margin, which is the difference between its sales revenue and variable costs.

- **How does a company's business risk affect its cost of capital?**
Answer: A company with higher business risk will typically have a higher cost of capital, as investors will demand a higher return to compensate for the increased risk. This is because the company's future earnings are less certain, which makes it riskier to invest in.

- **How does a company's use of leverage affect its return on equity (ROE)?**
Answer: A company's use of leverage can magnify its ROE by increasing the amount of profit that is attributable to shareholders' equity. However, it also increases the risk of the company's earnings, which can result in larger losses for shareholders.

- **What is the difference between operating leverage and financial leverage?**
Answer: Operating leverage refers to the use of fixed costs in a company's cost structure, while financial leverage refers to the use of borrowed funds to finance a company's operations. Both types of leverage can affect a company's profitability and risk.

- **How can a company reduce its business risk?**
Answer: A company can reduce its business risk by diversifying its operations, reducing its debt levels, or implementing risk management strategies such as hedging.

- **How does a company's break-even point affect its profitability?**
Answer: A company's break-even point represents the level of sales at which it is neither making a profit nor a loss. Any sales above the break-even point will result in a profit for the company, while any sales below it will result in a loss. Therefore, the lower the break-even point, the more profitable the company will be.

- **How does a company's cost of capital affect its investment decisions?**
  Answer: A company's cost of capital represents the minimum return that it must earn on its investments to satisfy its investors. If a potential investment has a return that is lower than the company's cost of capital, it will not be undertaken, as it will result in a loss for the company.

- **How can a company use leverage to increase its return on equity (ROE)?**
  Answer: A company can use leverage to increase its ROE by borrowing funds to finance its operations. This magnifies the effect of its earnings on shareholders' equity, resulting in a higher ROE. However, it also increases the risk of the company's earnings, which can result in larger losses for shareholders.