Financial Leverage

Financial leverage refers to the degree a firm is using long-term debt and other liabilities to enhance its performance. The use of financial leverage can exaggerate a firm's performance in either a good or a bad way. If a firm is using debt profitably (earning more on the debt than it is paying), its profit will increase; if a firm is using debt unprofitably (earning less on the debt than it is paying), its profit will decrease.

The use of debt and other leverage increases the volatility of a firm's performance. And the firm has to also factor this effect into its decision about to what degree it should employ financial leverage.

The other form of leverage a firm can employ is called operating leverage. Operating leverage refers to the degree a firm uses fixed costs to enhance its performance. Fixed costs usually lower a firm's per unit costs, but because these costs are fixed, they accrue whether sales are strong or weak. Therefore, they exaggerate a firm's profit performance.