

PRINCIPLES OF FINANCIAL MANAGEMENT: OPERATIONAL LEVERAGE AND FINANCIAL LEVERAGE

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Abstract

Understanding and mastering the principles of financial management is not only the key to success in running a business, but also very vital in our personal lives. In this world full of uncertainty, the ability to manage finances wisely can determine financial stability in the future. With good financial management, companies can allocate expenditure and income funds appropriately. Understanding the principles of operational leverage and financial leverage is very important in financial management. Both can be used to maximize profits, but also carry risks that need to be managed properly. With the right strategy, companies can use leverage to achieve their financial goals. In financial management, leverage is an important concept used to increase the company's profit potential. The utilization of fixed costs in the business's cost structure is associated with operational leverage. Leverage in finance is the process of using debt to fund a company's operations and assets. The performance of the business as a whole may be impacted by these two interrelated forms of leverage. Nevertheless, the amalgamation of these two categories of leverage can also increase risk, so financial managers need to be careful in planning the company's cost and financing structure.

Keywords: Financial management, operational leverage, financial leverage

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INTRODUCTION

Veronica, A. (2015) stated that financial management is the art and science of managing funds, whether for individuals, businesses, or organizations. This process involves various very important activities, such as planning, allocating funds, controlling, and evaluating finances to achieve financial goals effectively and efficiently. In practice, it is not just about keeping the numbers in the ledger balanced, but also about maximizing every penny earned, invested, or spent. With the advancement of technology and the constant change in market dynamics, modern financial management has transformed into more than just numbers

Now, it involves in-depth analysis, predictions, and strategies that not only secure current assets but also ensure long-term growth. From planning a household budget to managing the billion-dollar assets of a multinational company, the principles of financial management remain the same: earn, use, and manage finances in a smart and productive way.

The importance of financial management is evident when we face a financial crisis or when we are trying to achieve ambitious financial goals. Without a solid foundation in financial management, even the largest ship can sink in an economic storm (Petty et al., 2015). Therefore, understanding and implementing financial management principles is not just an option, but a must for anyone who wants to sail smoothly towards a safe and prosperous financial future. In a company, financial arrangements are often referred to as financial management. This activity usually includes planning, operating, analyzing financial activities, as well as financial control and control.

According to Titman et al., (2018) there are several financial management principles that need to be considered which means they can prevent non-transparent financial administration patterns. In general, Financial management encompasses all actions pertaining to securing finance for working capital, allocating or using funds, and managing owned assets in order to accomplish the primary objective. In actuality, financial management refers to the steps done to keep the business's finances stable. Implementing financial management is certainly not easy, principles are needed that can underlie financial transaction management.

In a company, financial arrangements are often referred to as financial management (Eichhorn, P., & Towers, 2018). This activity usually includes planning, operating, analyzing financial activities, as well as financial control and control. There are several principles of financial management that need to be considered which means it can prevent non-transparent financial

administration patterns. In general, financial management encompasses all actions pertaining to securing finance for working capital, allocating or using funds, and managing owned assets in order to accomplish the primary objective. Financial management is actually an action done to sustain the financial stability of the company. Implementing financial management is certainly not easy, it requires principles that can underlie financial transaction management.

The existence of the capital market is currently increasingly in demand by various groups which are a location where different parties can sell bonds and stocks, particularly businesses. As a result, they can invest their resources in a variety of ways, and business owners can raise more money by selling the long-term financial instruments debt or equity that their company has invested in. According to Dudycz, T. (2020) based on the source, Both external and internal sources provide funding. Leverage is the kind of outside funding that the business requires.

Mohamed, I. (2016) states that Leverage is the strategy used by businesses with fixed expenditures (fixed expenses) to increase prospective earnings for shareholders by utilizing assets and funding sources. The corporation will be able to generate profits with certainty if all costs are variable. However, in order to turn a profit, a minimum amount of sales is necessary, as corporate costs are set. Fixed costs are expenses that are unrelated to the business's operations and are therefore unrelated to sales.

When a company has fixed costs (fixed expenses), it uses its assets and funding sources as leverage to increase potential returns for shareholders. Since fixed costs are unrelated to sales and the company's activities, the company is required to assume the risk associated with them. Operating and financial leverage are the two categories of leverage identified by Magli et al. (2018). Due to their lack of correlation with sales, fixed costs provide a risk that the business must assume, so it is necessary to identify the types of leverage used.

According to Megawati, L. R. (2020) operating leverage and financial leverage. Operating leverage is a company's cost structure that is associated with management decisions in determining the company's asset combination. While financial leverage describes the level of debt funding sources in the company's capital structure. The use of relatively high debt incurs fixed costs and increases risk. Leverage analysis is used to measure the comparative composition between own funds or capital which is reflected in the capital component with external funds. Operating profit, or earnings before interest

and taxes, is affected by sales. This is demonstrated by operating leverage analysis. Financial leverage analysis, on the other hand, involves using fixed expenditures to maximize or increase earnings per share. Defined as the percentage change in earnings per share as a result of a percentage change in operating profit (EBIT), DFL (Degree Of Financial Leverage) is a measure of financial leverage. For financial planning, analysis, and management, the concepts of operating and financial leverage are helpful. Leverage in financial management refers to a company's utilization of resources and assets to raise earnings for shareholders while maintaining constant costs (Towo, 2023).

RESEARCH METHOD

This study uses a descriptive method by collecting data from various reliable sources, including literature studies and recent publications. A descriptive approach is used to describe the principles of financial management: operational leverage and financial leverage comprehensively. The first stage in this research method is collecting literature relevant to the research topic. A literature search is conducted through academic databases, scientific journals, and related publications that discuss the principles of financial management: operational leverage and financial leverage. The selected literature must be of good quality and relevant to the research objectives. After collecting the literature, an analysis and synthesis of the information found is carried out. Relevant data and information on the principles of financial management, capital structure, measurement, and distribution of leverage, the relationship between operational leverage and financial leverage in financial management, which are related to the research topic.

RESULT AND DISCUSSION

Principles of Financial Management

Understanding and mastering financial management is not only the key to success in running a business, but also very vital in our personal lives. In this world full of uncertainty, the ability to manage finances wisely can determine financial stability in the future. Financial management is an important part of the lives of individuals, organizations, or companies. In business, for example, the function of financial management is as a planning process to controlling funds. Fatmawatie, N., & Endri, E. (2022) the definition of financial management is a business activity as a form of responsibility to obtain and use company funds in achieving goals in an effective manner. In essence, financial

management is all company activities related to how to use, obtain, and manage company funds in achieving certain goals and targets.

Zutter, C. J., & Smart, S. B. (2019) the importance of financial management is clearly seen when we face a financial crisis or when we are trying to achieve ambitious financial goals. Without a strong foundation in financial management, even the largest ship can sink in an economic storm. Therefore, understanding and applying the principles of financial management is not just an option, but a must for anyone who wants to sail smoothly towards a safe and prosperous financial future. Financial management in business is not just about keeping money in and out of the cash register. More than that, it is about maximizing every dollar earned. With good management, companies can ensure that every investment, expenditure, and financial decision is supported by solid data and in-depth analysis. This creates a strong foundation not only to survive, but also to thrive in a competitive environment (Madura, 2018).

Furthermore, effective financial management allows businesses to make strategic decisions quickly and accurately, such as when to take investment opportunities or when to cut expenses during an economic crisis. This is very important because in the business world, time is money and quick decisions can often determine whether or not a business survives. Therefore, building a responsive and adaptive financial management system is not only a competitive advantage, but also a vital safeguard against unexpected financial risks.

Some of the scopes of financial management are Armour et al., (2016):

1. Funding

Funding in financial management is all policies regarding how to obtain money for the company. For example, issuing securities or short-term and long-term debt.

2. Investment

Financial management investment is an activity related to the company's capital investment, such as fixed or financial assets, such as buildings, land, stocks, and bonds.

3. Asset Management

In managing company assets, the task of financial management is to control the assets owned so that they are efficient and achieve the company's goals.

There are a number of financial management principles that need to be applied by every company in making financial decisions, including (Maheshwari et al., 2021):

1. Prudence, decisions are based on accurate information considering the potential risks.
2. Independence, the goal of financial management is to be able to make decisions without any interference outside the company's problems.
3. Adequate returns, investment decisions based on the company's goals in returning adequate funds.
4. Sufficient liquidity to meet the company's financial obligations.
5. Efficiency, optimizing the use of the company's financial capital.
6. Consistency based on the company's goals and management principles.
7. Transparency, in order to provide accurate, useful, and reliable information for the company's stakeholders.

In essence, financial management is an activity in managing company funds to achieve effective goals. With good financial management, the company can allocate expenditure and income funds appropriately.

Capital Structure, Measurement, and Leverage Distribution

Capital structure is part of the financial structure representing the quantity of equity and the total external capital (both short- and long-term) in an absolute or relative manner (Graham et al., 2015). In the long-term financial structure of the corporation, the capital structure consists of a mix of debt and equity. Sales stability is the first element that affects capital structure, according to Ferrarini et al. (2017). Businesses with reasonably consistent sales can more comfortably get more loans and withstand greater fixed costs than businesses with erratic sales. The second factor is asset structure; businesses that have assets that may be pledged as security for loans typically have higher debt levels. The third factor that influences capital structure is operating leverage. In this case, companies due to their lower business risks, companies with less operating leverage are typically better equipped to grow financial leverage. The growth pace is the fourth aspect; businesses that expand quickly need to rely more on outside funding. Rapidly expanding businesses, however, frequently experience more uncertainty, which tends to lessen their inclination to take on debt. In addition to the four factors above, another determinant of capital structure is profitability. According to the pecking order theory, companies with high levels of profitability have larger internal funding sources and have a smaller need to finance investments through external funding (Hang et al., 2018). One measure of a company's

capital structure is indicated by financial leverage (Brown et al., 2021). The literal meaning of "leverage" itself is actually the power of leverage, derived from the word "lever" which means lever. Meanwhile, according to (Procasky et al., 2014) explains that Leverage is a strategy used by businesses to invest money or find funding sources that come with upfront expenses that the business must pay. Meanwhile, leverage is defined as the use of assets or cash for which the business is required to pay a fixed burden in the form of interest or depreciation (Brailsford et al., 2002).

Financial leverage is used to measure how much of the company's funding comes from long-term debt, (Getzmann et al., 2014). Financial leverage affects income after interest and taxes, or income available to common shareholders. The measurement of leverage in this study uses the proxy Long term debt. The leverage ratio is a metric that expresses the amount of debt that a firm has relative to its equity or assets. This gives a general idea of the company's capacity to pay its debts.

The use of leverage has several benefits, including:

Increasing Return on Investment (ROI): By using debt, companies can increase the potential profit from the investment made.

Expanding Investment Capacity: Leverage allows companies to make larger investments without having to spend their own capital in full.

However, there are also risks associated with the use of leverage, namely:

Limitations in Debt Repayment: If the company cannot generate enough revenue to cover the cost of debt, this can lead to bankruptcy

Dependence on Creditors: The greater the proportion of debt, the greater the company's dependence on creditors, which can affect business decisions.

Leverage measurement is an important tool for companies to understand their capital structure and ability to meet financial obligations. By utilizing the leverage ratio, companies can make better decisions regarding financing and investment, while remaining aware of the risks that may arise from the use of debt (Chadha, S., & Sharma, 2015).

In financial management, Operating and financial leverage are the two different forms of leverage. The goal of using both is to increase earnings over the cost of assets and funding sources. Thus, the proper use of leverage will certainly increase profits for shareholders. Conversely, leverage can also pose a risk of loss. If the company gets lower profits compared to Leverage and its fixed costs will undoubtedly lower shareholder earnings.

1. Operating Leverage

Using assets with fixed costs to generate enough revenue to cover both fixed and variable costs and boost profitability is known as operating leverage. Changes in sales or revenue can be compared to the operational profit of the business to determine operating leverage. The operating leverage measure, also known as the Degree of Operating Leverage (DOL), is the percentage change in operating profit as a result of variations in the number of units sold. The formula for determining the degree of operating leverage will be clarified in the following according to Astuti (2002:142), namely:

$$DOL = \frac{\% \text{ CHANGE IN EBIT}}{\% \text{ CHANGE IN SALES}}$$

Operational The term "leverage" describes how a company's cost structure uses fixed costs. This indicates that the business can increase profits by increasing sales volume, because fixed costs do not change even if there are changes in sales. Operational leverage focuses on the effect of fixed costs on earnings before interest and taxes (EBIT). The higher the operational leverage, the greater the impact of changes in sales on the company's profits.

Income smoothing actions tend to be carried out by companies that have high operating leverage, because there is an assumption that investors in investing want a large return with a small level of risk. Sutrisno (2007:227), states that Using assets that result in the corporation bearing fixed costs in the form of depreciation is known as operating leverage (Chu, Y., & Wang, 2017).

2. Financial leverage

Financial leverage, which is a smaller change in financial costs (which are fixed) will result in a large change in price. Financial leverage, according to Sartono (2001:263), is the use of funding sources with a set burden in the hopes of generating additional benefits that outweigh it, increasing the profits accessible to shareholders. The process of determining the level of financial leverage will be explained in the following namely:

$$DFL = \frac{\% \text{ CHANGE in EPS}}{\% \text{ CHANGE in EBI}}$$

In order to increase the company's profitability, financial leverage is the use of funds in the form of long-term debt in the capital structure of the business. This is accompanied by a fixed cost requirement, in the form of loan interest.

Leverage in finance refers to the utilization of debt to fund an organization's operations and assets. Businesses can boost their earnings per share and prospective return on equity (ROE) by utilizing debt, because they do not need to spend their own capital in full. However, the use of debt also increases financial risk, especially if the company is unable to meet its debt obligations (He, W., Tang, X., & Zeng, 2024).

Relationship between Operational Leverage and Financial Leverage in Financial Management

According to Sarkar, S. (2020) risk to finances is The portion of stockholder risk coming from the use of financial leverage, above and beyond fundamental business risk. Unable to pay for its expenses, a firm is said to be in financial risk. As leverage rises, this risk will also have to be absorbed by the company, as it will result in an urgent principal payment due to the increased financial load. When a business employs a lot of operating leverage, then its breakeven point is at a relatively high level of sales and changes in the level of sales have an increasing impact on profits. Operating leverage has exactly the same type of effect on profits; the higher the leverage factor, the higher the breakeven sales volume and the greater the impact on profits of a given change in sales volume. Increasing the company's leverage is expected to increase income for the company's owners, but at the same time, the risk caused by the increase in income also increases because EBIT must be increased to allow the company to continue operating. The EBIT level is greater than the amount needed to pay fixed financial obligations, then the benefits of financial leverage will be obtained. Financial Leverage is like a double-edged sword. In addition to increasing returns for investors, it also increases the company's financial risk (Chen, 2020).

This happens because the company will be burdened with loan interest which can ultimately burden the company's net profit and cash flow. And if the debt increases, creditors will apply a higher interest rate to compensate for the increase in financial risk. From the above, it can be concluded that the higher the fixed costs, the higher the business risk. High fixed costs are generally usually caused by the use of high technology that is automatic so that it requires capital intensive or businesses that use highly skilled workers which must still be maintained even in a recession. So if a company has high fixed costs, the company can be said to have a high level of operating leverage. These two types of leverage interact with each other in determining the company's risk and profit potential. High operating leverage can increase the sensitivity of profits to changes in sales, while high financial leverage can

increase financial risk. When a company has both types of high leverage, the potential for profit can increase, but the risk of loss also increases significantly (Goel et al., 2015). For example, if a Sales are up for the corporation, and its operational leverage is high will result in a greater increase in profits. However, if the company also has high debt, financial leverage will increase the interest expense that must be paid, which can reduce net income. Therefore, financial managers need to consider the balance between these two types of leverage to reduce risk and increase the company's worth.

According to Asraf, A., & Desda, M. M. (2020) the factors that are generally considered when a company formulates basic policies related to financial structure are; 1) Future sales growth rate, 2) Future sales stability, 3) Competitive industry structure, 4) Company asset structure, 5) Control position and attitude towards risk of owners and management, AND 6) Attitude of lenders (Lenders) towards the company and industry. A company's above average sales growth is typically predicated on the industry it operates in, which is predicted to grow at a quick rate. Nonetheless, by gaining market share from overall industry demand, businesses can attain growth rates that are above average. Forecasting final demand for a company's products is a useful right.

In financial management, It is critical to comprehend how operational and financial leverage relate to one another. Both can be strategically applied to raise an organization's performance, but they also carry risks that need to be carefully managed. With proper analysis, companies can leverage both types of leverage to achieve their financial goals.

CONCLUSION

Understanding the principles of operational leverage and financial leverage is essential in financial management. Both can be used to maximize profits, but they also carry risks that need to be managed properly. With the right strategy, companies can use leverage to achieve their financial goals. In financial management, leverage is an important concept used to increase a company's profit potential.

It is important to comprehend the two primary forms of leverage, which are financial and operational. The utilization of fixed expenses in a business's cost structure is associated with operational leverage. The impact of variations in sales volume on profits before interest and taxes (EBIT) is the main emphasis of this leverage. The greater the operational leverage, the greater the impact of changes in sales on the company's profits. In other words,

companies with high fixed costs will experience greater fluctuations in profits as sales change. Leverage in finance is the process of using debt to fund an organization's operations and assets. A business can boost earnings per share and potential return on equity (ROE) by utilizing debt, because it does not have to spend its own capital in full. However, the use of debt also increases financial risk, especially if the company is unable to meet its debt obligations. A high percentage of financial leverage can increase the risk of bankruptcy, so it is important for financial managers to manage debt carefully.

These two types of leverage are interrelated and can affect the overall performance of a company. Operational leverage can increase profits when sales increase, while financial leverage can increase earnings per share if the company manages its debt well. However, the combination of these two types of leverage can also increase risk, so financial managers need to be careful in planning the company's cost and financing structure.

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