

Financial Management - II

Paper Code: MS 304

Topic: Concept and Theories of Capital Structure

Unit 1: Concept and Theories of Capital Structure

Objectives

After studying this unit, you will be able to:

- Define the capital structure
- Recognize the conception of optimum capital structure
- Explain the different considerations in capital structure planning
- Describe the theories of capital structure.

Meaning of Capital Structure

The basic objective of financial management is to maximize the shareholders wealth. Therefore, all financial decisions in any firm should be taken in the light of this objective.

Whenever a company is required to raise long-term funds the finance manager is required to select such a mix of sources of finance that overall cost of capital is minimum (i.e., value of the firm/wealth of shareholders is maximum). Mix of long-term sources of finance is referred as “capital structure”.

Optimum Capital Structure

The capital structure is said to be optimum when the firm has selected such a combination of equity and debt so that the wealth of firm (shareholder) is maximum. At this capital structure, the cost of capital is minimum and market price per share is maximum.

It is very difficult to find out optimum debt and equity mix where capital structure would be optimum because it is difficult to measure a fall in the market value of an equity shares on account of Increase in risk due to high debt content in capital structure. Hence, in practice, the expression “appropriate capital structure” is more realistic expression than ‘optimum capital structure’.

Features of an Appropriate Capital Structure

1. **Profitability:** The most profitable capital structure is one that tends to minimize cost of financing and maximize earning per equity share.
2. **Flexibility:** The capital structure should be such that company can raise funds whenever needed.
3. **Conservation:** The debt content in the capital structure should not exceed the limit, which the company can bear.
4. **Solvency:** The capital structure should be such that firm does not run the risk of becoming insolvent.
5. **Control:** The capital structure should be so devised that it involves minimum risk of loss of control of the company.

Major Considerations in Capital Structure Planning

In planning the capital structure, one should keep in mind that there is no one definite model that can be suggested/used as an ideal for all business undertakings. This is because of varying circumstances of business undertakings. It is, therefore important to understand that different types of capital structure would be required for different types of business undertakings.

However, finance manager should take into consideration following factors while planning the capital structure:

1. **Risk:** Risk is of two kinds, i.e. financial risk and business risk. In the context of capital structure planning, financial risk is

relevant. Financial risk also is of two types:

- (a) **Risk of cash insolvency:** As a firm raises more debt, its risk of cash insolvency increases. This is due to two reasons. Firstly, higher proportion of debt in the capital structure increases the commitments of the company with regard to fixed charges. This means that a company stands committed to pay a higher amount of interest irrespective of the fact whether it has cash or not. Secondly, the possibility that the supplier of funds may withdraw the funds at any given point of time. Thus, the long-term creditors may have to be paid back in installments, even if sufficient cash to do so does not exist. This risk is not there in the case of equity shares.
 - (b) **Risk of variation in the expected earnings available to equity shareholders:** In case a firm has higher debt content in capital structure, the risk of variations in expected earnings available to equity shareholders will be higher. This is because of trading on equity, Financial leverage works both ways, i.e.; it enhances the shareholders return by a high magnitude, or brings it down sharply depending upon whether the return on investment is higher or lower than the rate of interest.
2. **Cost of capital:** Cost is an important consideration in capital structure decisions, it is obvious that a business should be at least capable of earning enough revenue to meet its cost of capital and finance its growth.
 3. **Control:** Along with cost and risk factors, the control aspect is also important consideration in planning the capital structure. When a company issues further equity shares, it automatically dilutes the controlling interest of the present owners. Similarly, preference shareholders can have voting rights and thereby affect the composition of the Board of Directors in case dividends on such shares are not paid for two consecutive years. Financial institutions normally stipulate that they shall have one or more directors on the Board. Hence, when the management agrees to raise loans from financial institutions, by implication it agrees to forego a part of its control over the company. It is obvious therefore, that decisions concerning capital structure are taken after keeping the control factor mind.
 4. **Trading on Equity:** A company may raise funds either by the issue of shares or by borrowings. Borrowings carry a fixed rate of interest and this interest is payable irrespective of fact whether there is profit or not. Of course, preference shareholders are also entitled to a fixed rate of dividend but payment of dividend is subject to the profitability of the company. In case the Rate Of Return (ROI) on the total capital employed i.e. shareholders funds plus long term borrowings, is more than the rate of interest on borrowed funds or rate of dividend on preference shares, it is said that the company is trading on equity. One of the prime objectives of a finance manager is to maximize both the return on ordinary shares and the total wealth of company. This objective has to be kept in view while making a decision on a new source of finance its impact on the earnings per share has to be carefully analyzed. This helps in deciding whether funds should be raised by internal equity or by borrowings.
 5. **Corporate Taxation:** Under the Income Tax laws, dividend on shares is not deductible, while interest paid on borrowed capital is allowed as deduction for computing taxable income. The cost of raising finance through borrowing is deductible in the year in which it is incurred. If it is incurred during the pre-commencement period, it is to be capitalized. Cost of issue of shares is allowed as deduction. Owing to these provisions corporate taxation plays an important role in determining the choice between different sources of financing.
 6. **Government Policies:** Government policies are a major factor in determining capital structure.
Example: a change in the lending policies of financial institutions may mean a complete change in the financial pattern to be followed in the companies. Similarly, the Rules and Regulations framed by SEBI considerably affect the capital issue policy of various companies. Monetary and fiscal policies of the government also affect the capital structure decisions.
 7. **Legal Requirements:** The finance manager has to keep in view the legal requirements while deciding about the capital structure of the company.
 8. **Marketability:** To obtain a balanced capital structure it is necessary to consider the ability of the company to market corporate securities.
 9. **Maneuverability:** Maneuverability is required to have as many alternatives as possible at the time of expanding or contracting the requirement of funds. It enables use of proper type of funds available at a given time and also enhances the bargaining power when dealing with the prospective suppliers of funds.
 10. **Flexibility:** Flexibility refers to the capacity of the business and its management to adjust to expect and unexpected

changes in circumstances. In other words, management would like to have a capital structure, which provides maximum freedom to changes at all times.

11. **Timing:** Closely related to flexibility is the timing for issue of securities. Proper timing of a security issue often brings substantial savings because of the dynamic nature of the capital market. An Intelligent management tries to anticipate the climate in capital market with a view to minimize the cost of raising funds and also to minimize the dilution resulting from an issue of new ordinary shares.
12. **Size of the Company:** Small companies rely heavily on owners' funds while large companies are generally considered to be less risky by the investors and therefore, they can issue different types of securities.
13. **Purpose of Financing:** The purpose of financing also to some extent affects the capital structure of the company. In case funds are required for productive purposes like manufacturing etc.; the company may raise funds through long-term sources. On other hand, if funds are required for non-productive purposes, like welfare facilities to employees such as schools, hospitals etc., the company may rely only on internal resources.
14. **Period of Finance:** The period for which finance is required also effects the determination of capital structure. In case such funds are required for long-term requirements, say 8-10 years, then it will be appropriate to raise borrowed funds. However, if the funds are required more or less permanently, it will be appropriate to raise them by the issue of equity share.
15. **Nature of Enterprise:** The nature of enterprise too, to a great extent, affects the capital structure or the company. Business enterprises that have stability in their earnings or those who monopoly regarding their products may go for borrowings or preference shares, since they have adequate profits to pay interest/fixed charges. On the contrary, companies, which do not have assured income, should preferably rely on internal resources to a large extent.
16. **Requirement of Investors:** Different types of securities are issued to different classes of investors according to their requirement.
17. **Provision for Future:** While planning capital structure the provision for future requirement of capital is also to be considered.

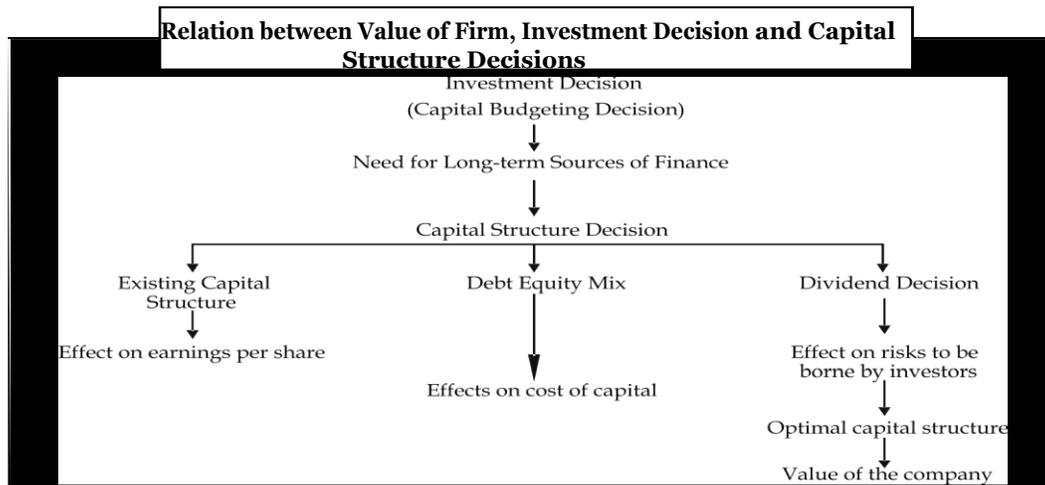
Value of the Firm and Capital Structure

Value of the firm depends on the earnings of the firm and earnings of the firm depend upon the investment decisions of the firm. Investment decision influences the size of the EBIT. The EBIT is shared among three main claimants:

1. The debt holders who receive their share in the form of interest.
2. The government which receives its share in the form of taxes.
3. The shareholders who receive the balance.

Thus, the investment decisions of the firm determine the size of the EBIT pool while the capital structure mix determines the way it is to be sliced. The total value of the firm is the sum of the value to the debt holders and its shareholders. Therefore, investment decision can increase the value of the firm by increasing the size of the EBIT whereas capital structure mix can affect the value only by reducing the share of the EBIT going to the government in the form of taxes.

Thus, the value of the firm, investment decisions and capital structure decisions are closely related and is depicted by the following figure.



Capital Structure Theories

These approaches analyze the relationship between the leverage, the cost of capital and the value of the firm in different ways. However, the following assumptions are made to understand these relationships.

1. There are only two sources of funds viz., debt and equity.
2. The total assets of firm are given. The degree of leverage can be changed by selling debt to repurchase shares or selling shares to retire debt.
3. There are no retained earnings. It implies that entire profits are distributed among shareholders.
4. The operating profit of firm is given and expected to grow.
5. The business risk is assumed to be constant and is not affected by the financing mix decision.
6. There are no corporate or personal taxes.
7. The investors have the same subjective probability distribution of expected earnings.

Net Income (NI) Approach

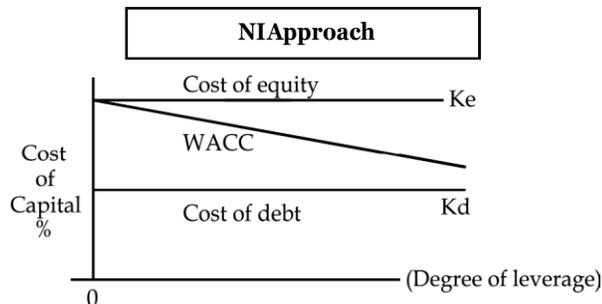
The Net Income (NI) approach is the relationship between leverage and cost of capital and value of the firm. This theory states that there is a relationship between capital structure and the value of the firm and therefore, the firm can affect its value by increasing or decreasing the debt proportion in the overall financing mix. The NI approach makes the following additional assumptions:

1. That the total capital requirement of the firm is given and remains constant.
2. That cost of debt is less than cost of equity capitalization rate.
3. There are no corporate taxes.
4. The use of debt content does not change the risk reception of the investors as a result; both the debt capitalization rate and the equity capitalization rate remain constant.

NI (Net Income) Approach is suggested by Durand.

The NI approach starts from the argument that change in financing mix of a firm will lead to change in Weighted Average Cost of Capital (WACC) of the firm, resulting in the change in value of the firm. As debt capitalization is less than equity, the increasing use of cheaper debt (and simultaneous decrease in equity proportion) in the overall capital structure will result in magnified returns to the shareholders.

The increased returns to the shareholders will increase the total value of the equity and this increases the total value of the firm. The WACC will decrease and the value of the firm will increase. On the other hand, if the financial leverage is reduced by the decrease in the debt financing, the WACC of the firm will increase and the total value of the firm will decrease. The NI approach to the relationship between leverage costs of capital has been presented graphically.



The value of the firm on the basis of Net income approach can be ascertained as follows: $V = S + D$.

Where

- V = Value of the firm
- S = Market value of equity.
- D = Market value of debt.

Where,

$$\text{Market value of equity (S)} = \frac{\text{NI}}{K_e}$$

NI = Earnings available for equity shareholders, K_e = Equity capitalization rate.

Under NI approach, the value of the firm will be maximum at a point where average cost of capital is minimum. Thus the theory suggests total or maximum possible debt financing for minimizing the cost of capital.

$$\text{The overall cost of capital} = \frac{\text{E.B.I.T.}}{\text{Value of the firm}} \times 100$$

The NI approach can be illustrated with the help of the following example.

Example: Expected EBIT of the firm is 2,00,000. The cost of equity (i.e., capitalization rate) is 10%. Find out the value of Firm and overall cost of capital if debenture capital is:

₹ 200000

₹ 500000

₹ 700000

Debenture interest rate is 6%.

Statement Showing the Value of Firm and Overall Cost of Capital WACC

	Degree of Leverage.		
	₹	₹	₹
Debenture capital	200000	500000	700000
EBIT	200000	200000	200000
Less Int.@ 6%	12000	30000	42000
Net profit (i.e. earning available to equityshare holders)	188000	170000	158000
Equity capitalization rate i.e. K_e	10%	10%	10%
Therefore value of equity (e.g. 188000/10%)	1880000	1700000	1580000
+ Value of debt (D)	200000	500000	700000
Therefore value of firm (V)	2080000	2200000	2280000
WACC, $\frac{EBIT}{\text{value of firm.}} \times 100$	$\frac{200000}{2080000} = 9.6\%$	$\frac{200000}{2200000} = 9\%$	$\frac{200000}{2280000} = 8.7\%$

Conclusion: Firm is able to increase its value and to decrease its (WACC) increasing the debt proportion in the capital structure. The NI approach, though easy to understand, ignores perhaps the most important aspects of leverage that the market price depends upon the risk, which varies in direct relation to the changing proportion of debt in capital structure.

Net Operating Income (NOI) Approach

The Net Operating Income (NOI) approach is the opposite of the NI approach. According to the NOI approach, the market value of the firm depends upon the net operating profit or EBIT and the overall cost of capital, WACC. The financing mix or the capital structure is irrelevant and does not affect the value of the firm. The NOI approach makes the following assumptions:

1. Investors see the firm as a whole and thus capitalize the total earnings of the firm to find the value of the firm as a whole.
2. The overall cost of capital of the firm is constant and depends upon the business risk, which also is assumed to be unchanged.
3. The cost of debt is also taken as constant.
4. The use of more and more debt in the capital structure increases the risk of shareholders and thus results in the increase in the cost of equity capital i.e., the increase in cost of equity is such, as to completely offset the benefits of employing cheaper debt, and
5. There is no tax.

The NOI approach is based on the argument that the market values the firm as a whole for a given risk complexion. Thus, for a given value of EBIT, the value of the firm remains the same, irrespective of the capital composition and instead depends on the overall cost of capital. The value of the equity may be found by deducting the value of debt from the total value of the firm i.e.,

$$V = \frac{EBIT}{K_o}$$

E = Value of equity

V = Value of firm.

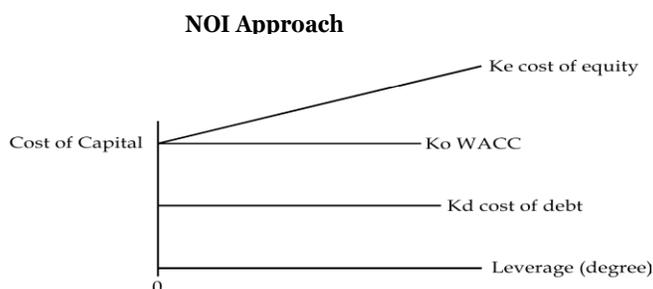
D = Market value of debt

And $E = V - D$

And the cost of equity capital, K_e , is

$$K_e = \frac{EBIT - \text{Interest}}{V - D}$$

Thus, the financing mix is irrelevant and does not affect the value of the firm. The value remains same for all types of debt-equity mix. Since there will be change in risk of the shareholders as a result of change in debt-equity mix, therefore, the K_e will be changing linearly with change in debt proportions. The NOI approach to the relationship between the leverage and cost of capital



has been presented in the following figure.

The above diagram shows that the cost of debt, K_d , and the overall cost of capital K_o are constant for all levels of leverage. As the debt proportion or the financial leverage increases, the risk of the shareholders remains constant because increase in K_e is just sufficient to off set the benefits of cheaper debt financing.

The NOI approach considers K_o to be constant and therefore, there is no optimal capital structure as good as any other and so every capital structure is an optimal one. The NOI approach can be illustrated with an example.

Example: A firm has an EBIT of 200,000 and belongs to a risk class of 10%. What is the value of cost of equity capital, if it employs 6% debt to the extent of 30%, 40% or 50% of the total capital fund of ₹ 10,00,000?

Solution:

₹

The effect of changing debt proportion on the cost of equity capital can be analyzed as follows:

	30% debt	40% debt	50% debt
EBIT	Rs. 200,000	200,000	200,000
Overall cost of capital	10%	10%	10%
Value of the firm, V	2000,000	2000,000	2000,000
Value of 6% debt, D	300,000	400,000	500,000
Value of equity, (E=V-D)	17,00,000	1600,000	1500,000
Net profit (EBIT Interest)	182,000	176,000	170,000
Cost of equity = $\frac{\text{Net profit}}{\text{Value of equity}} \times 100$	10.7%	11%	11.33%

The NI and the NOI approach hold extreme views on the relationship between the leverage, cost of capital and the value of the firm. In practical situations, both these approaches seem to be unrealistic. The traditional approach takes a compromising view between the two and incorporates the basic philosophy of both. It takes a midway between the NI approach (that the value of the firm can be increased by increasing the leverage) and the NOI approach (that the value of the firm is constant irrespective of the degree of financial leverage).

The traditional viewpoint states that the value of the firm increases with increase in financial leverage but only up to a certain limit. Beyond this limit, the increase in financial leverage will increase its WACC and hence the value of the firm will decline.

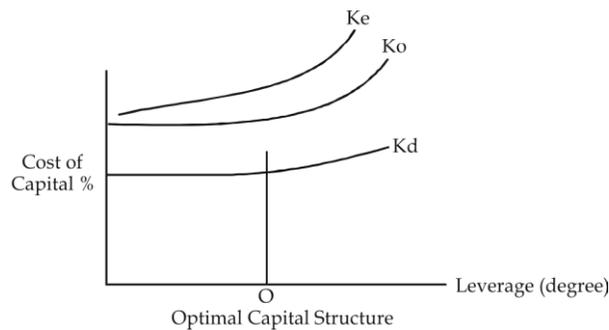
Under the traditional approach, the cost of debt is assumed to be less than the cost of equity. In case of 100% equity firm, overall cost of the firm is equal to the cost of equity, but, when (cheaper) debt is introduced in the capital structure and the financial leverage increases, the cost of equity remains the same as the equity investors expect a minimum leverage in every firm.

The cost of equity does not increase even with increase in leverage. The argument for K_e remaining unchanged may be that up to a particular degree of leverage, the interest charge may not be large enough to pose a real threat to the dividend payable to the shareholders. This constant K_e and K_d makes the K_o to fall initially. Thus, it shows that the benefits of cheaper debts are available to the firm. But this position does not continue when leverage is further increased.

The increase in leverage beyond a limit increases the risk of the equity investors too and as a result the K_e also starts increasing. However, the benefits of use of debt may be so large that even after offsetting the effects of increase in K_e , the K_o may still go down or may become constant for some degree of leverages.

However, if the firm increases leverage further, then the risk of the debt investor may also increase and consequently the K_d of debt also starts increasing. The already increasing K_e and the now increasing makes the K_o increase. Therefore, the use of leverage beyond a point will have the effect of increase the overall cost of capital of the firm and thus results in the decrease in the value of the firm.

Thus, there is a level of financial leverage in any firm, up to which it favorably affect the value of the firm may decrease. There may be a particular leverage or a range of leverage, which separates the favorable leverage. The traditional viewpoint has been shown in the following figure.



Example: ABC Ltd., having an EBIT of 1,50,000 is contemplating to redeem a part of the capital by introducing debt financing.

Presently, it is a 100% equity firm with equity capitalization rate, K_e , of 16%. The firm is to redeem the capital by introducing debt financing up to 3,00,000 i.e., 30% of total funds or up to 5,00,000 i.e., 50% of the total funds. It is expected that for the debt financing up to 30%, the rate of interest will be 10% and the equity capitalization will increase up to 17%. However, if the firm opts for 50% debt financing, then interest will be payable at the rate of 12% and the equity capitalization rate will be 20%. Find out the value of the firm and its overall cost of capital under different levels of debt financing.

Solution:

On the basis of the information given, the total funds of the firm is 10,00,000 (whole of which is provided by the equity capital) out of which 30% or 50% i.e., 3,00,000 or 5,00,000 may be replaced by the issue of debt bearing interest at 10% or 12% respectively. The value of the firm and its WACC maybe ascertained as follows:

	0% Debt	30% Debt	50% Debt.
Total debt		Rs. 300,000	Rs. 500,000
Rate of interest		10%	12%
EBIT	Rs. 150,000	150,000	150,000
Interest		30,000	60,000
Profit before tax	150,000	120,000	90,000
Equity capitalization rate	0.16	0.17	0.20
Value of equity, E	937,500	70,5882	450,000
Value of debt,		300,000	500,000
Total value	937,500	1005,882	950,000
Overall cost of capital (EBIT)	0.16	0.149	0.158
Total value of the firm.			

The example shows that with the increase in leverage from 0% to 30%, the firm is able to reduce its WACC from 16% to 14.9% and the value of the firm increases from 9,37,500 to 10,05,882. This happens as he benefits of employing cheaper debt are available and the cost of equity does not rise too much.

However, thereafter, when the leverage is increased further to 50%, the cost of debt as well as the cost of equity, both, rises to 12% and 20% respectively. The equity investors have increased the equity capitalization rate to 20% as they are now finding the firm to be more risky (as a result of 50% leverage). The increase in cost of debt and the equity capitalization rate has increased the cost of equity, hence as a result, the value of the firm has reduced from 10,05,882 to 9,50,000 and K_o has increased from 14.9% to 15.8%.

Modigliani–Miller’s Approach (Extension of NOI Approach)

The Modigliani–Millers (MM) model is considered to be one of the most influential papers ever written in corporate finance.

The Modigliani–Miller approach is similar to the Net Operating Income (NOI) approach. In other words, according to

this approach, the value of a firm is independent of its capital structure. However, there is a basic difference between the two. The NOI approach is purely conceptual. It does not provide operational justification for irrelevance of the capital structure in the valuation of the firm. While MM approach supports the NOI approach providing behavioural justification for the independence of the total valuation and the cost of capital of the firm from its capital structure. In other words, MM approach maintains that the weighed average cost of capital does not change in the debt equity mix or capital structure of the firm.

Basic Proportions

The following are the three basic proportions of the MM approach.

1. The overall cost of capital (K) and the value of the firm (V) are independent of the capital structure. In other words, K and V are constant for all levels of debt-equity mix. The total market value of the firm is given by capitalizing the expected Net Operating Income (NOI) by the rate appropriate for that risk class.
2. The cost of equity (K_e) is equal to capitalization rate of a pure equity stream plus a premium for the financial risk. The financial risk increases with more debt content in the capital structure. As a result, K_e increases in a manner to off set exactly the use of a less expensive source of funds represented by debt.
3. The cut-off rate for investment purposes is completely independent of the way in which an investment is financed.

Assumptions

The MM approach is subject to the following assumptions:

1. Capital markets are perfect: This means that investors are free to buy and sell securities.
2. The form can be classified into homogenous risk classes. All the forms within the same class will have the same degree of business risks.
3. All investors have the same expectations of a firm's net operating income (EBIT) with which to evaluate the value of any firm.
4. The dividend payout ratio is 100%. In other words, there are no retained earnings.
5. There are no corporate taxes. However, this assumption has been removed later. In brief, the MM hypothesis can be put in the following words:

“MM hypothesis is based on the idea that no matter how you bifurcate the capital structure of a firm among debt, equity and other claims, there is a conservation of investment value. That is because the total investment value of a corporation depends upon its underlying profitability and risk”.

It is invariant with respect to relative changes in the firm's financial capitalization. Thus, the total pie does not change as it is divided into debt, equity and other securities. The sum of the parts must equal the whole; so regardless of financing mix; the total value of the firm stays the same.

Criticism

Theoretically speaking, the MM model seems to be good. However, most of its assumptions are unrealistic and untenable. Following are criticisms against MM Model:

1. The arbitrage process, which provides the behavioural justification for the model is itself questionable in real life because of following reasons:
 - (a) Investors do not have complete information about levered and unlevered firms.
 - (b) It is extremely doubtful that investors would substitute personal leverage for corporate leverage, as they do not have the same risk characteristics. Rates of interests are not the same for individuals and the firms.
2. The assumption that there is no corporate tax is unrealistic.
3. The assumption of no transaction cost is also imaginary. In reality, whenever a firm tries to obtain debt capital associates creditors, they seek certain restrictions on the firm. On the part of the firm, some protective comments incorporated in the loan contract.
4. In subsequently analyses, MM agreed that the leverage might increase the value of the firm.

Effects of a Financing Decision on Earnings Per Share

One of the present objectives of a finance function is to maximize both the return on ordinary shares and the total wealth of the company. This objective is also important at the time of deciding in the new source of finance. Earnings Per Share (EPS) denote what has been earned by the company during a particular period in each of the ordinary shares. It can be worked out by dividing net profit after interest, taxes and preference dividend, by the number of equity shares.

If the company has a number of options of new financing, it can compute the impact of each method of new financing on earnings per share. It should also calculate the EPS without the new financing and compares it with cash of the various alternatives of financing available, is accepted. It is obvious that earnings per share would be the highest in case of financing, which has the least cost to the company.

Example: X Ltd. requires 50 lacs for a new plant, which is expected to yield earnings before interest and taxes of Rs. 10 lacs. The company has three alternatives for financing.

Option I: Raising debt of Rs. 5 lacs and the balance by equity. Option II: Raising debt of Rs. 20 lacs and the balance by equity. Option III: Raising debt of Rs. 30 lacs and the balance by equity.

Equity shares of Rs. 100 each	Rs. 40,00,000
Retained earnings	10,00,000
9% preference shares	25,00,000
7% debentures	25,00,000

The company's share is currently selling at Rs. 150, but it expected to decline to Rs. 125 in case the funds are borrowed in excess of Rs. 20 lacs and at 20% over Rs. 20 lacs. The tax rate applicable to the company is 50%. Which option of financing the company should choose?

Solution:

The earnings per share is higher in Alternative 2 i.e., if the company finances the project by raising debt of 70,00,000 and issue equity shares of 30,00,000.

	Alternative I	Alternative 2	Alternative 3
	Debt Rs. 5 lacs + equity Rs. 45 lacs.	Debt Rs. 20 lacs + equity Rs. 30 lacs.	Debt Rs. 30 lacs + equity Rs. 20 lacs.
Earnings before interest and tax	Rs. 10,00,000	Rs. 10,00,000	Rs. 10,00,000
Less interest on debt	50,000	275,000	475,000
Earnings before tax	9,50,000	725,000	525,000
Tax @ 50%	475,500	362,500	262,500
Earnings after tax	475,500	362,500	262,500
No. of equity shares	30,000	20,000	16,000
Earnings per share	Rs. 15,833	18,125	16,406

EPS Volatility

EPS Volatility refers to the magnitude or the extent of fluctuations of earnings per share of a company in various years as compared to the mean or average earnings per share. In other words, EPS volatility shows whether a company enjoys a stable income or not.

Higher the EPS volatility, greater would be the risk attached to the company.

A major cause of EPS volatility would be the fluctuations in the sales volume and the operating leverage. It is obvious that the net profits of a company would greatly fluctuate with small fluctuations in the sales figures specially if the fixed cost instant were very high. Hence, EPS will fluctuate in such a situation. This effect may be heightened by the financial leverage.