

Degree of financial leverage Interview prep questions

A. Conceptual Interview Questions

1. What is the degree of financial leverage?

Degree of Financial Leverage (DFL) measures how sensitive **EPS** is to changes in **EBIT** due to fixed interest costs.

2. Why does financial leverage increase EPS volatility?

Because interest is a fixed cost, any change in EBIT disproportionately affects earnings available to shareholders.

3. How is financial leverage different from operating leverage?

Operating leverage arises from fixed operating costs, while financial leverage arises from fixed financial costs (interest).

4. What does a DFL greater than 1 indicate?

The company is using debt, and EPS will change more than proportionately to EBIT.

5. Can a company have zero financial leverage?

Yes, if it has no debt and no interest expense. In that case, DFL = 1.

6. Why is interest considered a fixed financial cost?

Interest must be paid regardless of the company's profitability.

7. How does financial leverage affect shareholder risk?

Higher leverage increases both potential returns and downside risk for shareholders.

8. Why does DFL increase when EBIT is low?

Because $EBIT - Interest$ becomes small, making DFL mathematically larger.

9. Is high financial leverage always bad?

No. It can enhance returns in stable environments but becomes risky during downturns.

10. How does financial leverage impact a recession?

High leverage magnifies losses when EBIT falls, increasing default risk.

11. Why is DFL important in capital structure decisions?

It helps management balance return maximization with financial risk.

12. How does tax affect financial leverage?

Interest provides a tax shield, lowering effective cost of debt.

13. What happens to DFL when debt is repaid?

Interest decreases, reducing DFL and financial risk.

14. Why do startups usually have low financial leverage?

Due to unstable cash flows and limited debt capacity.

15. How do investors use DFL?

To assess earnings volatility and risk before investing.

B. Numerical / Direct Calculation Questions

Formula used:

$$\text{DFL} = \text{EBIT} \div (\text{EBIT} - \text{Interest})$$

1. EBIT = 1,000; Interest = 200

$$\text{DFL} = 1,000 / 800 = \mathbf{1.25}$$

2. EBIT = 5,00,000; Interest = 1,00,000

$$\text{DFL} = 5,00,000 / 4,00,000 = \mathbf{1.25}$$

3. EBIT \uparrow 10%, DFL = 2

$$\text{EPS} \uparrow = 10\% \times 2 = \mathbf{20\%}$$

4. EBIT = 2,00,000; Interest = 50,000

$$\text{DFL} = 2,00,000 / 1,50,000 = \mathbf{1.33}$$

5. EBIT = 8,00,000; Interest = 6,00,000

$$\text{DFL} = 8,00,000 / 2,00,000 = \mathbf{4 (\text{Very high risk})}$$

6. No debt

$$\text{DFL} = \mathbf{1}$$

7. EBIT \uparrow from 10,00,000 to 12,00,000 (20%); EPS \uparrow 30%

$$\text{DFL} = 30\% / 20\% = \mathbf{1.5}$$

8. EBIT = 4,00,000; Interest = 1,00,000

$$\text{DFL} = 4,00,000 / 3,00,000 = \mathbf{1.33}$$

9. EBIT = 1,20,000; Interest = 40,000

$$\text{DFL} = 1,20,000 / 80,000 = \mathbf{1.5}$$

10. EBIT \downarrow 10%, DFL = 3

$$\text{EPS} \downarrow = \mathbf{30\%}$$

11. EBIT = 9,00,000; Interest = 3,00,000

$$\text{DFL} = 9,00,000 / 6,00,000 = \mathbf{1.5}$$

12. EBIT = 6,00,000; Interest = 5,00,000

$$\text{DFL} = 6,00,000 / 1,00,000 = \mathbf{6 (\text{Extremely risky})}$$

13. EBIT \uparrow 15%, EPS \uparrow 45%

$$\text{DFL} = 45\% / 15\% = \mathbf{3}$$

14. EBIT = 2,50,000; Interest = 50,000

$$\text{DFL} = 2,50,000 / 2,00,000 = \mathbf{1.25}$$

15. $EBIT = 10,00,000$; Interest = 0

$DFL = 1$

C. Scenario-Based / Practical Questions

1. **Impact of high DFL in recession?**

EPS falls sharply, increasing default risk.

2. **Same EBIT, different debt levels, who is riskier?**

The firm with higher debt (higher interest \rightarrow higher DFL).

3. **Why would management increase leverage?**

To boost EPS and ROE when cash flows are stable.

4. **How does DFL help equity research?**

It helps forecast EPS sensitivity under different EBIT scenarios.

5. **Utilities: high or low DFL?**

Moderate to high, due to stable cash flows.

6. **Effect of DFL on DCF valuation?**

Higher leverage increases equity risk and discount rate.

7. **Effect of rising interest rates?**

Interest expense rises, increasing DFL and risk.

8. **Why do lenders monitor DFL?**

To assess repayment capacity and solvency risk.

9. **After issuing bonds, what happens to DFL?**

Interest increases \rightarrow DFL increases.

10. **EBIT approaches interest, what happens?**

DFL becomes extremely high, signalling danger.

11. **Why avoid firms with extreme DFL?**

Small EBIT shocks can wipe out EPS.

12. **Impact on dividends?**

High leverage reduces dividend-paying flexibility.

13. **Explain DFL to non-finance people.**

“Debt makes profits grow faster but losses too.”

14. **Role in stress testing?**

Helps simulate EPS impact under EBIT shocks.

15. **Why is DFL critical in M&A?**

Post-merger debt can dramatically change earnings risk.

D. Interview Tips to Increase Hiring Chances (Very Important)

1. Always Explain Before Calculating

Interviewers prefer **logic + clarity** over speed.

First explain **what DFL measures**, then calculate.

2. State Assumptions Clearly

Mention assumptions like:

- No preference dividends
- Interest is fixed
- Tax ignored for simplicity

This shows **professional maturity**.

3. Link DFL to Risk and Decision-Making

Never stop at the number. Always add:

"This indicates higher financial risk due to fixed interest obligations."

4. Use Real-World Context

Relate DFL to:

- Debt-heavy companies
- Cyclical industries
- Recession scenarios

5. Avoid Common Mistakes

Confusing DFL with DOL

Forgetting interest in denominator

Not interpreting the result

6. Be Ready for Follow-Up Questions

After DFL, interviewers often ask:

- DOL vs DFL
- Combined leverage
- Risk mitigation strategies

7. Practice Calm, Structured Answers

Use this structure:

1. Definition

2. Formula
3. Calculation
4. Interpretation

This **dramatically improves interview scores.**

All the best! Hope this helps!