

## CHAPTER - 4

## ECONOMIC LEVERAGE

## 4.1.0 THE CONCEPT AND ITS SCOPE :

Economic Leverage can be defined as consisting of all those economic variables that could be managed / manipulated to smooth the income streams of the firm. The individual variables may be termed as Economic Leverage variables.

## 4.1.1 WHY DO WE NEED A NEW CONCEPT 'ECONOMIC LEVERAGE ?

A new concept 'Economic Leverage' is needed since (i) the concept of organisational slack is not logically consistent and lacks general validity, (ii) Economic Leverage is wider in scope than organisational slack, (iii) and provides a distinct name to all the 'discretionary expenditures.'<sup>1</sup> Economic Leverage not only embodies them but also provides a purpose of exercising the discretion.

#### 4.1.2 ECONOMIC LEVERAGE VARIABLES :

The following are the Economic Leverage variables identified from the previous studies : managerial perquisites, public services, staff expenditure, office modernisation expenditure, administrative costs, factor costs, other costs, capitalisation of new equipment costs, selling costs, travel expenses, operating costs, investment outside, investment in subsidiaries, workmen and staff welfare expenditure, deferred revenue expenditure, financial leverage, research and development expenditures, growth of the firm, capital expenditures, volume of staff, expenditure on mechanisation, overhead expenses, innovation, production, capacity utilisation, sales, product mix, stock options, payment and recovery of dues.

#### 4.2.0 HOW DO ECONOMIC LEVERAGE STABILISES THE INCOME STREAMS ?

When the performance, measured by the reported profits for example exceeds the target or smoothed reported profits during good times Economic Leverage is deliberately created and manipulated, in this case, increased, to smooth the

reported profits. This retards the upward revision of aspirations. When the reported profits fall below the smoothed reported profits Economic Leverage is managed, in this case reduced, so as to release a pool of resources to smooth the reported profits. Thus Economic Leverage permits the aspirations be achieved and maintained. Figure-4.1 explains the Economic Leverage management process in the decision process wherein T indicates time trend;  $D1$ =interim dividend;  $SDD$  = smoothed dividend;  $PBT$ =profits before tax;  $XI$ =reported income;  $SXI$ =smoothed reported income;  $EL$ =Economic Leverage;  $PART$ =a fraction of the  $SDD$ .

#### 4.3.0 WHO CREATES ECONOMIC LEVERAGE DELIBERATELY ?

Unlike Cyert and March, the present study proposes that it is both the top and the below the top management<sup>2</sup> which deliberately create and manipulate Economic Leverage to provide stability to the income streams of the firm.

#### 4.3.1 WHY ?

The rationale for, the top management, the deliberate creation and management of Economic

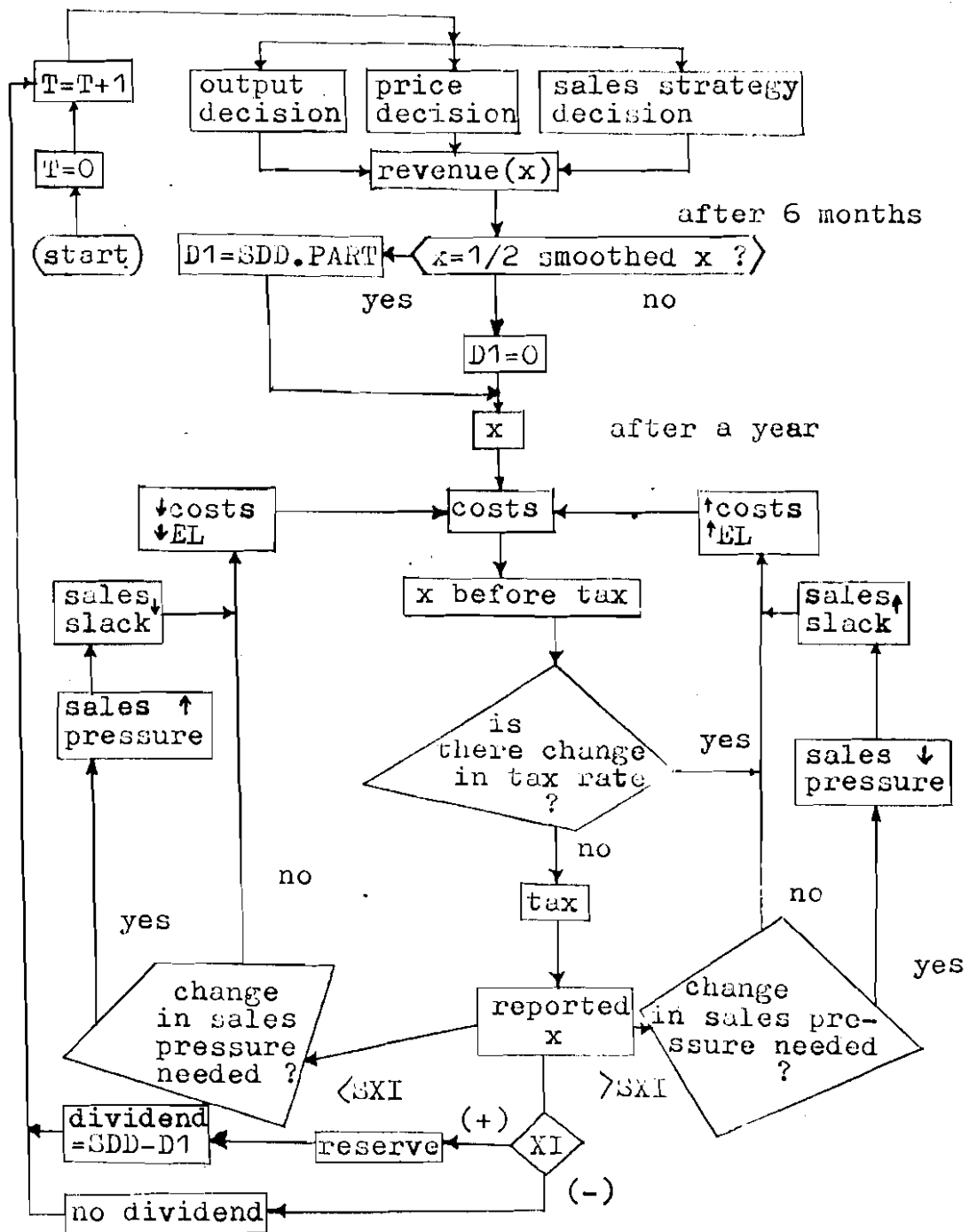


Fig -4.1 : Economic Leverage and 'smoothing' process.

Leverage is for the survival of the existing management. The explanation is as follows : at an earlier stage, it was derived that the performance of the firm may be indicated by the profits streams, hence it is assumed that the performance of the firm i.e., profits stream influences the market value of the managers' human capital. Higher the performance higher will be the reported profits, higher the market value of managers' human capital, lower the risk of their survival in the firm, higher the dividend paid to the equity holders and lower the risk to the shareholders. Lower the performance, lower will be the profits stream, lower the market value of their human capital, higher the shareholders' risk. Thus fluctuating / unstable profits stream will result in fluctuating risks for both the managers and the shareholders.

Shareholders would prefer stable rather than fluctuating dividends. Moreover, the stockholders can always diversify their risk by holding stocks across many firms. If the dividend paid is consistently low, they would prefer to go for alternative investment opportunities by disposing off their stocks. Thus, if most of the stockholders dispose off their stocks, there is a probability that the

disposed stocks may concentrate with the other interest groups or rival firms. This may endanger the survival of the existing management.

The manager can not diversify his risk like the stockholders because he invests a substantial amount of his human capital and capital with the corporation he manages. Fluctuations in the performance of the firm affects his stock investment in his own firm, market value of his human capital, risk of his survival in the firm. Therefore, the manager would be expected to reduce his risk internally. It is where the Economic Leverage helps the manager. Since Economic Leverage absorbs the potential variations in the performance of the firm, the manager deliberately creates and manages them to smooth the performance of the firm. Thus smoothed performance will smooth the dividends paid, reduce the risk of shareholders as well as his own risk of survival and stabilises the market value of his human capital. Besides these, the manager gets the services of the capital market and minimises the tax costs.

The rationale, for the below the top management, is as follows : since budget is the criterion, as Schiff and Lewin<sup>3</sup> put it, by which they (all the managers) will be judged throughout the year and for resource allocation, budget preparation process is a highly participative effort on the part of all the managerial levels, they incorporate varying degrees of organisational slack, hence Economic Leverage, in the budget intentionally. They do it deliberately because by doing so, they smooth their own performance or marginal product and thereby increase or stabilise the value of their human capital both inside the firm and in the managerial labour market. This will ultimately increase their outside opportunity wage. Schiff and Lewin studied three divisions of a firm and found that the division controller of one of the divisions, who was an important member of the 'fore-cast committee', initiated a program officially referred to as 'profit recovery', a device used by the controller fundamentally to plan slack in the budget.<sup>4</sup> And since "all managers realise that the managerial labour market uses the performance of the firm to determine each manager's outside opportunity wage....each manager has a stake in the performance of the managers above and below

him and as a consequence, undertakes some amount of monitoring in both directions."<sup>5</sup> That is they make their contributions in creating Economic Leverage and also "all the managers below the very top level have an interest in seeing that the managers choose policies for the firm which provide the most positive signals to the managerial labour market."<sup>6</sup> Thus, we believe that both the top management and all the managers below them deliberately create and manipulate Economic Leverage simultaneously to stabilise the reported profits, income, streams.

#### 4.4.0 APPROXIMATION OF THE AMOUNT OF ECONOMIC LEVERAGE :

The very purpose of creating and managing Economic Leverage is to smoothen the income series. Income series could be managed by (i) managing production levels and (ii) costs. For instance, keeping inventory level constant, an increase in production and sales will increase sales revenue. Or by keeping production level constant, *ceteris paribus*, will lead to a constant sales revenue. Or by reducing production level, *ceteris paribus*, will lead to a reduction in sales revenue. Management of production level will also lead to management of costs

in the sense higher the production level, higher will be the labour costs, material costs, selling costs etc which are Economic Leverage variables. Thus all the Economic Leverage variables involve cost elements. The ultimate result of the creation of Economic Leverage will be an increase in the total manufacturing costs. However the amount of total manufacturing costs may be due to (i) the production level, (an Economic Leverage variables), (ii) time trend. Taking the variables (i) and (ii) in the following regression model, the amount of Economic Leverage may be approximated.

$$Y = \hat{a} + \hat{B} \text{ PRODUCTION} + \hat{c} \text{ YEAR} + \hat{e}$$

where PRODUCTION refers to production level, YEAR is the time period, Y, the actual total manufacturing costs,  $\hat{Y}$ , is that part of the total manufacturing costs which is due to the production level and the time trend i.e., the explained variation,  $\hat{a}$  and  $\hat{B}$  are parameter coefficients,  $\hat{e}$  is that part of total manufacturing costs which is, considered to be because of the creation of Economic Leverage.

However this method of approximating the amount of Economic Leverage is subject to a limitation. The amount of Economic Leverage can be

approximated only from a time series of observations. It is not possible to approximate it with two or three years data. Once the regression equation is estimated it becomes easier for approximation.

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NOTES

1. Christofides and Tapon.op.cit.,p.303.
2. Those who are making general policy decisions are referred as the top-management. The below the top management,may include middle management,lower management etc,all those who are involved either in decision making or controlling the executions.
3. Schiff and Lewin.op.cit.,p.50.
4. Ibid.,p.56.
5. Fama (1980),p.293.
6. Ibid.,