**EFFECTIVE FINANCIAL MANAGEMENT**

**Learning Outcome 3: ACTIVITY 5**

**Operating gearing**

A business with high fixed costs relative to variable costs is said to have high operating gearing. Such businesses do not proportionately increase expenses as a result of increased revenues and are therefore generate increases in operating profit at a faster rate than businesses with lower operating gearing.

Imagine that you are a financial manager at Otobai Company, a small business that manufactures electrically powered motor scooters. The business plans to launch a new product. It will finance the investment needed to fund the manufacture of this new product using debt finance.

Your colleagues have prepared the following forecast of cash flows arising from the manufacture and sale of two types of new scooter.

Scooter A Scooter B

$ $

Revenue 100,000 120,000

Variable expenses 30,000 36,000

Fixed expenses 60,000 60,000

Net operating income 10,000 24 ,000

#### In small groups

Identify a business with which you are familiar. This could be a multinational company from which you have purchased goods/services, a business that owns your favourite brand or the business for which you work (or wish to work in the future).

Ideally this should be the business you chose earlier to re-visit throughout your classroom activities.

From your research:

1. Outline the nature of operating gearing.
2. Compare and contrast operating gearing and financial gearing.
3. Explain the potential importance of operating gearing for your chosen business.
4. Use the information in the case study to calculate operating gearing.
5. Explain which the two new products should Otobai Company choose to manufacture.
6. Comment on your results in terms of operating gearing, the forecast profitability of the two new scooters and on the risk of each of the two investment opportunities.
7. Prepare a short presentation on your findings.