

CHAPTER No.1 · LEVERAGES

Points to be discussed

- Variable cost and Fixed cost
- Operating Expenses and Financial Expenses
- Contribution
- Profit volume Ratio and Cost volume Ratio
- Income Statement
- Leverages - Meaning
- Operating Leverage
- Financial Leverage
- Combined Leverage
- Conclusion

Operating Leverage

- Relationship between sales and operating profits
- If sales changes by x%, by how much will the operating profits change?

Example :

Income Statement

Sales	2,00,000	+10% →	2,20,000
- Variable Costs	- 60,000		- 66,000
Contribution	1,40,000		1,54,000
- Fixed Costs	- 42,000		- 42,000
EBIT / Operating Profits	98,000	+14.286% →	1,12,000

- Interest

EBT

$$\% \Delta = \frac{\text{New Value} - \text{Old Value}}{\text{Old Value}} \times 100$$

$$= \frac{112000 - 98000}{98000} \times 100$$

- Tax @ 2%.

$$= 14.286\%$$

NPAT

- Preference Dividend

Profits for Equity shareholders

÷ NO of Equity shares

EPS

$$OL = \frac{\text{Contribution}}{\text{EBIT}} = \frac{140000}{98000} = 1.4286$$

$$OL = \frac{\% \Delta \text{ in EBIT}}{\% \Delta \text{ in Sales}} \quad \therefore 1.4286 = \frac{\% \Delta \text{ in EBIT}}{10}$$

$$\therefore \% \Delta \text{ in EBIT} = 1.4286 \times 10$$

$$\therefore \% \Delta \text{ in EBIT} = \underline{14.286\%}$$

Leverages - Summary

Operating
Leverage

Sales & EBIT

Because of Fixed
operating cost

$$OL = \frac{\text{Contribution}}{\text{EBIT}}$$

Financial
Leverage

EBIT & EPS

Because of Fixed
Financial cost

$$FL = \frac{\text{EBIT}}{\text{EBT}} \quad \text{OR}$$

$$FL = \frac{\text{EBIT}}{\text{EBT} - \frac{P \cdot D}{(1-t)}}$$

Combined
Leverage

Sales & EPS

Because of Total
Fixed costs

$$CL = \frac{\text{Contribution}}{\text{EBT}} \quad \text{OR}$$

$$CL = \frac{\text{Contribution}}{\text{EBT} - \frac{P \cdot D}{(1-t)}}$$

$$OL = \frac{\% \Delta \text{ in EBIT}}{\% \Delta \text{ in SALES}}$$

$$FL = \frac{\% \Delta \text{ in EPS}}{\% \Delta \text{ in EBIT}}$$

$$CL = \frac{\% \Delta \text{ in EPS}}{\% \Delta \text{ in SALES}}$$

$$CL = OL \times FL$$

