

HW - Chapter 6 - Leverages - Q6

Workings:

Total Assets = Rs. 20 crores

Total Asset Turnover Ratio = 2.5

Hence, Total Sales = $20 \times 2.5 = \text{Rs. } 50 \text{ crores}$

(i) Computation of EPS

	Rs. in crores
Sales	50.00
Less: Variable Operating Cost @ 65%	32.50
Contribution	17.50
Less: Fixed Cost (other than Interest)	4.00
EBIT	13.50
Less: Interest on Debentures (15% of Rs. 10 crores)	1.50
PBT	12.00
Less: Tax @ 30%	3.60
PAT	8.40
÷ Number of Equity Shares	50 Lakh
EPS	Rs. 16.80

COMMENT: It indicates the amount the company earns per share. Investors use this as a guide while valuing the share and making investment decisions. It is also an indicator used in comparing firms within an industry or industry segment.

(ii) Operating Leverage = $\text{Contribution} \div \text{EBIT} = \text{Rs. } 17.50 \text{ crores} \div \text{Rs. } 13.50 \text{ crores} = 1.29$

It indicates the choice of technology and fixed cost in cost structure. It is level specific. When firm operates beyond operating break-even level, then operating leverage is low. It indicates sensitivity of earnings before interest and tax (EBIT) to change in sales at a particular level.

(iii) Financial Leverage = $\text{EBIT} \div \text{EBT} = \text{Rs. } 13.50 \text{ crores} \div \text{Rs. } 12.00 \text{ crores} = 1.125$

The financial leverage is very comfortable since the debt service obligation is small vis-à-vis EBIT.

(iv) Combined Leverage = $\text{OL} \times \text{FL} = 1.296 \times 1.125 = 1.458$

The combined leverage studies the choice of fixed cost in cost structure and choice of debt in capital structure. It studies how sensitive the change in EPS is vis-à-vis change in sales. The leverages, operating, financial and combined are used as measurement of risk.