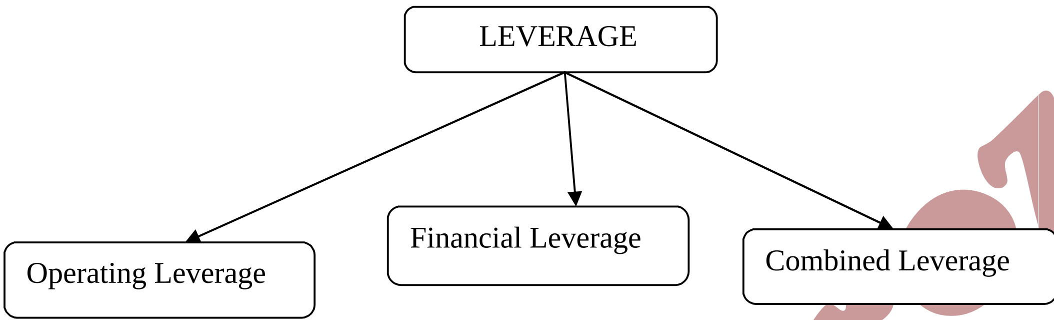
Leverage

Leverage in business is derived from the word 'lever'. A lever is a simple tool by which a large weight can be moved with a small force.



OPERATING LEVERAGE

Operating leverage is a measure of the extent to which, fixed operating costs are being used in an organization.

Formula

Degree of Operating Leverage = $\dfrac{\text{Percent Change in Operating Income}}{\text{Percent Change in Sales}}$

OR

Degree of Operating Leverage = $\dfrac{\text{Contribution Margin}}{\text{Earnings Before Interest and Taxes}}$

OR

Degree of Operating Leverage =

$$\frac{\text{Total Sales} - \text{Total Variable Cost}}{\text{Total Sales} - \text{Total Variable Cost} - \text{Total Operating Fixed Cost}}$$

Impact:

A Business with a high break-even point is more risky than one with a low Break-even point. Therefore, high operating leverage indicates to high risk whereas, low operating leverage indicates to lower risk.

FINANCIAL LEVERAGE

Financial leverage is the extent to which debt (liability) is used in the Capital Structure (financing) of the business. Capital Structure refers to the relationship between assets, debt (liability) and equity.

Higher debt reduced the profit of business. However, it helpful to increases in earnings per share (EPS) as the EBIT.

Formula

Degree of Financial Leverage = $\dfrac{\textit{Percent Change in Earnings Per Share}}{\textit{Percent Change in Operating Income}}$

OR

Degree of Financial Leverage = $\dfrac{\textit{Earnings Before Interest and Taxes}}{\textit{Earnings Before Interest and Taxes} - \textit{Interest}}$

COMBINED LEVERAGE

Combined leverage is combination of Operating leverage and financial leverage the combining both concepts as can be seen below:

Operating Leverage means **Change in sales leads** to a change in *EBIT*

And

Financial Leverage means Change in *EBIT* leads **to a change in EPS**

Therefore, Combined Leverage means **Change in sales leads to a change in EPS.**

Formula

Degree of Combined Leverage = $\dfrac{\textit{Percent Change in Earnings Per Share}}{\textit{Percent Change in Sales (or volume)}}$

OR

Degree of Combined Leverage = Degree *of Operating Leverage X Degree of Financial Leverage*

Statement showing calculation of profit before tax:

S.No.	Particulars	Amount
A.	Sale	****
B.	Variable Cost	****
C.	**Contribution (A-B)**	****
D.	Fix Cost	****
E.	**EBIT (C-D)**	****

Breakeven point formula

$$\textbf{EPS} = \frac{(EBIT - Int.) - Tax - Pref.Dividend}{No.\ Of\ Equity\ Shares}$$