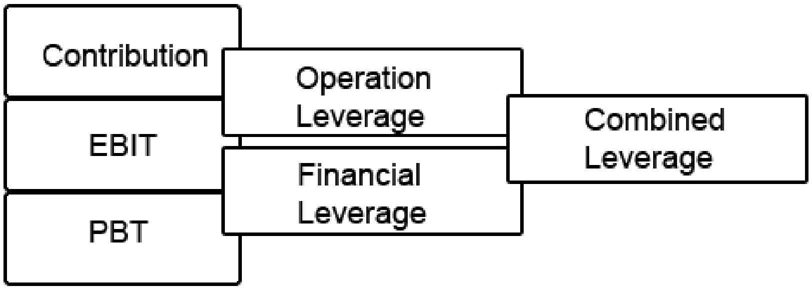
LEVERAGE

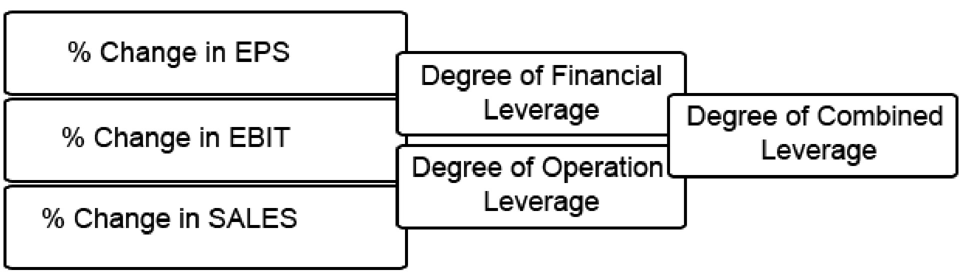
Leverage Formula in short:



How to read:
OL= Contribution/EBIT
FL = EBIT/PBT
CL = OL x FL

How to remember the picture:
In an Income Statement always **Contribution** is the **big figure** compared to EBIT and EBIT bigger than PBT. So arrange in **Descending order.**

Degree of Leverage Formula in short:



How to read:
DFL= % Change in EPS/ % change in EBIT
DOL = % Change in EBIT/ % Change in Sales
DCL = DOL x DFL

How to remember the picture:
In an Income Statement always **EPS** is the **Small figure** compared to EBIT and EBIT smaller than Sales. So arrange in **ascending order.**

***** Remember one more thing that in Degree of leverage formula. In middle block, DFL comes first.**

Operation leverage (OL): is the firm's ability to use **Fixed Operating Cost** to magnify the effects of change in sales on its Earnings Before Interest and Tax (EBIT). OL is directly proportionate to business risk. i.e. a small change in sales will make big change in profit.

OL exist when a change in sales will make a change in EBIT and it is more than the proportionate change in sales. In other words **if Proportionate Change in EBIT is more than proportionate change in sales due to a change in sales OL exist. OL exist only when there are fixed cost.**

E.g. Sales Increases 10% EBIT Increase 10% - OL doesn't exist

Sales Increases 10% EBIT increases 15% - OL exist in this situation.

$$\textit{Operation Leverage (OL)} = \frac{\textbf{Contribution}}{\textbf{EBIT}}$$

$$\textit{Degree of Operation Leverage(DOL)} = \frac{\textbf{\% change in EBIT}}{\textbf{\% Change in Sales}}$$

Financial Leverage (FL): is the usage of funds with a fixed cost in order to increase Earnings per Share (EPS). FL involves the usage of funds obtained at a fixed cost (Interest on debt) in the hope of increasing the return to common stockholders.

$$\textit{Financial Leverage (FL)} = \frac{\textbf{EBIT}}{\textbf{PBT}}$$

PBT= Profit before Tax

$$\textit{Degree of Financial Leverage (DFL)} = \frac{\textbf{\% Change in EPS}}{\textbf{\% Change in EBIT}}$$

$$\textit{Financial Leverage (Income)} = \frac{\textbf{Profit After Tax}}{\textbf{EBIT}}$$

PAT= Profit After Tax

Financial Leverage (Balance Sheet) = $\dfrac{\textbf{Net Asset}}{\textbf{Net Worth}}$

Combined Leverage (CL): CL is the potential use of Fixed Cost, both operating and Financial, which magnifies the effect of sales volume change on the EPS of the firm.

Degree of Combined Leverage indicates the effect on EPS on change in Sales.

Combined Leverage (CL)= $\dfrac{\textbf{Contribution}}{\textbf{PBT}}$

Degree of Combined Leverage (DCL)= $\dfrac{\textbf{\% Change in EPS}}{\textbf{\% Change in Sales}}$

OR

DCL = DOL x DFL