# OPERATING LEVERAGE

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# OPERATING LEVERAGE

- Operating leverage affect a firm's operating profit (EBIT), while Financial leverage affects PAT i.e. EPS.
- When the sales level increases or decreases, the EBIT [Earning Before Interest and Tax] also changes i.e. the variability of EBIT
- Here, the environment in which the firm operates, determine the variability. This variability has 2 components
  - Variability in sales
  - Variability in expense

# OPERATING LEVERAGE

- Variability in sales revenue is the major factor in operating leverage, the sales may fluctuate because of following reason
  - Economic condition
  - Business cycle
  - Availability of raw material, technological changes, competitors, shift in consumer preference, industrial relation
  - Internal factors
- These changes have a great influence on company sales
- Variability of expense
- The variability in EBIT is also affected by the composition of fixed & variable expense

# OPERATING LEVERAGE

- The degree of operating leverage is defined as the percentage change in the EBIT to a given percentage change in sales
- The operating leverage measures the relationship between the sales revenue and the EBIT.
- The operating leverage is calculated by dividing the % change in EBIT by the % change in sales revenue.
- Operating leverage = % change in EBIT / % change in Sales
- O.L. = Contribution/ EBIT
- Sales Revenue - Variable Cost = Contribution — Fixed Cost = EBIT

# OPERATING LEVERAGE

- The operating leverage may be defined as the firm's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes.
- The operating costs of a firm fall into three categories. i) fixed cost ii) variable cost iii) sem-variable costs are fixed over a certain range of sales volume and increase to higher levels for higher sales volumes.

# COMBINED LEVERAGE

- A firm has to look into the overall risk or total risk of the firm, which is business risk plus the financial risk. Therefore, a financial manager should consider both the operating leverage and the financial leverage.
- Thus combined leverage is a product of the operating leverage and the financial leverage. The combined leverage be defined as the % change in EPS for a given % change in the sales level.
- CL = % change in EBIT/% change in Sales* % change in EPS / % change in EBIT

= % change in EPS / % change in Sales

- CL = OL × FL