NMIMS GLOBAL ACCESS
SCHOOL FOR
CONTINUING EDUCATION

NMIMS Global Access

School for Continuing Education (NGA-SCE)

Course: Corporate Finance

Model Answer

Important Instructions:

- The below questions and answers are only for reference purpose "*Model answers*" and will help you understand how to prepare Assignments
- Please do not use this for submitting any assignment
- **Understand the following:**
  - ✓ 3 major aspects of Assignment [**Understanding and usage of the formula, Procedure / Steps, Correct Answer and Interpretation**]
  - ✓ Marks allotted for every section

Question:

Simplex Ltd generated sales for the year amounting Rs 10 lacs. The variable cost is 50 % of sales. The fixed cost being 25 % of sales that is, Rs 250000. The company also has an interest obligation as the amount of debt employed by the company in its capital structure is Rs 4 lacs @ 8 %.

You are required to calculate both the operating and financial leverage for the company. Further, What if the firm wants to double its earnings before interest and taxes (EBIT), how much of an increase in sales would be essential on a percentage basis? Give sufficient reasons and calculations supporting your answer.

Answer:

Particulars	**Amount**	**Marks allotted**
Sales	1000000	
Less : variable cost	(500000)	
= contribution	**500000**	**1 mark**
Less: fixed cost	(250000)	
= EBIT	**250000**	**1 mark**

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Less: interest **= EBT**	(32000) **218000**	 **1 mark**
Operating leverage = contribution / EBIT	500000/ 250000 = 2 times	**1 mark for formula** **1 mark for correct answer**
Financial leverage =EBIT/EBT	250000/ 218000 =1.146 times	**1 mark for formula** **1 mark for correct answer**
Sales required to double the EBIT can be calculated as under Operating leverage is two times it means that 50 % increase in sales volume causes a 100% increase in the operating profit or EBIT Thus , at the sales of Rs15 lacs , the EBIT will be Rs 5 lacs ***The same can be verified as under:***		**1 mark for the interpretation**
Sales: 1500000 Less : variable cost: (750000) **= contribution**: 750000 Less: fixed cost: (250000) **= EBIT**: 500000		**1 mark for the contribution** **1 mark for the EBIT**

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	Total marks	**10 marks**

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