A Theoretical Framework on EBIT- EPS Analysis

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Abstract *– In deciding the capital structure of firm the financial managers depends on EBIT – EPS analysis to find which capital structure gives the maximum Earnings per share (EPS) over the expected Earnings before interest and tax. It is used to find the impact of various financial plans with respect to earnings available to equity shareholders. This study aims to focus on how EBIT-EPS analysis works, its merits & demerits.*

Keywords: *Capital structure, Earning per Share (EPS), Earnings Before Interest and Tax(EBIT).*

I. Introduction

The capital structure is the combination of various types of capital raised through long term sources of finance by issuing debt, equity & Preference shares. The various needs of finance represent the financial structure of the firm. The financial structure is entirely different from capital structure. As the financial structure indicates the short term and long term sources of finance (Total liability of the firm), the capital structure indicates only the long term source of finance (Long term liability of the firm).In Balance sheet total liabilities plus equity share capital represent the financial structure whereas in capital structure short term borrowings are excluded and only long term borrowings is considered.

EBIT and EPS analysis is a scientific tool used to compare various financial plans to find the maximum EPS .EBIT and EPS analysis can be defined as tool which evaluates various financial alternatives and suggest the best alternative which gives the highest EPS and shows the profitable level of EBIT.

EBIT(Earnings before interest and tax) is otherwise called as operating profit and it shows how the firm is functioning by excluding the impact of Balance sheet. EPS (Earnings per share) shows the profit earned by the firm including tax and interest paid.EPS helps investors to measure their profit.

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Objective of the study:

To study the EBIT - EPS Analysis

Significance of EBIT - EPS Analysis:

- EBIT and EPS analysis is used to find the optimum capital structure of the company.
- It is a scientific tool used by the financial managers to find the right financial plan which gives the maximum EPS among various alternatives.
- It helps in maximizing the firms value by suggesting the best alternative which gives maximum EPS among the various financial plan.

II. Review of Literature:

Dr. Puttanna K (2014)[1] studied how EBIT -EPS analysis allows managers to find how capital structure affects the profit levels of the firm.The study tried to analyse the average profitability , debt level and EPS in infrastructure sector over 5 years period from 2009 to 2013. As a result earning capacity and debt capacity is firm specific and not influenced by the sector.

K.Bhagyalakshmi[2] conducted a study on “EBIT-EPS Analysis in Cement Industry - A Study on Select Companies”. The aim of the study is to analyse how debt content in capital structure impact the profit available to equity share holders of four selected cement companies for a period from 2011-12 to 2016-17 by using EBIT -EPS analyses.The study concludes that debt capital is double edged knife , the usage of debt is magnifying the profit of shareholders in case of two companies , while in case of other two companies the debt is affecting the EPS negatively under adverse conditions.

EBIT - EPS Analysis - Concept:

The EBIT - EPS Analysis is tool that studies the combination of leverage i.e comparing different plans at various levels of EBIT. In simple EBIT - EPS analysis analyze the financial leverages effect on EPS with different alternative plans. EBIT - EPS analysis is used to find the combinations from various sources. It is tool helps to identify the best alternative which provides maximum EPS.

We know that the company can raise finance for its investments form various sources like Debt, Equity shares, Preference shares, long term borrowings and retained earnings. The proportion of different sources will differ under various alternative financial plans.Every financial plans main objective is to maximize the EPS.

III. Data Analysis and Interpretation:

i. Format / Income statement for calculation of EBIT - EPS Analysis calculation:

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Operating Profit/ EBIT	xxx
Less: Interest	(xxx)
Earnings Before Tax (EBT)	xxx
Less: Tax	(xxx)
Profit After Tax (PAT)	xxx
Less: Pref. Dividend (if any)	(xxx)
Net Earnings available to equity shareholders/ PAT	xxx
No. Equity shares (N)	
Earnings per Share (EPS) = (PAT ÷ N)	

ii. APA Limited has equity share capital of Rs.10,00,000 (face value of Rs100) .To meet the requirements of an expansion programme. Thecompany wishes to raise Rs.6,00,000 and is having four alternative sources to raise thefunds.

Plan I: To raise full Amount from the issue of equity shares .

Plan II: To raise Rs 2,00,000 from equity issued at par and Rs.4,00,000 through long term borrowings at 10% interest per annum.

Plan III: To raise entire Amount through long term borrowings at 10% per annum.

Plan IV : Rs.3,00,000 through equity issue at par and Rs.3,00,000 at 8% on preference shares.

The company's EBIT is 3,00,000. The corporate tax is 10%.

Find the best plan from the above four alternative plans to raise the required funds.

Solution:

	PLAN I	PLAN II	PLAN III	PLAN IV
EBIT	300000	300000	300000	300000
Less : Interest	NIL	40000	60000	NIL
EBT	**300000**	**260000**	**240000**	**300000**
Less : Tax(10%)	30000	26000	24000	30000
PAT	**270000**	**234000**	**216000**	**270000**
Less : Preference dividend	NIL	NIL	NIL	24000
Net earning available to Equity shareholders / PAT	**270000**	**234000**	**216000**	**246000**
No. of Equity shares	16000	12000	10000	13000
EPS (PAT / No.of Equity shares)	**16.875**	**19.5**	**21.6**	**18.9**

Workings:

No.of equity shares:

Plan I : Existing equity shares + new equity shares = 10000+6000 = 16,000

Plan II : Existing equity shares + new equity shares = 10000 + 2000 = 12,000

Plan III : Existing equity shares + new equity shares = 10000+ 0 = 10,000

Plan IV: Existing equity shares + new equity shares = 10000 + 3000 = 13,000

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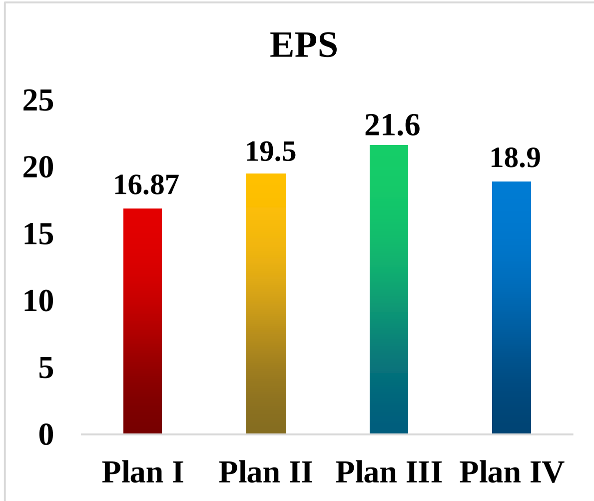

Suggestions:

As Financial plan III gives the maximum EPS of Rs. 21.6 when compared to the other financial alternatives , we can suggest to implement Plan III to raise the entire additional capital amount Rs. 6,00,000 through long term borrowings for Expansion programme in their business.

Merit of EBIT - EPS Analysis:

- EBIT - EPS analysis helps the company to select the optimum financial plan which gives maximum EPS.
- In the aspect of financial planning EBIT - EPS Analysis analyze various financial alternatives and find the level of EBIT which maximizes the EPS
- It enables comparative analysis between various financial options.

Demerits of EBIT - EPS Analysis:

- Risk factor is not considered in EBIT - EPS Analysis.
- EBIT - EPS Analysis does not consider the over Capitalization of the firm
- If various different financial plans are considered, the comparison becomes very difficult.

IV. Conclusion:

EBIT - EPS Analysis is a important tool of capital structure which finds the best alternative plan which provide Maximum EPS. It shows the relationship between EBIT and EPS in various financial forms (i.e) debt - equity ratio. The financing pattern which provides the maximum EPS to its equity shareholders in assumed EBIT level is considered as the best financial plan or optimum capital structure.

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