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★★★★★ 3.6

₹ 450

MANU		VINU			
		CONVERSATION BETWEEN MANU AND VINU ABOUT <u>FINANCIAL BREAK EVEN POINT</u>			
Vinu	Manu! I know little bit about Break Even Point in Costing. But in Capital Structuring also, I understand there is a Break Even Point. Do you have any idea about that?				
Manu	Yes Vinu! It is called Financial Break Even Point.				
Vinu	Why we have to find that?				
Manu	Vinu! It is calculated when we have mix of funds in capital structure.				
Vinu	Can you explain that in simple terms?				
Manu	Ok! You know, that business entities can raise funds for its business in different forms.				
Vinu	Yes.				
Manu	It can be in the forms like.....				
Vinu	Equity Share Capital, Preference Share Capital, Debentures, Bank Loans, etc.				
Manu	Good! Some of these funds will have fixed cost whereas some will not have.				
Vinu	Yes. Bank Loans / Debentures / Preference Share Capital have to be paid fixed interest / dividend whereas Equity share holders are paid dividends only when the business makes profits.				
Manu	Correct. So when your business generates profits, firstly it should be sufficient enough to cover the fixed financial charges like interest and preference dividend.				
Vinu	Yes.				
Manu	So finding whether your business generates sufficient profits to cover the fixed financial charges are called as finding Financial Break Even Point.				
Vinu	Fine! So it is the level of profit which will match our Fixed Financial Charges.				
Manu	Yes! So which profit is that? Is it PBIT / PBT / PAT?				
Vinu	Hmmm??? We are talking about charges like Interest / Preference Dividend. Then profits should be before those items. So Profit Before Interest and Tax (PBIT) should be the ideal one. Is that right?				
Manu	Yes! Because from PBIT you pay Interest and after providing for taxes, you will pay your Preference Dividend. So PBIT is the right profit.				
Vinu	But, how to find the PBIT level which covers Fixed Financial Charges?				
Manu	Let's take an example: Let's say you have -10% Debentures of Rs.100 Crs; -14% Preference Shares of Rs.50 Crs;				

	-30% Income Tax Rate.																
Vinu	Ok.																
Manu	In this example, both the debentures and preference shares carry fixed cost.																
Vinu	Yes!																
Manu	Please calculate those costs.																
Vinu	<table border="1"> <thead> <tr> <th>Funds</th> <th>Value</th> <th>Interest %</th> <th>Interest Amount</th> </tr> </thead> <tbody> <tr> <td>Debentures</td> <td>100.00</td> <td>10%</td> <td>10.00</td> </tr> <tr> <td>Preference Shares</td> <td>50.00</td> <td>14%</td> <td>7.00</td> </tr> <tr> <td colspan="3">TOTAL</td> <td>17.00</td> </tr> </tbody> </table>	Funds	Value	Interest %	Interest Amount	Debentures	100.00	10%	10.00	Preference Shares	50.00	14%	7.00	TOTAL			17.00
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Debentures	100.00	10%	10.00														
Preference Shares	50.00	14%	7.00														
TOTAL			17.00														
Manu	Good! These are your?																
Vinu	Fixed Financial Charges.																
Manu	Excellent! So how much should be your minimum profit to cover / pay these Fixed Financial Charges?																
Vinu	Obviously Rs.17 Crs!																
Manu	No, you are getting it wrong?																
Vinu	Why is that? Fixed Financial Charges are Rs.17 Crs and Profit should be at least Rs.17 Crs.																
Manu	No. It is wrong?																
Vinu	Please prove that then!																
Manu	I am not going to prove. You will find by yourself. Since you say, minimum profit should be Rs.17 Crs., work out in a table form and check whether this profit is sufficient to pay both the charges.																
Vinu	<p>Ok! Let me do that!</p> <table border="1"> <tbody> <tr> <td>EBIT</td> <td>17.00</td> </tr> <tr> <td>Less: Interest on Debenture</td> <td>(10.00)</td> </tr> <tr> <td>Earnings Before Tax</td> <td>7.00</td> </tr> <tr> <td>Less: Tax @ 30%</td> <td>(2.10)</td> </tr> <tr> <td>Earnings After Tax</td> <td>4.90</td> </tr> <tr> <td>Less: Preference Dividend</td> <td>(7.00)</td> </tr> <tr> <td>??</td> <td>??????</td> </tr> </tbody> </table> <p>Oops!!! My profits are not covering Preference Dividend!!!</p>	EBIT	17.00	Less: Interest on Debenture	(10.00)	Earnings Before Tax	7.00	Less: Tax @ 30%	(2.10)	Earnings After Tax	4.90	Less: Preference Dividend	(7.00)	??	??????		
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??	??????																
Manu	Why did that happened?																
Vinu	<p>Ya! Now I understood.</p> <p>Preference Dividends are paid out of Profits available after Tax.</p> <p>In this case our Profit after Tax was Rs.4.90 Cr whereas Preference Dividend is Rs.7.00 Crs</p>																
Manu	So, what should be your ideal Profit After Tax at your Financial Break Even Point?																
Vinu	At Financial Break Even Point, Profit after Tax should be equal to Preference Dividend.																
Manu	In this case, what should have been your PAT?																
Vinu	It should have been Rs.7.00 Cr, so that it can be used for paying Preference Dividend.																
Manu	Good! If PAT is Rs.7 Cr what should have been your PBT?																
Vinu	<p>I can tell you that.</p> <p>PAT can be equated to 70% because it is after 30% Tax.</p> <p>So PBT should be 100%.</p> <p>In this case, if PAT is 7 Cr (70%), then PBT should be Rs.10 Cr (100%)</p>																
Manu	Good! Then what should be your PBIT?																

Vinu	If PBT is Rs.10 Cr, which is after subtracting Interest of Rs.10 Cr, then PBIT should be Rs.20 Cr														
Manu	Very Good! Now construct what you have said in the form of table.														
Vinu	Ok! <table border="1" data-bbox="363 331 981 600"> <tr> <td>PBIT</td> <td>20 Cr</td> </tr> <tr> <td>Less: Interest on Debentures @ 10%</td> <td>10 Cr</td> </tr> <tr> <td>PBT</td> <td>10 Cr</td> </tr> <tr> <td>Less: Tax @ 30%</td> <td>3 Cr</td> </tr> <tr> <td>PAT</td> <td>7 Cr</td> </tr> <tr> <td>Less: Preference Dividend</td> <td>7 Cr</td> </tr> <tr> <td>Earnings available for Share holders</td> <td>Nil</td> </tr> </table>	PBIT	20 Cr	Less: Interest on Debentures @ 10%	10 Cr	PBT	10 Cr	Less: Tax @ 30%	3 Cr	PAT	7 Cr	Less: Preference Dividend	7 Cr	Earnings available for Share holders	Nil
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Manu	So, what do you understand from this?														
Vinu	Financial Break Even Point is a level of profit which covers all the fixed financial charges.														
Manu	So?														
Vinu	At this level of EBIT, only Fixed Financial charges are covered and there will be no returns for Equity Share holders.														
Manu	Exactly! It is a level of EBIT at which earnings for the shareholders in NIL. To put it simply, EPS will be ZERO. Now tell me why this level of profit is calculated?														
Vinu	To know when they reach BEP!														
Manu	That's right. But why they should know it?														
Vinu	Hmmm.....By finding Financial Break Even Point, we can compare our Expected EBIT? Does it make sense?														
Manu	Yes! It makes sense. Let us go back to our example. We have calculated Financial Break Even Point as Rs.20 Crs when we had 10% Debentures of Rs.100 Crs and 14% Preference Shares of Rs.50 Crs under 30% Tax Rate.														
Vinu	Yes!														
Manu	The message from Financial Break Even Point of Rs.20 Crs is -the company should earn at least Rs.20 Crs. of EBIT if it is planning the above funding structure.														
Vinu	Correct! If the company doesn't earn Rs.20 Crs, it will not be able to pay interest / dividend and it will affect the credibility and even solvency of company.														
Manu	Very True. On the other hand, let's say the business entity has capacity to make EBIT of Rs.30 Crs. Then what message you would get from Financial BEP?														
Vinu	Then it would mean, they can take some more fixed cost funds in their capital structure, because EBIT is greater than Financial BEP and the difference can be used for paying further fixed charges.														
Manu	Very correct. So when ever, entities makes profit more than Financial BEP, it would mean, they can take more debt funds because, their profit would support payment of interest / preference dividend to the extent of difference.														
Vinu	Yes!														
Manu	At the same time, when the entities earn less than Financial Break Even Point, then it is a serious warning message to the entities that they would be defaulting in their future payments.														
Vinu	So it's an action call right?														
Manu	Yes! It's an action call for the entity to not to add too much of debt to their capital structure because their earning capacity (EBIT) is limited.														

Vinu	Wow! A simple computation carrying very serious message for business entities. I am happy I have understood an important concept.
Manu	Yes Vinu! Business entities who manage their Financial Management professionally will test for Financial Break Even Point before finalising their capital structure so they can avoid damages on account of fixed cost funds.
Vinu	Yes Manu! I'll try to practice the same in our business. Thanks for the explanation!
Manu	Welcome Vinu!

Author:

CA N Raja

Chartered Accountant

My Email	nrajca@gmail.com
Check out my Online Courses relevant for Bankers / CA / CMA / CFA / CS / MBA Finance Students	
www.carajaclasses.com	
My Mobile	07736022001