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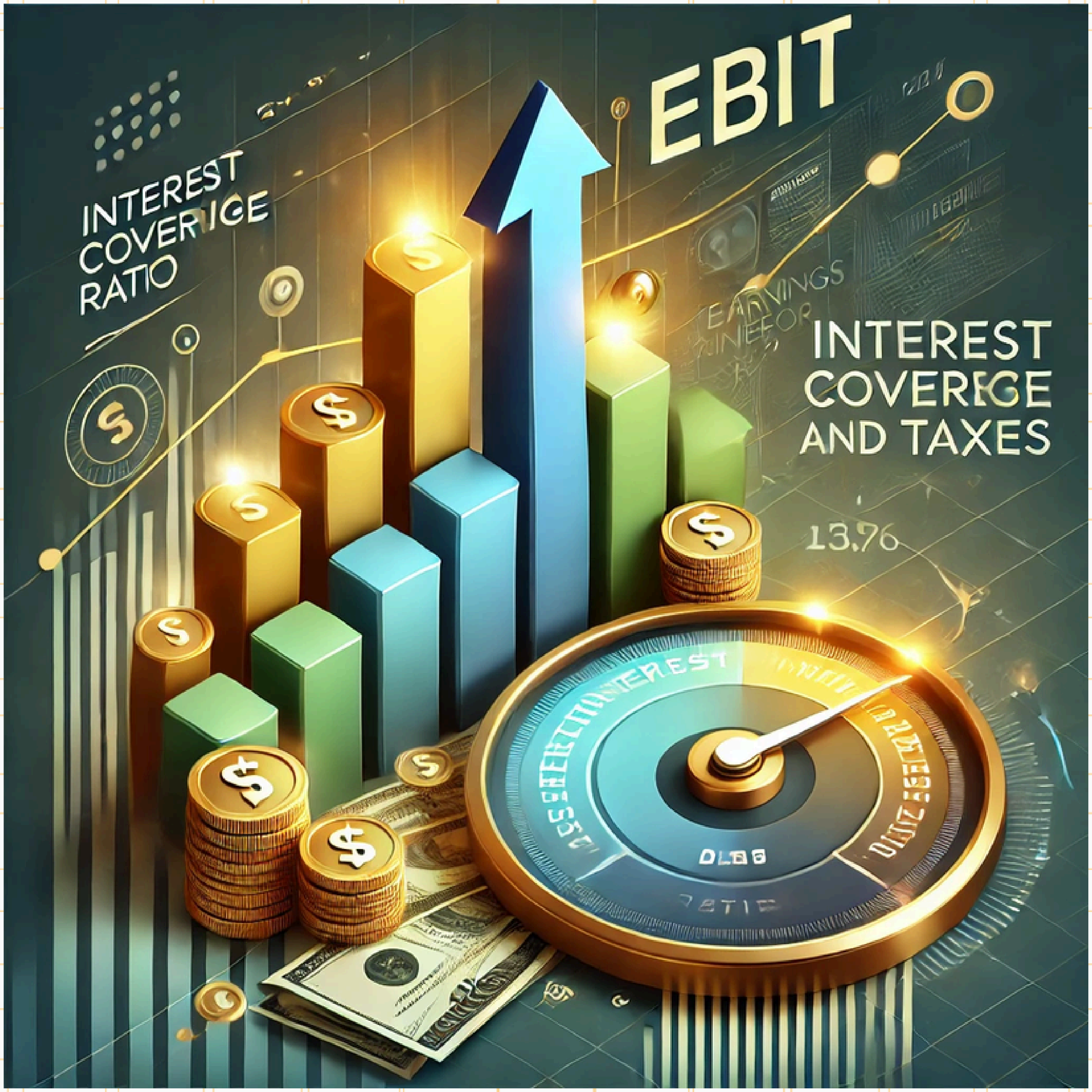
Understanding The Concept : INTEREST COVERAGE RATIO



The Interest Coverage Ratio is a financial metric that measures a company's ability to pay the interest on its debt with its operating income. It shows how comfortably a company can handle its interest expenses. Think of it as a "safety buffer" for lenders and investors to see if the company is at risk of defaulting on its loans.

How to Calculate Interest Coverage Ratio

Here's the formula:

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expense}}$$

- EBIT (Earnings Before Interest and Taxes): This is the profit a company makes from its core operations before paying interest and taxes. You can find it on the income statement.
- Interest Expense: The cost a company pays for borrowed money, also available in the income statement.

Example Calculation:

Imagine a company has:

- EBIT = ₹500,000
- Interest Expense = ₹100,000

$$\text{Interest Coverage Ratio} = \frac{500,000}{100,000} = 5$$

This means the company earns 5 times more than what it needs to cover its interest payments.

Why is it Important?

1.Creditworthiness:

- A higher ratio indicates the company is financially healthy and capable of handling debt. Lenders like to see this because it reduces the risk of default.
- A ratio below 1 means the company isn't earning enough to pay its interest—this is a red flag.

2.Risk Assessment:

- For investors, a high ratio shows the company has enough profits to reinvest or return to shareholders instead of struggling with debt payments.

3.Comparison Across Companies:

- **Comparing this ratio across similar companies helps understand which ones are managing debt better.**

Think of it Like This:

If you have ₹5000 as monthly income (EBIT) and your loan EMI is ₹1000 (Interest Expense), your ratio is 5. This shows you're in a safe zone because even if your income drops a bit, you can still manage your EMIs. However, if your EMI is ₹6000 and income is ₹5000, your ratio is 0.83—not good!