To shareholders, management, investors, employees and the enlightened public, there are two financial statements of basic importance namely the balance sheet and the profit and loss account of a company. The balance sheet depicts the summary of the resources of the company and its obligations at a given point of time and the profit and loss account expresses the results of the business operations in terms of profit or loss by taking into account the items of revenue and expenses during a given period of time. But in order to assess the performance of the company and for collecting information for locating weak and strong points in the operations of the company for having better performance in future, study of the changes in assets and liabilities (including owners' equity) is necessary. The balance sheet and the profit and loss account do not explain the changes in these assets and liabilities and hence they give only a static view which is not sufficient to evaluate the performance of a company. What is required is a dynamic approach for evaluating the operations of a company which may be a bank or a manufacturing company. This kind of dynamic approach is provided when we prepare a separate statement of changes in the financial position of a company.

There are two widely used forms of statement of changes in the financial condition of a company - the funds-flow statement and the cash flow statement. But what is the meaning of the
funds? Now the funds may mean (1) only the working capital. So the funds-flow statement narrowly conceived may depict only the changes in working capital while the cash-flow statement may show only the changes in the flow of cash. Both these statements do not reveal the changes in the total financial resources of the company. As the banks mainly deal with transactions in money, if the overall funds-flow statement is prepared so as to depict the changes in the total financial resources of the bank ultimately resulting into the change in the working capital (i.e. the change in the difference between current assets and current liabilities), it will serve our purpose and the separate cash-flow statement may not be required. So that is the approach that we have adopted here.

Working capital can be understood as "gross working capital" or "net working capital".

"Gross working capital" means the sum total of current assets and the "net working capital" means the difference between the total current assets and the total current liabilities.

Here, we have considered the "net working capital" concept, because it is more relevant and more significant in measuring the liquidity of the concern.

Working capital is the difference between current assets and current liabilities and it at once, determines the liquidity position of the bank. The funds-flow statement is the statement regarding the causes of the change in the working capital. But the non-working capital items also affect the working capital. The working capital flow comes into being when, as the net effect of a transaction, there results an increase or decrease in the working capital.

Suppose at the time of the commencement of the bank, it issues shares, here two accounts are involved - the cash account
and the share-capital account. Cash account is a current account and represents the asset for the bank while the share-capital account is a non-current account which depicts the liability for the bank as a legal entity separate from the individual existence of the shareholders. The bank receives cash against owners' equity which is a liability for a banking company. Working capital being the difference between the current assets and current liabilities and the share-capital account being non-current, there is a net increase in the working capital which shows the use of funds in the form of accumulation of cash which is an asset for the bank. Or suppose if a bank purchases the computer by paying in cash, there are two accounts involved here namely - the cash account and the equipment or the machinery account. The cash account is a current asset account and the equipment account is non-current asset account being depicted by taking into consideration the difference between the current assets and the current liabilities and the computer being a non-current item, this increase in the fixed asset is offset against decrease in cash involved in purchasing the computer: Thus the working capital will decrease which indicates the use of funds.

In both the transactions, current items are affected by the non-current items.

In the income statement i.e. in the profit and loss account, the revenue items enhance the resources in the form of cash or receivables and thereby increase working capital while the items involving expenses reduce cash or give rise to current liabilities and thereby decrease working capital. But in the income statement, there are certain non-current items like depreciation of fixed assets, which do not involve any change in working capital, because depreciation is deducted from gross
profit for making provision for the future and just now there is no outflow of cash. So for finding out the netflow of working capital, this notional value of depreciation should be added to profit, because it was previously deducted for another purpose. For our purpose of measuring the flow of funds, depreciation which was deducted from profit, should be added to profit in order to gauge the true amount of profit and also because there is no outflow of fund and hence there is no effect on net working capital.

Also if a bank receives cash from its borrowers i.e. debtors, it implies increase of cash and decrease of debtors and both are current asset accounts and hence there is no change in the net current asset position and hence there is no change in the working capital of the bank, though its composition is changed.

When the depositors withdraw their money from their current account, here also only two current accounts are affected. The cash reserves decrease which is a current asset account and the creditors also diminish which also represent the current liability account. Current assets diminish equivalently and hence there is no change in the working capital.

From this discussion, it becomes clear that the operation of the bank which affects the working capital when, out of the two accounts affected, one account should be a current account (current asset or current liability) and another account should be a non-current account (i.e. long-term asset or long-term liability). Thus it follows that,
(1) The net working capital does not change when the operation of the bank involving the two accounts are both current accounts only.

(2) The net working capital also does not alter when the operation of the bank affecting the two accounts are both non-current accounts only.

(3) The net working capital changes only when, out of the two accounts affected by the operation of the bank, one is a current account and the other one is a non-current account.

In the balance-sheet, total assets are equal to total liabilities (owners' funds i.e. internal liabilities + external liabilities). Working capital represents the difference between current assets and the current liabilities and thus it represents the net current asset position of the bank. Increase in the asset implies the use of funds and increase in the liability represents the source of funds to be used. When some current or non-current asset is acquired, there is the use of funds and when some current or non-current liability is incurred, source of funds is enhanced. In the same way when the current or the non-current asset is sold, the source of funds is enhanced and when the current or the non-current liability is disposed off, the use of funds is involved. Thus though the working capital takes into account the difference between the current assets and current liabilities only, the change in this difference reflects the operations of the current as well as the non-current items of the assets and the liabilities sides of the balance sheet. Of course,
income (profit) from the income statement given in the balance sheet is to be adjusted for depreciation and for gain or loss from the sale of a non-current asset.

Sources of Working Capital

Accordingly, sources of Working Capital will be as follows:

1) Funds from operations or adjusted net income (from the Income Statement)

2) Sale of Non-current assets:
   (a) Sale of long-term investments (like securities, etc.)
   (b) Sale of tangible fixed assets like building, land, equipment etc.
   (c) Sale of intangible fixed assets like goodwill etc.

3) Long-term Financing:
   (a) Issue of Equity and Preference Shares.
   (b) Long-term Borrowing (fixed deposits etc.)

4) Short-term Financing (like borrowing from other banks etc)

Typical sources of funds have been described above and now we shall describe the typical uses of these funds.

Uses of Working Capital

1) Adjusted net loss from operations i.e. from the Income statement.

2) Purchase of Non-current Assets:
   (a) Purchase of Long Term investments (like securities etc.)
   (b) Purchase of tangible fixed assets like building, land, equipment etc.
   (c) Purchase of intangible fixed assets like goodwill etc.
3) Repayment of Long-term debt:
(Withdrawal of fixed deposits, by the depositors, purchase of debentures etc), and of short term debt (repayment of money borrowed from other banks)

4) Redemption of Redeemable Preference Shares

5) Payment of Cash Dividend.

Thus it can be said that the funds-flow statements is the statement that depicts the changes in the financial position of the bank or any other company prepared to identify the sources and uses of working capital between two balance sheets of two years.

In many countries, it has been made compulsory for companies to publish the funds-flow statement along with their balance sheet and the income statement. The importance of the funds-flow statement can hardly be exaggerated as far as the evaluation of the operations of the banks is concerned. Account Principles Board of the American Institute of Certified Public Accountants had the following to state in favour of its importance:

"Information concerning the financing and investing activities of a business enterprise and the changes in its financial position for a period is essential for financial statement users, particularly owners and creditors, in making economic decisions. When financial statements purporting to present both financial positions (balance sheet) and results of operations (statement of income and retained earnings) are issued, a statement summarising changes in financial position should also be presented as a basic financial statement for which income statement is prepared." Now we discuss the theory of Ratio Analysis.
Theory of Ratio Analysis

The management, depositors and creditors, shareholders and the Central Bank and the intelligent laymen—all are interested in the operating performance and the financial position of the banking company. This essential need can be satisfied by having the financial analysis of the balance sheet and the income statement of the bank. Thus the balance sheet and the income statement provide the basic raw material of essential information regarding the performance as well as the actual financial condition of the bank. In the direction of the financial analysis, we have already taken the first step of deriving the funds-flow statement based on the balance-sheet and the income statement of the respective bank. The funds-flow statements are pertaining to changes in the financial position of the respective banks. These statements of changes in the financial position of the company are considered to be so much important that in certain countries, the publication of these statements has been made compulsory along with the publication of the balance sheet and the profit and loss account (i.e. the income statement) of the company. The first step of the preparation of the funds-flow statement has been already taken and now we carry the financial analysis further and undertake an important task of ratio analysis which is a powerful tool of financial analysis. Ratio-analysis is much helpful to management, depositors, creditors, shareholders and other interested classes and persons in getting a detailed idea about the liquidity, profitability, solvency and efficiency of the bank so as to enable them to have informed
judgments about the operating performance in various respects and the actual financial position of the bank.

Ratio Analysis, as the most important tool of financial analysis, helps much in identifying the financial strengths and weaknesses of the banking company by expressing the relationships between the different items of its balance sheet and the income statement. Knowledge of these strong and weak points pertaining to the performance and the financial condition of the bank is very much necessary for management so as to enable them to take corrective measures in removing weaknesses and planning for consolidation of the stronger features of the banking company.

The relationship between two accounting figures taken from the financial statements of the company and expressed mathematically is called the financial ratio. It is a relationship between two financial variables. These ratios enable us to summarize enormous financial data and make qualitative judgments from various points of view about the performance of the banking company.

There are four most important financial dimensions through which the performance of any company can be judged. For this, ratios can be evolved and calculated. Different classes of people are interested in different types of ratios. But we can divide all these ratios into four broad classes of ratios which are as under:

I Liquidity Ratios
II Profitability Ratios
III Leverage Ratios
IV Activity Ratios
I. Liquidity Ratios:

For the banks, liquidity is very important. Liquidity ratios measure the banking company's ability to meet its current obligations.

The banking company or for that matter, any company should ensure that it does not suffer from lack of liquidity. For the bank, the necessary and sufficient liquidity is very essential, because without it, sometimes it may be landed into unwarranted trouble and its image in the financial market may be blurred and the confidence of the depositors may be shaken. So the bank should ensure sufficient liquidity.

But here there is a snag also. If liquidity is greater than what is necessary, the company loses the chance of earning profit. To that much extent, the money is idle or can be invested only in short-term assets where the interest rate or the income rate is very low. So the bank has to choose between greater liquidity and greater profitability. Thus the bank has to strike a reasonable balance between the two.

II. Profitability Ratios:

A banking company has to earn good profits in order to survive and develop over a period of time. Profit represents the difference between the revenues and the expenses of the banking company over a period of time. Profit is the final output of a banking company and it has to earn sufficient profits in order to survive and grow. The Manager has to evaluate the operational efficiency of the banking Company in terms of profits and so the
Profitability ratios have been devised for that very purpose of evaluating their performance in this respect. Of course, the interests of the depositors, employees, borrowers and the society at large will be taken into account because in the long-run, directly or indirectly they all affect the profitability of the banking company. The enlightened management always takes into account all these factors.

III. Leverage Ratios:

These leverage ratios indicate the proportion of debt in the total financing of the assets of the company. They clarify the extent to which the assets have been financed by the incurring of debt. Shareholders' funds provide finance internally while debt is finance from the external source. Incurring of debt is beneficial for shareholders in two ways - one is that the shareholders can manage and control the company with a narrow base of their money and the other one is that their earnings are enlarged when the rate of return on the total money capital employed is higher than the average rate of interest on deposits and other borrowed funds. This process of enlarging the shareholders' return by the employment of depositors' money and other borrowed funds is known as "trading on equity" which represents the "financial leverage" of the respective banking company. Items from the balance sheet and the income statement are utilized to compute these ratios. The leverage ratios are calculated to find out the degree to which the operating profits are able to cover the fixed charges for the company. There should be a proper and valid mixing of debt and owners' equity in
financing the total assets of the company. Legally it is compulsory for the company to pay interest to the depositors and other debt-holders irrespective of the profit or loss incurred by the company. Thus these financial leverage ratios which reveal the actual character of the capital-structure of the company are very important.

IV. Activity Ratios:

Activity ratios are meant to evaluate the efficiency with which the company utilizes its assets. They are also called turnover ratios. They represent turnover of assets.

The equity funds and the funds received from the creditors are invested in different assets for generating sales and profits. This is a general statement. As far as the banks are concerned, their sales are their loans and advances and their funds are received from shareholders, depositors of the banks and other creditors. Cash is also an asset, but it is a sterile asset while loans and advances and investments are productive assets, because they generate interest-income. Cash is good for liquidity, but not for profitability. Loans and advances and investments are good for profit but involve liquidity risk. Good management has to strike a balance. Activity ratios indicate a relationship between sales and assets, and in the case of banks, they express the relationship between loans and advances and investments of banks on one hand and their total assets on the other or between cash and assets. Thus the effectiveness of asset utilization can be judged. A proper balance between the items in the numerators and the denominators of the activity
ratios will show whether the assets are managed well or not.

While evaluating the performance and the operations of the 18 native i.e. local commercial banks of U.A.E., we shall use the ratio analysis with the following considerations given with the ratios:

1. **Liquidity Ratios**

   Liquidity ratios measure the ability of the banking company in meeting its current obligations. They are calculated by taking into account the relationships between some or all of the current assets and current liabilities. In this connection, we take into account the following three liquidity ratios.

1. **Current Ratio**
   \[
   \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}
   \]

2. **Quick Ratio**
   \[
   \text{Quick Ratio} = \frac{\text{Cash}}{\text{Current Liabilities}}
   \]

3. **Inter-Bank Lending Ratio**
   \[
   \text{Inter-Bank Lending Ratio} = \frac{\text{Cash and deposits and balance due from banks}}{\text{Deposits and balance due to banks}}
   \]

Let us discuss them and their norms in a nutshell:

(i) **Current Ratio**
   \[
   \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}
   \]

Current Assets include cash and loans and advances and also investment in marketable securities. The current liabilities consist of mainly the deposits in the current and saving accounts, short-term loans from other banks and fixed deposits maturing in the current year.
Thus the current ratio measures the liquidity position of the banking company under analysis. Liquidity refers to the ability of the bank to discharge its obligations as and when they mature. The standard norm of the current ratio is 2:1 generally speaking, but it should be at least more than one. Higher the ratio, better for the bank for meeting its current obligations, because in that case, its liquidity will be higher. For a bank, this is very essential. If the current ratio is higher, there, is better liquidity and the default rate in servicing the borrowing and the redemption of the principal amounts would be less. Of course, loss of profits must be juxtaposed against increase in liquidity.

\[
\text{(2) Quick Ratio} = \frac{\text{Cash}}{\text{Current Liabilities}}
\]

It is an acidic test of our paying ability.

If this ratio is higher, it is better for the bank, as it provides a quick test of bank's instant paying capacity.

\[
\text{Inter-bank Lending Ratio} = \frac{\text{Cash and deposits and balances due from banks}}{\text{deposits and balances due to banks}}
\]

If this ratio is higher, it indicates the improvement in the liquidity position of the bank. So if the ratio is higher, it is better.

Here, it should also be borne in mind that higher the liquidity, lesser the profitability, but for a bank, higher liquidity is essential for inspiring confidence among the depositors and other creditors and hence it is helpful indirectly even in generating higher profitability by building up the credibility of the bank in the money market.
II. Profitability Ratios:

The banking company has to earn enough profits for its growth over a long period of time and even for its survival. Profit is the difference between the income of the bank and the expenses of the bank. Income of the bank mainly consists of its interest income of loans and advances given by it to its borrowers. But it also has to pay interest on the deposits, deposited in the bank by the depositors. But the interest rate on its borrowers is higher than the interest rate on its creditors and hence its net interest income which represents the excess of its total interest income over its total interest cost constitutes its gross profit. This net interest income is the chunk of its profits.

We shall take into account five profitability ratios to evaluate the performance of these 18 banks.

(1) Profit ratio = \[ \frac{\text{Net interest income}}{\text{Operating income}} \]

(2) ROI (Rate of return on investment)

\[ \text{ROI} = \frac{\text{Profits for the year}}{\text{Total Assets}} \]

(3) Expense Ratio = \[ \frac{\text{Interest Expenses}}{\text{Interest Income}} \]

(4) ROE (Return on shareholders' equity)

\[ \text{ROE} = \frac{\text{Profit for the year (Net Profit after taxes)}}{\text{Total shareholders' funds}} \]
Let us clarify the meaning of these ratios in relation to the banks one by one.

(1) Profit ratio = \[ \frac{\text{Net interest income}}{\text{Operating income}} \]

Net interest income is the main income for the bank, as it expresses the excess of its interest income over its interest cost, its main business being collecting the savings of the people in the form of deposits and lending these savings of the people to borrowers mainly for their investment purposes. But operating income takes into account other incomes also besides interest income and from which administrative expenses and provision and other expenses and taxes have not been netted out. The main function of the bank is borrowing and lending and hence net interest income is the main component of profit and we wish to measure the proportion of bank's net interest income to its total income. It means that operating income is the sum of net interest income and the other income. Operating income is the total income from which only interest cost has been deducted and administrative and other costs and taxes have not been substracted from it. Thereby, it shows the proportion of profit derived from interest income to its total gross profits. This ratio indicates the efficiency in respect of mobilizing the savings of the people and yielding returns on them through loans and advances. If this ratio is higher, it is better for the
nation as well as the bank, because the bank has succeeded well in mobilizing the resources and becoming instrumental in enhancing investment and increasing national output as well as employment which is quite in the fulfilment of the national objectives.

(2) \[ \text{ROI} = \frac{\text{Profit for the year (Net Profit after taxes)}}{\text{Total Assets}} \]

Here, profits represent profits after payment of taxes i.e. PAT.

It is the rate of return on investment. Investment indicates the management of the pool of funds provided by the shareholders and the lenders. It is investment in different types of assets in such a fashion as to maximise the total profits of the bank. ROI expresses the amount of net profit after taxes i.e. return per unit of assets. So it represents the rate of return on assets i.e. on total capital employed. Higher the ratio, better for the bank. Thus this is a very important ratio to judge about the efficiency of the bank and thereby evaluate the performance of the bank. It is of great interest to the management and to the present as well as the prospective shareholders.

(3) \[ \text{Expense ratio} = \frac{\text{Interest expense}}{\text{Interest Income}} \]

It is a measure of operating efficiency in the main business of the bank. It shows two elements - one is tapping the low-interest bearing deposits and the other one is using every Dirham available for getting profits. The ratio should be lower than 1 otherwise the bank will incur losses in this regard. Lower the ratio, better it is for the bank, because in that case, the
The proportion of interest cost to interest income will be lower and the bank will be making profit which will be gross profit from which administrative expenses and provisions and other expenses and taxes have not been deducted.

This is another important measure to mark the efficiency of the bank in its main business of lending. Deposits by the depositors in the bank are its raw-material. Lending by the bank is like manufacturing output from this raw-material.

(4) ROE (Return on shareholders' Equity)

\[
\text{ROE} = \frac{\text{Profits for the year (Net profits after taxes)}}{\text{Total shareholders' funds}}
\]

Profits for the year is the difference between the sum of interest income and other income on one hand and the sum of interest expense, administrative expenses, provisions and other expenses and taxes on the other hand. Thus it is the difference between the total income and total expenses (including taxes) of the bank. This difference defines profit for the year. This is about the numerator of the ratio.

Now let us have the clear comprehension about the meaning of the total shareholders' funds. It is the total sum of paid up capital, legal reserves, other reserves, retained earnings and proposed bonus shares. Giving of bonus shares to the shareholders becomes possible when there is good profit for the year. Paid-up capital is the actual share capital provided by the shareholders, but the legal reserves, other reserves and retained earnings are all out of the profits earned in the past and the present. They
all being the part of the profit, the receipt of which is the prerogative of the shareholders, they all constitute different elements or parts of the total shareholders' funds. So the total shareholders' funds are the sum of all these elements. They represent shareholders' equity.

So ROE represents rate of return or rate of profits on shareholders' equity. It is net profit after taxes divided by shareholders' equity. It indicates how well the management of the bank has used the resources of the owners i.e. shareholders. Higher the ratio, better for the bank, as it shows the higher efficiency of the management of the bank in generating profit on owners' funds.

EPS (Earnings per unit of share Capital)

\[ EPS = \frac{\text{Profit for the year (Net profit after taxes)}}{\text{Paid-up Capital}} \]

The meaning of the profit for the year has already been explained and it is actually net profit after payment of taxes. This is about the numerator of the ratio. Now coming to the explanation of the denominator of the ratio, we have opted for paid up capital of the shareholders rather than the number of the shares which enhances the utility of this measure, because in that case the ratio EPS represents the earnings of profit per one unit (i.e. one Dirham) of paid up capital contributed by the shareholders rather than per one share when the share value may be different for different banks. Paid-up capital is actual money
capital provided by the shareholders, as subscribed capital here is not important because all of it is not paid. Total shareholders' funds also here are not important, because all types of reserves and retained earnings emanate from profits and we want to measure the very profit creating capacity of the bank on the basis of the shareholders' actually contributed money capital which is nothing but the paid up capital of the shareholders. Dirham being the common unit of measurement for all the banks in U.A.E., we have chosen to compute the amount of profit per one unit of paid up capital (share capital) which shows the rate of return on share capital.

If this ratio is higher, it shows succinctly that the bank management has succeeded in generating higher profits on the share capital and so it must be applauded and appreciated.

III. Leverage Ratios:

The function of the leverage ratios is to clarify the nature and the pattern of the capital structure of the bank. These ratios mainly indicate the long-term financial position of the bank. Long-term funds are provided by equity holders and lenders. There should be a proper mix of debt and equity. Debt helps in maximising profit on equity capital, but it enhances risk also. So the management has to try for the optimum mix of debt and equity. Leverage ratios are actually financial structure ratios. Here, we take into account the following financial structure ratios:

1. Gearing ratio = \[
\frac{\text{Long-term loans raised}}{\text{Total shareholders' funds}}
\]
Interest Coverage Ratio = \[ \frac{\text{Profit for the year (Net profit after taxes)}}{\text{Interest Expenses}} \]

Let us explain the significance of these ratios one by one.

1. **Gearing ratio** = \[ \frac{\text{Long-term loans raised}}{\text{Total shareholders' funds}} \]

   It is a ratio between debt and equity which enhances the possibility of getting more profit by widening its base and also the operations with the help of borrowed money i.e. external finance. But the banks mainly work with the depositors' money which are not owners' funds but actually borrowed money representing current liabilities, as interest is paid by the bank on the deposits deposited in the bank. Here we are taking into account the long-term loans which represent long-term liabilities. Depositors' money constitute current liabilities and they are short-term loans. They are like raw-materials for a manufacturing company on which the bank works and makes it a manufactured commodity i.e. gives the loans and advances to the borrowers of the bank. Higher the ratio, it is better for the bank, but the risk also is greater. Shareholders' funds are
owner's funds and in comparison with their cost, even the long-term loan is considered to be low cost debt and the funds provided by long-term loans are harnessed to benefit the shareholders. But here it is assumed that they are used profitably. Thus it is a double-edged weapon. So long-term loans (raised) are different from the raw-material in the form of the customers' deposits and the banks' loans and advances are like sales of the manufactured commodity. Principal sum plus the interest charged constitute sales value. Now the principal sum has to be returned by the borrower to the bank just as the bank has to return the principal sum to the depositors. So these two principal amounts are equal, so what makes the difference is the interest to be given by the bank on the deposits deposited by the depositors and also the interest charged by the bank in its own loans and advances to others. So when we net out interest income by its interest expenses, we get net interest income which is net of interest expenses. Of course, banks have other incomes also. Besides, banks also have to undergo administrative and other expenses. Net interest income plus the income which is equal to operating income is like gross profit and when administrative expenses and other expenses and taxes are deducted, we get net profit after taxes which is called profit for the year. Now the ratio of profit for the year to interest expense is the interest coverage ratio. So the interest coverage ratio will be as follows:

\[
\text{Interest coverage ratio} = \frac{\text{Net profits after taxes}}{\text{Interest expenses}}
\]
This ratio not only measures the efficiency of the bank in generating profits, but it also evaluates the financial position of the bank, because the ratio represents profit per unit interest cost and profit is also nothing but net interest income. Thus indirectly, it is a ratio between loans and advances given by the banks, which are interest income (numerator) and the deposits of the banks which represent interest cost (denominator), though other elements also are involved in the numerator as well as the denominator. But it does not make much difference. If this ratio is higher, it is better. In the case of companies other than banks, earnings before payment of interest and taxes are taken into account while in the case of banks, we take profit for the year (which is profit net of the interest cost and taxes) in the numerator of the ratio and we put interest cost in the denominator. The question may arise that when interest cost is already deducted and net profit arrived at, how can this profit when divided by interest cost, give the interest coverage ratio. As it is not the case of a manufacturing company, but a bank, we have to take into account net profit which has been netted out by interest cost also along with other costs. Even taxes also can be deducted, as their ratio will be uniform on different slabs of income. These will be uniformly deducted. So deduction of interest cost and taxes from gross profit and getting net profit or profit for the year will not detract from the utility of this ratio. So the numerical value of the ratio will be proportionately less and in that circumstance also, it will serve our purpose of evaluating its efficiency in generating profits.
If the value of the ratio increases, it means that the profit generated per unit cost of interest is more and hence the performance of the bank has improved. It also shows that the long-term financial position of the bank has improved.

\[
\text{Total shareholders' funds} \quad \frac{\text{(3)}}{\text{Total Assets}}
\]

Assets are meant for generating profits. Shareholders' funds are a liability for the banking company. Outside funds are always cheaper, because shareholders become owners. This ratio shows the proportion of shareholders' funds to total assets. If the ratio is higher, it means that in creating the assets for generating profit, less outside money i.e. outside debt is created. Now the outside debt is cheaper than the share-capital which is internal and represents owners' funds. So if the ratio is increasing, it is not good for the company. Lower ratio is better for the banking company.

\[
\text{Deposits from customers} \quad \frac{\text{(4)}}{\text{Total Assets}}
\]

Deposits from customers represent the savings of the people. So if the value of the ratio is higher, it means that the bank is a good mobilizer of the savings of the people. The proportion of the deposits is to be taken into account in relation to the total assets of the bank, because assets are meant for generating profits. Of course, deposits are the liability for the bank. If the ratio is higher, it is better, because it indicates that cheaper outside debt is used for generating profit and the bank is also contributing better in mobilizing savings in the economy.
for investment purposes which may contribute to the growth of the economy of the country.

Deposits from customers + deposits and balances due to Banks

\[
\frac{\text{Deposits from customers + deposits and balances due to Banks}}{\text{Long-term debt}}
\]

The numerator and the denominator both represent the liabilities, but the numerator represents the short-term borrowing while the denominator represents long-term borrowing. So the ratio is

\[
\frac{\text{Short-term borrowing}}{\text{Long-term borrowing}}
\]

If the ratio is higher, it means that the liquidity is lower. This is because the short-term loans are to be returned earlier and hence liquidity will be less while the long-term loans are to be returned after a good lapse of time and hence the liquidity is better. So if the proportion of short-term borrowing in relation to long-term borrowing increases, it means that the liquidity of the company is lessened. But its profitability is most likely to be higher, because the rate of interest on the short-term loans is lower than the rate of interest on long-term loans and so its cost will be lower and consequent profit rate will be higher. So liquidity and profitability both have to be taken into account. But for a bank, liquidity is very important even from the point of view of profitability. So upto a point, higher liquidity should be welcome but not beyond a point, because it then is at the cost of profitability. It is expected that the bank will maximise its total profits by serving all the relevant classes.
It is a credit creation ratio. This ratio measures the extent to which the loans and advances are given by the bank on the basis of the deposits deposited in that bank. If the value of the ratio is more than one, it means that creation of credit takes place. Higher the ratio, more credit creation takes place. It is good from the point of view of profitability. This is because, on loans and advances by the banks, the bank gets interest income while on the deposits of the customers, the bank has to pay interest on these deposits. So if the value of the ratio is higher, it is better for maximizing profit.

IV. Activity Ratios:

Activity ratios are, in fact, assets-turnover ratios. They show the efficiency with which the assets are managed so as to ensure maximum amount of total profit without endangering liquidity. So in all these ratios which are pertaining to banks, assets will be in the denominator and profits or cash or cash and deposits with the bank or loans and advances will be in the numerator. Thus we take into account the following ratios.

\[
\begin{align*}
\text{(1) Profit for the year} & \quad \frac{\text{Fixed Assets}}{} \\
\text{(2) Profit for the year} & \quad \frac{\text{Loans and advances + Investments}}{} \\
\text{(3) Loans and advances} & \quad \frac{\text{Total assets}}{}
\end{align*}
\]
Let us elucidate these ratios in brief one by one.

(1) \[
\frac{\text{Profits for the year}}{\text{Fixed Assets}}
\]

When we deduct interest expense from interest income, we get net interest income. When we add 'other income' to this net 'interest income', we get operating income. When administrative and other expenses and provisions are deducted from the operating income, we get profit before taxes and when tax is deducted, we get net profit after taxes which is also called profit for the year.

In the above ratio, these profits are there in the numerator and fixed assets are there in the denominator.

If the ratio is higher, it may mean that either the value of the numerator is higher or the value of the denominator is lower.

If the value of the numerator is higher, it means that the profit is higher and if the investment in fixed assets is lower, then investment in non-fixed assets may be higher which will generate more income for the bank.

So, higher the ratio, better for the bank.

(2) \[
\frac{\text{Profit}}{\text{Loans and Advances + Investments}}
\]

The numerator is the same as it was in the first equation, but in the denominator, we take into account the non-fixed assets.
like loans and advances by the banks and the bank's investments which are the main generators of profit for the respective bank. If the ratio is higher, it is better, as it highlights the efficiency with which the assets are managed, specially loans and advances and investments which are the main generators of income.

Loans and Advances

\[
\frac{3}{\text{Total assets}}
\]

Loans and advances are the operational assets for the bank; they represent the essential part of the banking business and the main source of income. So the proportion of bank's loans and advances to its total assets highlight efficient activity performance of the bank. So if the ratio is higher, it means that the bank is trying to get profit from its real business of lending and not from other sources. Thus the bank is adhering to its real banking business.

Cash

\[
\frac{4}{\text{Total Assets}}
\]

Cash is a sterile asset.

It is a ratio between one kind of asset to total assets. Assets have to be managed efficiently so as to generate maximum profit, but without endangering liquidity of the bank. Cash being a sterile asset, it does not earn any income, but it provides liquidity, the maintenance of which is very necessary for the bank.

So, if the ratio is higher, it is not good from the point of view of profitability, as cash does not earn any income, it
being a sterile asset, but it is good from the point of view of liquidity. So the bank has to strike a balance.

\[
\frac{\text{Cash on hand + deposits with banks}}{\text{Total Assets}}
\]

OR

\[
\frac{\text{Cash on hand + deposits with banks + investments}}{\text{Total Assets}}
\]

The only point in which this ratio differs from the previous (4)th ratio, is that the "deposits with bank" and investments have been added to cash. This is because the deposits with other banks are just like cash and they earn a very low rate of interest.

Some analysts would like to add investments also to the numerator, because they represent marketable securities (financial assets) on which rates of interest (income) are low and they can be sold and encashed at any time.

Now a stage has come when we begin to discuss and analyse the performance of every individual bank in detail from amongst 18 local commercial banks of U.A.E.