IMPORTANT FINANCIAL INDICATORS
(PART TWO)

A. PROFITABILITY RATIOS

In this aspect the banks normally check the following ratios:

a. Gross Profit Ratio

It is a relationship of Gross Profit to Total Sales and is calculated as follows:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

An increasing trend would mean stabilization of production, effective management of inventories besides marketing efficiency and better production management. The lower ratio on the other hand may mean a strain on the margins due to increase in the cost of raw materials and other production costs without a corresponding increase in the sales realization

b. Operating Profit Ratio

It is a relationship of Operating Profit to Total Sales and is calculated as follows:

$$\text{Operating Profit Ratio} = \frac{\text{Gross Profit – Selling, general and administrative Exp.}}{\text{Sales}}$$

An increase in that ratio would mean stabilization of the market for the products of concern and effective control over selling and administrative expenses.

c. Return on Investment Ratio:

This ratio indicates the earning power of the project in relation to the investments made and risk undertaken. It will also benefit to compare it with other projects to find out the relative strength of any project in term of profitability.

This ratio is also checked for a successive number of years so that the trend could be established to see the continuous profitability. Any deterioration would mean a lower earning capacity of the project due to erosion in margin. A careful study of these factors may help to plan suitable strategies for improvement in future.

This ratio is calculated as follows:

$$\text{ROI} = \frac{\text{Net Profit before tax + Intt. On term Liabilities}}{\text{Net Worth + Term Liabilities}} \times 100$$

d. Return on Net Worth

To find out return on Net Worth which is a better indicator of earning capacity of project in relation to the owned funds employed for the project. This indicates the real amount available to owners as a return on their investments. It is calculated as follows:

$$\text{Return on Net Worth} = \frac{\text{Net Profit After Tax}}{\text{Tangible Net Worth}} \times 100$$

B. ACTIVITY RATIOS

1. Inventory Turnover Ratio:

This ratio indicates that how much fast the inventory is converted into sales so that any blockage of funds in inventory could be checked and liquidity in the system may be maintained. It is calculated as follows:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Sales}}{\text{Average Inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory + Closing Inventory}}{2}$$

Cost of sales = Raw Material Consumed + Direct Expenses (Direct Labour, Manufacturing Exp., Depreciation, Power & Fuel etc) + Opening Stock in Process- Closing Stock in process + Opening Stock of finished stock – Closing stock of finished stock

The higher ratio indicates that the enterprise as able to achieve higher turnover with low level of inventory thereby reducing the chances of inventory hold ups or carrying over of obsolete inventory. The decreasing trend shows the sluggishness' in demand of the product manufactured/traded by the concern with large carry over stocks demanding more investments with slow movements. It may also mean carry over of dead inventory.

2. Creditors Ratio

This ratio indicates the credit period available to the concern for its purchase policy and payment period to the creditors. It is calculated as follows:

Creditors Ratio (in days) = $\frac{\text{Bills Payable + Sundry Creditors}}{\text{Total Credit Purchase}}$ X 365

It indicates the reputation of the concern to get the material on credit; but it also shows sometimes the inability of the concern to pay its creditors promptly and timely which could be taken as adverse factor.

3. Debtors Ratio

This ratio indicates the credit period given to its customers and the recovery of credit sales. It is calculated as follows:

Debtors Ratio (in days) = $\frac{\text{Bills Receivables + Sundry Debtors}}{\text{Total Credit Sales}}$ X 365

Longer period in realization of sales proceeds shows the incapacity of the concern to realize its dues on time. Further the increasing trend in this ratio indicates the slowness' in the demand of the product of the company or has ended with some bad debts which can not be realized timely.

A small creditor's ratio with a higher debtor's ratio indicates that the concern is prompt to pay its dues but slow in recovery from customers i.e. longer credit cycle. This may be due to adverse market condition for the product and means larger investment for financing its sales.

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