FINANCIAL STATEMENT ANALYSIS OF BANKING COMPANIES IN INDIA

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The industrialised world for reasons more than one required ancilliary industries and other systems to facilitate its growing needs. The banking as a system has developed and grown into its present form simultaneously with the industrialisation.

The wild size of banks in terms of number of branches and size of deposits; and the strategic nature and sensitivity of work requires a thorough study of various dimensions of banking as a system both at micro and macro level. A lot of work has been done with regard to variouse facets but unfortunately a very little attention seems to have been paid in literature to the analisys of financial statements of banks particularly in India. One plausible reason for this might be vested in the way the banking system developed in India. Therefore in the present paper it is proposed to examine various issues connected with banking in India.

I. HISTORIAL PERSPECTIVE :

Banking in India existed as early as Vedic period in its most crude form. It was limited mainly to money lending as per the requirements of the economies. The need for banking system in its present form was neither felt nor required for such type of economies. It is with the emergence of industrial revolution that the change in the character and centent of banking become inevitable. The banking system at present has assumed such an importance that it has become the very life blood of industry, trade and commerce of the present day economies.

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The pattern of Indian banking has been largely inherited from British primarily because the first three banks were established under the British rule. The Precidency banks i. e. Bank of Bengal, Bank of Bombay and Bank of Madras, were established in the year 1806, 1840 and 1843 respectively and ware authorised by the East India Company to issue paper money*.

With the breaking of World War - I, the demand on the banking system increased beyond proportion for increased financial requirements of both - Government and public. As a result there was a mushroom growth of banks : sound and unsound, ethical and unethical. This was primarily one of the reasons for the set - back which the banking industry suffered immediately after the world war. The other reasons being the governmental policy of deflation in the year 1921 and the world wide depression of 1929 - 33. The failure of large number of banks during this period was responsible to shake the public confidence and made it inevitable for the government to evolve some mechanism to minimise and stop any further depletion of banks in the economy. Hence in 1935 on the recommendation of Central Banking Enquiry Commission the government established the Central Bank viz. Reserve Bank of India.

It was only after the independence that the Government's attitude towards the growth of banking changed and it was realised that banks play a vital role for faster economic development of a country. Again the partition of India adversely effected the banks and to come out of this situation Government of India gave additional responsibilities and powers to Reserve Bank of India to reconstruct the economy of the country. Taking Reserve Bank of India under the full control of Government on January 1, 1949 was the first step to this process. Subsequent nationalisation of State Bank of India, fourteen other scheduled commercial banks in the year 1969 and six banks in the year 1980 were the major steps towards the recognition of the role of banks in Indian economy.

II. FUNCTION AND ROLE OF BANKS :

Section 6 of Indian Banking Regulations Act 1949 deals with the functions that a modern bank is expected to perform. The functions can be broadly classified into two parts : 1. Main Functions, and 2. Other Funetions

1. Main Functions : The main function of a bank is to accept public deposits by way of current account, savings bank account and fixed deposits. This function has a two fold object - first, it ensures safe custody of money to the depositors with some interest and second, investment of these funds or lending it to the persons in need and thereby earn profits as a business enterprise.

2. Other Functions : The other functions of a bank include :—

(a) Lending Money :— Banks lend money in the form of advances, overdraft, cash credits or discounting bills of exchange etc.

* *The power of issuing paper money was, however, subsequently withdrawn in 1862*

(b) **Acting as Agent** :— of their customers in various ways, such as

i. Collect and pay their cheques, bills, promissory notes, coupens, dividend warrants, subscriptions, rents, income-tax, insurance premia and other periodical receipts and payments.

ii. purchase and sell on their behalf shares, stock, debentures and bonds etc. on the stock exchange and provide other merchant banking services including portfolio management etc.

iii. underwriting of shares and debentures.

iv. monetise long - terms investments by converting them into demand or crediting to current account acting as trustee, executors, administrator and attorney, and acting as referee to the financial status of its customers etc.

Misc. Functions :— These functions include :—

Safe custody of customers' valuables, ornaments, jewels, documents and deed etc., issuing of letters of credit, travellers, cheques, and circular notes to their customers and making the money available in the place it is required

Besides the functions performed for individuals, banks also perform certain very important services towards the nation. These services are of vital importance for the growth and development of an economy and are discussed below :

— Banks encourage trade, industry and commerce.

— Helps in equitable distribution of funds between different regions.

— Generates employment.

— Creates habit of saving among people and mobilise even very small savings into very large sums which can be profitably invested — the sums which otherwise would have remained unutilised.

— Influence interest rates in the capital worked by offering more or less funds.

III. BANKING SYSTEM]N INDIA :

Banking system in India can be broadly discussed under two heads :

1. **Organised Banking System, and**

2. **Unorganised Banking System.**

1 **Organised Banking System** :— The organised banking system comprises following main typet of banks :—

(i) **Reserve Bank of India (RBI)** :— As the central bank of nation, RBI is vested with sole right of issuing paper money. It controls and supervises the commercial banks in the country, implement the banking policy of the Government of India, control and regulate foreign exchange and value of Indian rupee in relation to foreign currencies. It publishes m netory and financial informations and aets as bank of banks.

(ii) ***Commercial Banks*** :— *Commercial banks in India are organised as joint stock companies and can be discussed under two heads* :

(A) Public sector banks, and (B) Private seetor Banks.

(A) **Public Sector** include : (a) State Bank of India and its subsidiaries which came into being as a nationalised bank on July 1, 1955.

(b) Nationalised Indian Scheduled Commercial banks : The Government of India in the year 1969 and 1980 nationalised 14 and 6 important private sector scheduled commereial banks respectively. These banks are operating as scheduled commercial banks under the control and management of Government of India and their day to day activities are being supervised by Reserve Bank of India.

(B) **Private Sector Banks** include : (a) Branches of banks incorporated outside India - such banks function under the permission of Government of India, through Reserve Bank of India, as commercial banks and are called as foreign banks.

(b) **Indian Scheduled Commercial Banks other than Nationalised Scheduled Commereial Banks** : The banks other than nationalised bank are scheduled with the Reserve Bank of India and are kept in second schedule. Their polices are governed by Central Government as well as Reserve Bank of India and they work under national banking policy.

(c) **Non-scheduled commercial banks** : These are the banks which are not included in II-nd schedule of Reserve Bank of India and do not conform to norms of RBI Act or its instructions. But these banks are under the obligation to maintain a minimum legal reserve which may be kept by them with RBI.

(iii) **Co-operative Banks :—** On April 1, 1966 an amendment to Banking Regulation Act 1949 was made to bring all the Co-operative banks having paid up capital of Rs. 1 lakh or more under the control of RBI. The types of banks included under this category are State Co-operative Banks, Central Co-operative Banks and Rural primary co-operative banks.

2. **Unorganised Banking System :—** The system mainly includes Sahukars, Mahajans and Money lenders. Inspite of the fact that the modern banking system has made a great progress, they still play a vital role in Indian economy because of their easy access to the borrower, accepting personal security and involving less complication. But they have always been criticised for charging very high rates of interet and exploitation.

However, our further discussion will be confined only to the organised banking system.

(IV) **Distinctive Features of Financial Statements of Banks :—** Looking at the role banks play and the position they occupy in an economy, it becomes necessary that they should run on sound financial principles. Because of the nature of business and services performed by banks it becomes utmost important that the bank in itself must be financially strong and have good profitability. If a bank is financially weak we can hardly expect any role that such a bank can play in the development of an economy. Rather, it will shake the confidence of public in the whole of the banking system of the country. That is the reason why unsound banks in any banking system should be discouraged.

The most common approach to judge the financial soundness and profitability of a concern is to analyse the financial sattements of that concern. The same approach could be followed for banks also. But the financial statement analysis of banks have some different features as compared to the financial statement analysis of a non-banking organization. The reasons being :

(a) the items included in the financial statements, viz, Balance sheet and profit and loss account, of a bank are different from that of a non-banking organization.

(b) the analysis of financial statements of a bank encounters problems which are different from the financial statement analysis of non-banking companies. For example : (i) there are some established norms in case of non-banking companies such as, a ratio of 2:1 for current assets and liabilities and 1:1 for debt equity. However, no such norms exist for banks.

(ii) Ratios or common size percentages to be computed to judge the financial soundness of a bank are quite different from the ratios computed for non-banking companies.

(c) The users of financial statements of a bank are also different from the users of financial statements of other commercial enterprises. The parties interested in financial statements of banks mainly include :

(i) Stock - holders and investors;

(ii) Depositors and borrowers;

(iii) Regulatory authorities such as RBI etc.

(iv) Analysts, researchers and authors; and

(v) Management.

V. **Need and Importance of Analysing Financial Statements of Banks :—** The first and foremost question arising before analysing the financial statements of a bank or of any other enterprise is regarding the utility of carrying out such an exercise. This question occupies a special significance in context with the manners the banking industry has developed and operate in India.

As discused earlier, the banks in India are broadly of two types, namely :—

Public Sector Banks :— including RBI, SBI and its subsidiaries, nationalised schedule commercial banks and co-operative banks, and

Private Sector Banks :— including branches of foreign banks, non-nationalised scheduled commercial banks and non-scheduled commercial banks.

As the performance of public sector banks is judged by their contribution towards national priorities rather than by their profitability and financial soundness, it is argued that financial statement analysis of such banks is a futile exercise. However, such an exercise could be of great use for the following interested parties :—

(a) **Stock-holders and investors :—** In case of public sector banks, Government is normally the hundred percent holders of shares and the investments are also made by Government itself. The main aim of the Government is not to earn profits but to achieve growth with social justice. It is the responsibility of the Government to provide finances to the needy and core sectors of the economy which can only be satisfied by the banks under public sector i.e. nationalised banks. The analysis of financial statements gives an opportunity to review whether the banks have applied their funds efficiently and effectively towards these needy and core sectors of the economy.

(b) **Depositors and borrowers :—** The depositors and borrowers of public sector banks feel safe because they know that government's prestige is at the stake. Moreover, government also feels that public confidence should not get hurt in its banking system. So even if banks do not have sufficient capital or liquid assets (though government ensures it by CRR and SLR) the depositors should not worry for the simple reason that the government is at the helm of affairs of such banks.

(c) **Regulatory Authorities :—**These constitutes mainly RBI and Central Government. Both of them see whether banks meet the legal reserve requirements and other such basic requirements as laid down by the Act.

(d) **Bank Management :—** The management analyses financial statements to review its performance and take decisions regarding future. But the managements of public sector banks are hardly entrusted with decision making, rather the decisions are imposed and the managements are to implement them only. However, looking to the enormous increase in number of frauds committed, the increasing misuse of resources and squeezing profitability of public sector banks, the financial statement analysis has come to occupy its key importance in the effective management of funds by these banks.

(e) **Researchers and analysits :—** Researchers always breath under free air and can make an attempt to know whether the financial soundness of a bank, be it public or private, has a key role to play in performing his role for the economy efficiently.

However, in case of private sector banks, the analysis of financial statements are of interest to all the parties, viz.

i. **Stock-holders and investers :** They are primarily interested in the general financial condition of the bank, its earnings, dividends and management's policy with reference to accumulation of reserves and surpluses.

ii. **Depositors and Borrowers :** They are interested in solvency of the bank, safety and availability of funds and use made of banks' resources

iii. **Regulatory authorities :** They desire to assure themselves that the banks are operating in accordance with the requirements of the law and are in good financial condition.

iv. **Bank managements :** They have to fulfil several obligations which is made easier and more certain with the help of financial statement analysis. These are :—

a. to meet the demands of the depositors, both for financial services and safe keeping of funds;

b. to satisfy sound credit needs of the community;

c to earn a fair return on the equity of stock-holders; and

d to fulfil legal requirements as reflected by laws and rules and regulations of the regulatory authorities.

ANALYSING BANK FINANCIAL STATEMENTS :—

A detailed analysis of a bank's financial and operating data sometimes not be made by an external analyst because only condensed bank statements are available to him But with the data available in the current annual report, the analyst may make a reasonably satisfactory analysis of the present financial condition and operating results of a bank To have a prudent analysis and interpretation, the analyst should not only assemble financial and operating data for a particular bank only rather for a number of similar banks (for example, analysis of all nationalised banks or all non-nationalised banks etc). The strength or weaknesses of an individual bank can be determined more accurately by making comparisons with a group of similar banks.

In interpreting and evaluating banks' financial statements the analyst must also consider many external factors some of which may be summerised as follows :—

i. type of community served; ii. the general business activities; iii industrial production and credit conditions; iv political factors; v. type and diversification of clientele deal with whether retail, wholesale, manufacturing, mining, agriculture or financial; vi. size of city or town in which bank is located whether it has small medium or large population In other words, the network of branches of the bank should be considered with cities, towns or villages they are located and population therein; vii. possible occurance of an extra ordinary event such as disastrous flood, a serious fire, establishment of a new corporation, transfer of business to another community or dissolution of a large business and existence or non-existence of a national emergency.

In breif it is necessary to study and interpret the economics business and political forces which are affecting the banking business.

Now we come to the question as to how to analyse the financial statements of a bank. To mention here, it is to be kept in mind that the techniques to be used will be the same as applied in any commercial enterprise i.e i. Ratio analysis; ii. Common size balance sheet and Profit and Loss Account. Looking to the special nature of bank's financial statements the analysis can be discussed under the following heads :—

Ratio of capital to deposits shows how much protection is provided to the depositors by the capital funds of the bank (which may include reserves and surplus also). But capital in its own is not sufficient to be considered, rather other factors (discussed earlier) must also be taken into account.

RATIO OF CAPITAL TO TOTAL ASSETS :—

The ratio tells how much of the assets of a bank are financed by capital funds.

But the common drawback to both these ratios is that they are unaffected by differences in risks associated with banks' differing asset structures, for example, two banks of equal asset size would require an identical amount of capital even though one of them might have all its asset in cash and short term government securities and other might have most of its assets as advances and loan As an improvement over these ratios a new ratio known as *Risk Asset Ratio* is suggested. This is a ratio of capital funds to total assets less cash, bank balance and government securities

This approach doesn't reflect varying degree of risk in a bank's remaining assets and was followed by the computation of an *Adjusted risk asset ratio* : This ratio not only related capital funds to risk assets but also include a secondary calculation in which assets close to cash and government securities in their riskless nature are also deducted from total assets in the determination of risk assets. This approach includes in riskless assets some assets in which the risk, although small is nevertheless present. There is market risk even in goverment securities and some risk in every loan no matter how well secured it is. The ratio again doesn't make a distinction between less risky and very risky assets, for example— secured loans and fixed assets.

One more approach to capital adequacy analysis is an attempt to indicate the amount of minimum capital funds, required by a bank on the basis of its own asset distribution. The amount of capital thus computed would be the minimum for a bank in which all other factors were favourable The area of judgment in this case would be to determine how much more capital than the minimum an individual bank might need because of its peculiar circumstances. This approach is more selective than a straight risk-asset ratio.

For the purpose of analysis bank assets are divided into various groupings (normally six) on the basis of risk To each of these categories is assigned a specific capital requirement which is large enough not only to absorb probable losses in each category of assets but also provide sufficient additional capital to maintain confidence and keep the bank open. For example first category may consists of highly liquid assets such as cash on hand, bank balances, short - term government securities and bankers' acceptances etc. Against these riskless assets no capital is required There may be some market risk even in short

term government securities but ordinarily it is small enough to be readily absorbed by earnings Similarly other categories may include minimum risk assets, normal or usual banking risk assets, more than normal banking risk assets, work-out assets and loss and fixed assets etc.

The requirements indicated above can best serve only as norms and can not give a clear idea about the actual capital required by a particular bank. A thorough appraisal of capital needs of a particular bank must take due account of all relevent factors affecting the bank These may include the charateristics of its assets, liabilities management as well as history and prospects of bank, its customers and its community. Again factors such as adequate safeguard and insurance coverage against fire, theft etc should also be considered.

So, one can say that these formulas, though are of use in assessing capital adequacy, do not take into account other factors of equal or even greater importance such as :—

i. The quality of management.

ii. The liquidity and quality of assets.

iii. The history of earnings and retention thereof.

iv. The quality and character of ownership.

v. The burden of meeting occupancy expenses

vi. The potential volatility of deposit structure.

vii. The equality of operating procedures.

viii. The capacity to meet present and future financial needs of its trade areas considering the competition it faces.

2. LIQUIDITY OF BANK :—

Liquidity can be defined as a bank's (or banking system's) ability not only to meet possible deposit withdrawals but also to provide for the legitimate credit needs of the community (or the economy) as well.

The liquidity needs of individual banks must be related to the demands made upon them for funds over periods of time. Some funds may be called for tomorrow, some may not be needed for a year or more and additional liquidity may be needed for unforseen or unpredictable demands as a margin of safety. A bank obviously would not be operating efficiently if it held in cash today the funds needed to make loans two years from now. Therefore just of the amount of liquidity is related to the size of the potential demand for funds, the form and maturity in which liquid assets are held should be related to the times

at which the demand for funds are likely to occur. Every bank is required by law to maintain a portion of its deposit in the form of cash on hand, deposits at Reserve Bank or demand balances due from other specified banks etc. In India scheduled banks must maintain a minimum percentage of its time and demand deposits in the form of legal reserve with the Reserve Bank of India. However, non-scheduled banks are at discretion to keep it either with then or deposit it with Reserve bank A bank's legal reserve is often considered its most liquid asset. But as per the definition of liquidity it is not liquidats, all because it can't be used (except for brief periods) to pay deposits or make additional loans.

The holders of sizable deposit balance and the customers who borrow in substantial amounts influence the short term liquidity needs of an individual bank to a degree that is directly related to their size Seasonal factors also influnce short terms liquidity need by effecting entire level of deposits supply or loan demand. Most of the seasonal fluctuations can be accurately timed and appropriate liquidity may be provided on the basis of past experience. In addition to providing funds for the known and generally foreseable short term demands, a margin of liquidity is required by banks for demands that can be predicted over the longer range or that may be unforeseen altogether. In rapidly expanding areas, loan demand grows faster than deposit accumulate. On the other hand in stable communities, deposits may show a steady rise while loan demand, remains virtually unchanged. In both these cases bank management must attempt some long range economic forecasting on the basis of which it can resonably estimate loan and deposit levels for a few years ahead.

The instruments of liquidity available to a bank consists of assets in which excess funds can be temporarily invested with the assurance that they either will mature and be paid when the funds are needed or will be readily saleable, without material loss, in advance of maturity. In the second place, liquidity instruments include the ways in which banks can borrow or otherwise obain funds.

Under the first category we include the money itself in the form of excess currency and demand deposits due from banks in excess of minimum working balance needs, short term securities of central or State Government or other short term high grade marketable securities of government agencies etc., treasury bills, notes and banker's acceptances etc. Besides this any credit worthy loan or investment may be included in the liquid assets if its maturity conforms with liquidlty needs and if bank will have not trouble about collecting it at maturity.

Under the second category we include a bank's ability to borrow or to dispose of assets either temporarily or permanently. In this. a bank's own notes discounted with Reserve Bank or corresponding banks is a prime instrument of liquidity. Short term borrowings from Reserve Bank or corresponding banks also serve to restore the bank's reserve balance temporarily depleted by deposits withdrawals to required levels.

Liquidity needs of a bank as already said, is related to both the demand for funds that may be made by depositors and that may arise from community needs for additional credit Finally the two must be combined for an estimate of overall liquidity. The more essential and probably larger portion of a banks liquidity needs at any time will be related directly to the volume and character of its deposits liabilities. Not all deposits require the same degree of liquidity.

For liquity the important thing is the likelihood that any specific deposit or group of deposits may be withdrawn within a reletively short period of time Potential deposit withdrawals may be grouped into (a) those that will surely occur; (b) those that might but are not certain to occur; and (c) those that are unlikely to occur but are not certain circumstance could possibly occur. In general, the greater the likelihood of withdrawals the larger the percentage of liquidity provided should be and the shorter the maturily of liquid assets helds hould be. On the other hand a major portion of liquidity problems has resulted from raising loan demand and a bank must maintain a sufficient supply of liquid assets to make the loans that its good customers will require. Part of this demand may be seasonal in charactor and can be depicted unlike deposit fluctuation however the rise in loan is subject to limited control by the bank itself. Management can tighten up its lending policies or even refuse entirely some loans

GENERAL MEASURES OF LIQUIDITY :—

Ratio of loans to deposits :— This ratio is often used to demonstrate the degree to which banks have already used up their available resources to accomodate the credit needs of their customers. The presumption is that higher the ratio of loans to deposits. the less able a bank will be to make additional loans. The loans to deposit ratio has a psychological effect on bank management. As the ratio rises, lending policies may become more cautious and selective. Obviously total of loanable funds, roughly measured by deposits, sets an upper limit to a bank's ability to make additional loans without recourse to more or less continuously borrowing.

The ratio of loans to deposits reveals little about the bank's other assets available for conversion into funds with which to meet, withdrawals or to make additional loans. To overcome this drawback the ratio of short term assets and deposits seems to be more significant for this purpose.

RATIO OF CASH TO DEPOSITS :—

This ratio is very close formula to judge the liquidity of a bank. The amount of cash that a bank should keep on hand depends on the portion legally required for deposit with Reserve Bank as statutory reserve and the likelihood of customer's demand

for cash. Cash is the only asset that may be deposited with Reserve Bank to satisfy legal reserve requirement. Unless it is in excess of the amount legally required it is in effect not usable for other operating purposes. In other words cash doesn't provide income as other assets, for example, loans and securities etc. Therefore banks are anxious to keep their cash at the lowest possible safe level. In this respect this ratio may give a misleading picture about the liquidity of a particular bank.

RATIO OF QUICK OR LIQUID ASSETS TO DEPOSITS :—

Quick assets include cash and those assets which can be readily converted into cash as mentioned earlier. The ratio is determined by dividing total quick assets evaluated at realizable amounts by total deposits. The higher this ratio, the greater the liquidity of a bank.

However a higher quick asset ratio doesn't necessarlly represent the most favourable ratio from an income point of view, since of cash and very low income producing assets may predominate. A bank has a favourable quick asset ratio when it has sufficient liquidity to meet the current demands, even though loan liquidation proves slow. But a problem to this ratio is that an external analyst has no way of determining the amount of quick assets because the publish reports in most of the cases reveals neither the nature and liquidity of loans and securities nor the valuation method that has been applied to these assets.

The other ratio that can be computed is *quick assets to total assets* which indicates how much of the total assets are in liquid form.

3. RISK AND SAFETY .—

A bank suffer from various types of risk. The most obvious is the credit risk the probability that loans will not be repaid or that investments will deteriorate in quality or go into default with consequent loss to bank. Another ever present risk in banking is the risk associated with liquidity needs - the possibility that customer demand for funds will require sale or forced collection of credit worthy assets at a loss. A depositor's demand for his money is one that a bank must meet promptly or go out of business. It was evidenced in depression of 1930s when depositors were seeking to convert their bank deposits in currency because of a general lack of confidence in banks. The third type of risk is the risk associated with solvency needs. Because of small margin between return on assets and cost of deposits, a high proportion of deposits is essential for commercial banks to obtain and adequate rate of return on their ownership equity The consequence of relatively low proportion of bank equity is that only a small percentage

loss can be incurred on the asset before a bank's capital is impaired or wiped out. Some minium amount of capital is therefore, required to keep a bank in business. The last type of risk is that of defalcation (embezzlement) and the risk of theft by outsiders. This risk niether can be estimated from financial statements of bank nor it can be avoided altogather.

MEASUREMENT OF RISK :—

Ratio of total deposits to capital or **Total deposits times Capital** :— The relationship between total deposits and capital is of great concern particularly to the depositors. Capital, the stockholders' equity represents a margin of safety for the depositors i e a protection for bank customers in the event of loss or shrinkage in the value of assets.

The ratio of total deposits to capital is determined by dividing total deposits by capital. To be of most significance, this relationship should be determined after all known or anticipated losses have been written off against undivided profits. But the problem is that external analyst can do little about it. Lower the ratio, greater will be the security for depositors. However the adequacy or inadequacy of the amount of capital relative to deposits also depends upon the amount of cash and safety and liquidity of assets, the economic conditions of the times, nearness to Reserve Bank, existence of insurance protection and effectiveness of management in its loan and investment policies. To the extent that the foregoing factors are favourable, a much higher ratio of deposits to capital will be justified.

Ratio of Capital to Total Assets :— The safety of customer deposits depends upon the adequacy of the capital if it is neccessary to absorb losses on various assets. The ability to absorb losses is also affected by the exitence or absence of insurance. The ratio of capital to total assets is computed by dividing capital by total assets. The smaller the ratio the more likely it is that substantial losses will be accompanied by drastic action in regard to the capital structure of the bank. The larger the ratio, the greater is the degree of safety enjoyed by the bank.

Some analyst compute this ratio as the ratio of total capital to total assets less cash on the basis that normally there will be no loss on cash. The relatively small amount of capital in comparison with total assets emphasizes the absolute necessity for banks to be ultraconservative with respect to their primary and secondary reserves and investment policies.

Ratio of Total deposits to Total assets; or Ratio of deposits to Total liabilities and Capital accounts (owner' equity) :— This ratio gives a broad idea about the protection provided by total assets to the depositors who represents a major item of liabilities A higher ratio means greater protection But the types of assets is one of the important consideration in this ratio. If the assets are very risky then even a very low ratio may not be satisfactory

4. EARNINGS POWER OR POTENTIAL :—

Earning power of a bank is the first line of defence against the risks inherent in banking business Just as the bank's capital or owners' equity is the ultimate protection for the depositors; the bank's earnings, current and accumulated, is a protection to stock-holders' investment in times of economic adversity.

Bank earnings provide the return on capital investment in banks It is for this return that a stockholder is willing to supply the capital that enables a bank to engage in the risky business of creating credit. Banks' earnings are normally retained and thus capital is accumulated but even if bank pays dividends, it tends to enhance the marketability and increase the value of stock thus enabling the bank to raise additional capital when needed. Specifically in the private sector it is the fact that adequate earnings are necessary for banks to recruit and keep complete management to face highly competitive market; and to attract able young men and women by offering competitive wages and salary rates.

Ratio of Total deposits to Capital :— The relationship between total deposits and capital is of concern not only to depositors for measuring risk but to stockholders also. The deposit funds, to the extent they are invested by the bank in income producing assets, represent a major source of earnings for the stockholders. A lower ratio would indicate less income on investment of funds for stockholders. However, with this the other factors should also be considered

The comparison of total deposits and capital furnishes a clue to probable earnings and risk. In other words, the principle of trading on equity is evidenced. Stockholders benefit by the investment of customers deposits when the realised income is greater than the cost of funds to the bank Consequently, the greater the amount of customer deposits that are profitably invested and the lower the amount of capital, the higher the return will be to stock-holders

Other things being equal, the bank that has the higher ratio of loans. discounts and securities to capital will earn the higher return for stock-holders. However the factors of safety, liquidity, ratio of income and expenses of operations must also be considered in determining the feasibility nnd profitability of trading on equity by each particular bank.

Another important factor in knowing the earning potential of a bank is to determine the relative amounts of capital invested in fixed assets and other non-income producing assets. A relatively large investment in these types of assets reduces the liquidity of capital and therefore, management is left with a smaller amount which is subject to its discretionary investment policy.

5. PROFITABILITY :—

The profitability is the difference between revenue and aggregate of bank expenses. Profitability analysis is of use to the stock-holders to know whether bank is actually earning sufficrent profits; and also it strengthen the financial position of bank itself. A detailed analysis of revenues and expdnses is usefull for management also Bank management can not successfully plan a broad lending and investing programme unless it knows the net yield as well as the gross return on various types af loans and investments. Revenue and expense analysis is also useful in controlling costs and expenditures. The profitability of a bank is a good indicator of efficiency and competence of management,

ANALYSING PROFITABILITY :—

Ratio of net income to total capital (or owners' equity) : — The ratio indicates as to the return on capital employed by the bank. Higher the ratio, greater is the profitability of a bank.

Ratio of net income to total Assets :—The ratio shows how efficiently the assets of the bank are employed. A higher ratio indicates greater profitability and more return on the assets of the bank.

Ratio of current operating expenses to current operating revenues :— It shows as to how much of the current operating revenue is being absorbed by the current years operating expenses. Higher the ratio lower the profitability.

Besides computing these ratios the following comparisons to judge profitability are also useful :—

Average rate of income on loans, investments, govt, securities etc.

Average service charges on demand deposits, average interest paid on time and savings deposits.

The assets of a bank should earn income sufficient to meet all expenses and losses, to provide a reasonable rate of interest on time deposits, to permit the declaration and payment of reasonable dividends to the stock-holders and to provide periodic additions to surplus.

If there are changes in ratios, the analyst should go into details in respect of the bank's policies which has affected that ratio. For example, if there is a change in the ratio of net income to owners' equity he must enquire the policies in respect to reserves, investments, loans services and other elements affecting net income and owners' equity. However the external analyst may not have sufficient details about revenues and expenses of a bank to make a comprehensive analysis and interpretation of a bank's operations or working.

To conclude, it may apparently appear that it is not very fruitful to analyse the financial statements of public sector banks in India Neverthless, looking to the recent incidents of frauds committed, cases of misappropriation of large sums of money, inefficient application of financial resources and fast declining profits, it not only becomes desirable to analyse financial statements of public sector banks but also becomes necessary to provide a second line of defence after the RBI's strict control on the working of these banks. Further. the increasing number, size and business of private sector banks has made them a very important part of the Indian banking industry. With the increasingly important role played by them in the Indian economy and lesser control exercised by the regulatory authorities. discussed earlier, calls for a very careful and intensive study of their financial statements to assess their financial soundness. Moreover, it becomes important to exercise control over these banks in view of the fact that an increasing competition amongst them may compel them to follow such policies which may not be desirable either from the point of view of public or from the point of view of the existence of bank itself It is therefore suggested that financial statements of banks be analysed both for internal decision making and for external users which may constitute, amongst others, depositors, borrowers, investors, regulatory authorities and society a large so that the resources of the society are utilised more efficiently.