

An illustration of a hand holding a pen, positioned as if writing on a document. The hand is brown, and the pen is blue. The background is a light yellow rounded rectangle.

SOURCE :

**NISM  
RESEARCH  
ANALYST  
WORKBOOK**

# Basics of Financial Analysis

A large, stylized white number '2' is centered within a light green circle. The circle has a darker green border. The background is a vibrant green with abstract shapes and patterns.

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# Financial Statement analysis using ratios

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# Profitability Ratios

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# EBITDA MARGIN :

used to find the profitability of the company purely based upon its operation and direct cost.

calculated as :

$$= \frac{\text{EBITDA}}{\text{Net Sales}}$$

- higher EBITDA margin - firm able to operate with greater efficiency than other peer group companies
- EBITDA margins not affected by depreciation policies, funding decisions and taxation rates

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# PAT MARGIN :

Shareholders get their dues after paying all stakeholders and hence, this ratio helps them to know how much of the business generated by the company actually comes their way.

calculated as :

$$= \frac{\text{PAT}}{\text{Net Sales}}$$

- higher PAT margin - greater efficiency in managing cost and earning profits.

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# Return Ratios

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# RETURN ON EQUITY :

communicates how a business allocates its capital and generate returns.

high RoE means efficient allocator of capital and vice versa.

calculated as :

$$= \frac{\text{PAT}}{\text{equity capital} + \text{reserves and surplus}}$$

- equity capital + reserve and surplus = net worth
- sales and net profit are for a given period whereas net worth and asset balance are as at a particular date and hence to compare the two metrics average of opening and closing balance is taken .

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# RETURN ON CAPITAL EMPLOYED :

communicates EBIT as percentage of money employed in the firm by way of both equity and debt.

high RoCE means higher returns for every rupee of capital employed :

$$= \frac{\text{EBIT}}{\text{Capital employed}}$$

- total assets + current liabilities = capital employed
- total equity + total debt = capital employed
- here again, for balance sheet items we take average values instead of year ending values
- to obtain post tax ROCE multiply by (1-tax rate)





# Leverage

# Ratios

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# DEBT/EQUITY (D/E) :

when business creates asset aggressively out of borrowed money, it could be quite dangerous if the assets are unable to generate the expected revenues and profitability.

calculated as :

$$= \frac{\text{Long term debt}}{\text{net worth}}$$

- a D/E of 1 or less should be considered as the benchmark.
- lower the debt lower the D/E

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# INTEREST COVERAGE RATIO :

tells us how many times the earnings of the business can meet its interest obligation.

calculated as :

$$= \frac{\text{EBIT}}{\text{Interest expense}}$$

- higher the better.
- if less than 1 or negative, then earnings are less than the interest to be paid.

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# Liquidity

# Ratios

Swipe >>>



# CURRENT RATIO :

measures liquidity situation by comparing its current assets with its current liabilities.

high ratio may indicate poor use of capital while a very low ratio may point towards deeper analysis.

calculated as :

$$= \frac{\text{current assets}}{\text{current liabilities}}$$

- also known as working capital ratio.
- elements forming working capital like trade receivables, inventory, trade payables are key component of this ratio

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# QUICK RATIO :

more stringent version of the liquidity ratio as it does not consider assets, which although current in nature, but cannot be converted into cash immediately.

example of such assets is inventory. hence,

calculated as :

$$= \frac{\text{current assets} - \text{inventory}}{\text{current liabilities}}$$

- accounts receivable, cash, investments in liquid funds are all included in quick ratio
- higher the ratio better the liquidity, but lesser will be the returns as cash is not a great source for generating return.



# Efficiency

# Ratios

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# ACCOUNT RECEIVABLE TURNOVER:

indicates how fast a company converts its sale into cash.

higher ratio means very small portion of its revenue are in the form of credit.

calculated as :

$$= \frac{\text{revenue}}{\text{accounts receivable}}$$

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# ACCOUNT PAYABLE TURNOVER:

indicates how much of a company's purchases are on credit.

higher ratio means long credit period with suppliers.

calculated as :

$$= \frac{\text{purchases}}{\text{accounts payables}}$$

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# ASSET TURNOVER:

indicates how many times assets of the company are put to use to generate the given revenues.

higher the ratio better the firm as it means assets are not lying idle

calculated as :

$$= \frac{\text{net sales}}{\text{total assets}}$$

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# INVENTORY TURNOVER:

indicates how many times inventory is rolled over by a company.

higher the ratio better the firm as it means inventory getting converted into sales fast

calculated as :

$$= \frac{\text{sales}}{\text{inventory}}$$

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## QUOTE OF THE READ

“

**IN MY OPINION, PROJECTIONS DO MORE HARM THAN GOOD. THEY ARE PUT TOGETHER BY PEOPLE WHO HAVE A PARTICULAR OUTCOME, HAVE A SUBCONCIOUS BIAS AND ITS APPARENT PRECISION MAKES IT FALLACIOUS. THEY REMIND ME OF MARK TWAIN'S SAYING - A MINE IS A HOLE IN THE GROUND OWNED BY A LIAR**      -- CHARLIE MUNGER



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Ekta Bhatt 