IFE Academy

Education Simplified

How to read a Balance Sheet of a Company?

How to read a Balance Sheet of a Company?

IFE Academy

Education Simplified

Investors Financial Education Academy

Phone : 044 - 2814 3044 E-mail : bulletin@ifea.in www.ifea.in

First Edition, 2021

About this Book

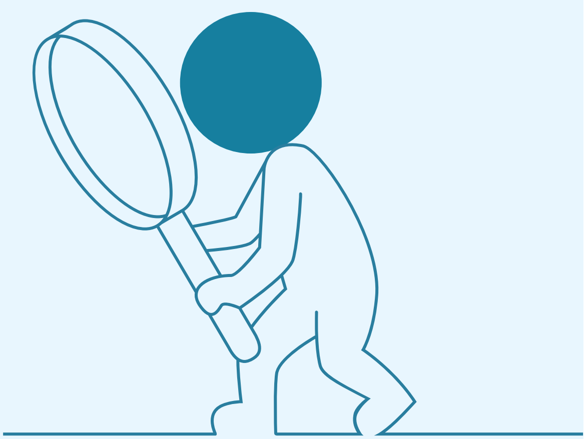
Rs. 40/-

Published By
Investors Financial Education Academy
Parkview, Basement, 85/17, G.N.Chetty Road,
T. Nagar , Chennai - 600017.

Introduction

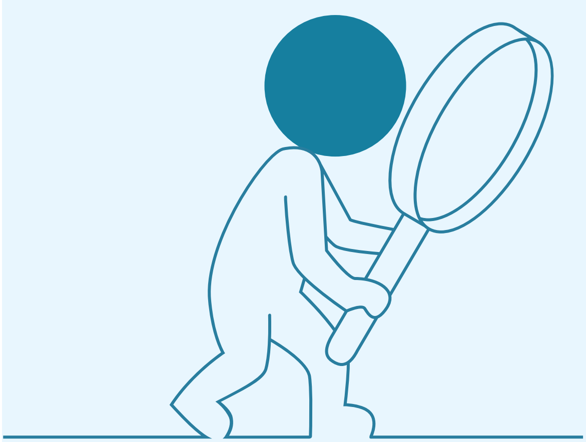
How to read the Financial Reports of a Company?

All shareholders will receive an annual report from the Company they have invested in. It is also readily available on the Company's official website. More often investors ignore it but these can prove to be very important to check how the company has been performing and to decide if they should remain invested in it. It is the easiest way to seek authentic information of the company's performance rather than other news on websites.



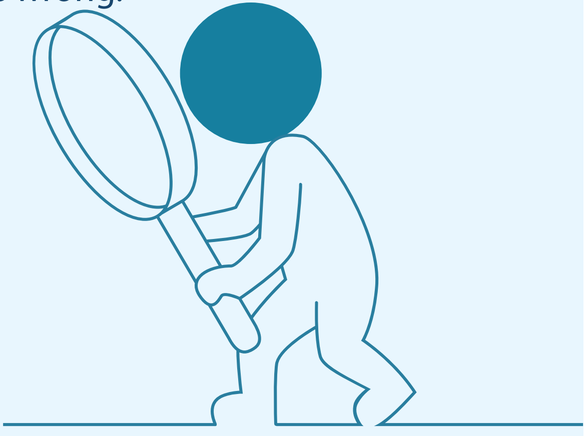
Basics of Financial reports that are to be known:

- An annual report is published for the one-year period ended 31 March of the respective year by listed companies in India.
- Quarterly (every 3 months) results are also published.
- Any information published in the report is audited by an external auditor and the company can be held liable for any misrepresentation in data.
- Some sections of the annual report are similar across companies but no two reports are the same. Sector-wise or business related prospects will change the way the reports are presented.



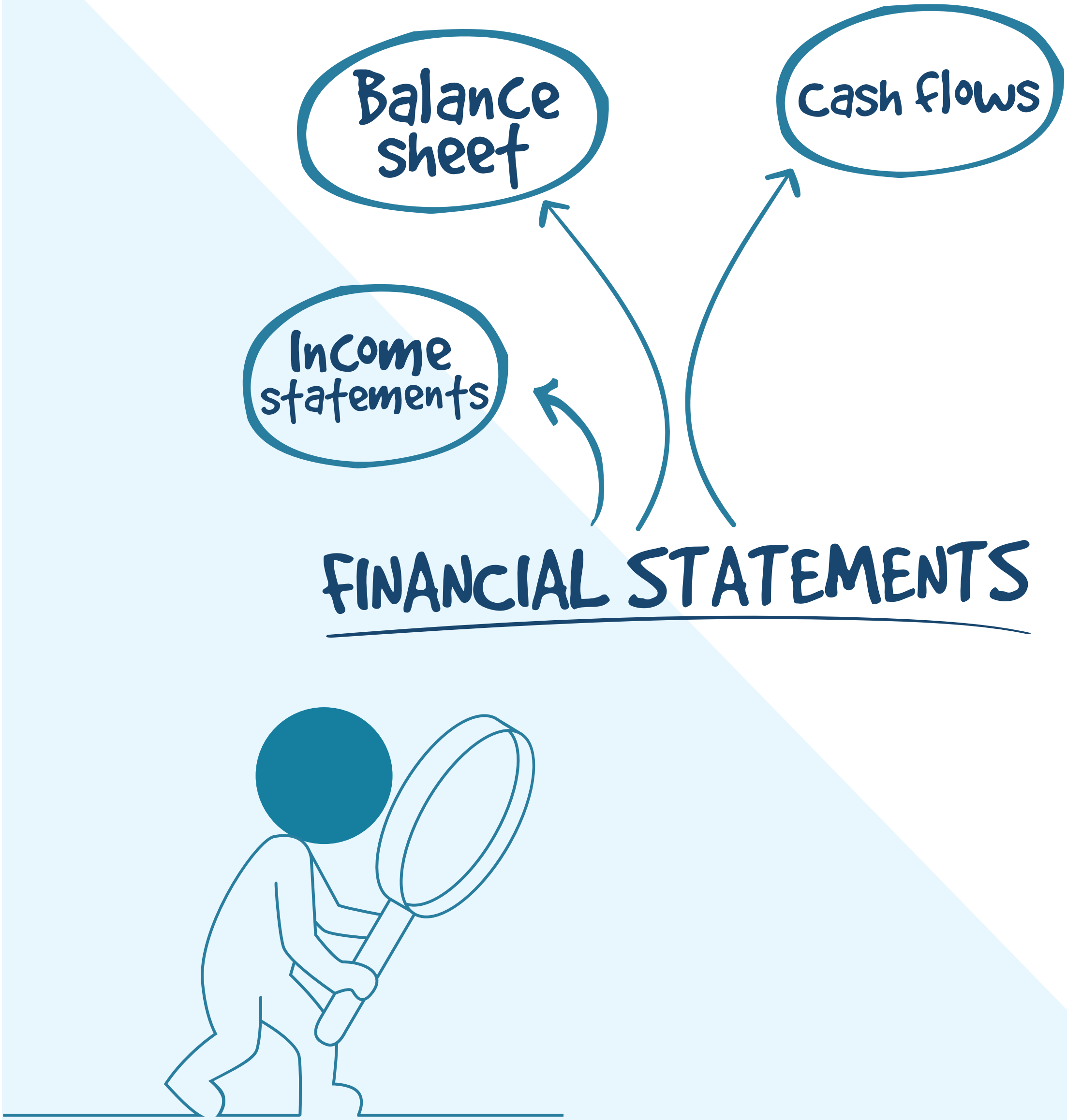
Important information that are to be noted in Companies Balance Sheet:

- **Financial Highlights:** This section is a brief representation of the financial ratios related to the company based on industrial specific significance. It will be in the form of a graph or some kind of info graphic for easy reading to the investors.
- **Management/Chairman message:** For an investor it is very much important to know the way the top management thinks about their company. The CEO or Chairman represents the company and with their view on the workings, investors can decide if the company will go in the right direction in the long run or if they are going to lose their money by investing in it.
- **MDA (Management Discussion and Analysis):** MDA focuses on the trends, the conditions of the industry and the factors that will affect the company's business. It will also specify regarding any significant decisions taken and the important issues that affect the industry at large and its own business. This will help the investors to think ahead and disinvest in the firm before things go wrong.



Things to know in Financial Statements:

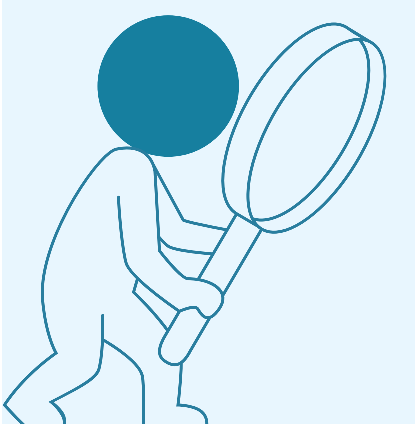
There are three important parts of a financial statement that an investor should know. They are:



Balance Sheet

The balance sheet gives a snapshot of a company's financial strength. This statement shows what a company owns or controls i.e. assets and what it owes i.e. liabilities plus equity. This represents the financial details from the time the company was established. **The three main parts are assets, liabilities and equity.**

Assets includes all things of value, whether tangible (like machinery, inventory) or intangible (like patents) that the company owns, which may be acquired in the year or over the years. It has helped the company generate revenue or will do so in the future.



Assets are classified as Current Assets and Non-Current Assets

A. Current Assets

A.1 Cash and Equivalents

The most liquid of all assets is cash. Cash Equivalents are also included under this item such as short-term maturities or assets that the company can liquidate on short notice, such as marketable securities. Companies will generally disclose what equivalents it includes in the footnotes to the balance sheet.

A.2 Accounts Receivable

This account includes the balance of all sales revenue still on credit, net of any allowances for doubtful accounts (which generates a bad debt expense). As companies recover accounts receivables, this account decreases, and cash increases by the same amount.

A.3 Inventory

Inventory includes amounts for raw materials, work-in-progress goods, and finished goods. The company uses this account when it reports sales of goods, generally under cost of goods sold in the income statement.

B. Non-Current Assets

B.1 Plant, Property & Equipments

Plant, Property & Equipments (PPE) capture the company's tangible fixed assets. This line item is accounted net of accumulated depreciation. Some companies will class out their fixed assets by the different types of assets, such as Land, Building, and various types of Equipment. All PPE is depreciable except for Land.

B.2 Intangible Assets

This line item includes all of the company's intangible fixed assets, which may or may not be identifiable. Identifiable intangible assets include patents, licenses, and secret formulas. Unidentifiable intangible assets include brand and goodwill.

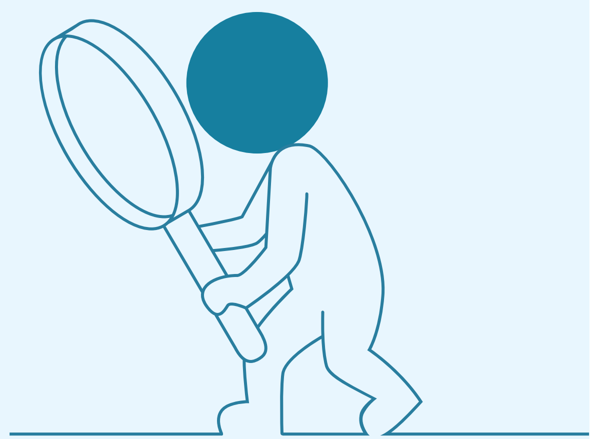
Liabilities

Liabilities are obligations of economic value that the company owes to others. It is classified in to current and long-term liabilities.

C. Current Liabilities

C.1 Accounts Payable

Accounts Payables, or AP, is the amount a company owes suppliers for items or services purchased on credit. As the company pays off their AP, it decreases along with an equal amount decrease to the cash account.



D. Non-Current Liabilities

D.1 Bonds

This account includes the amortized amount of any bonds the company has issued.

D.2 Long-Term Debt

This account includes the total amount of long-term debt which is still outstanding. This account is derived from the debt schedule, which outlines all of the company's outstanding debt, the interest expense, and the principal repayment for every period.

E. Equity

This is the amount invested by the shareholders. When a company is first formed, shareholders will typically put in cash. For example, a promoter starts a company and seeds it with Rs. 1 Crore cash. Cash (an asset) rises by Rs. 1 Crore, and Share Capital (an equity account) rises by Rs.1 Crore, balancing out the balance sheet.

F. Retained Earnings

This is the total amount of net income the company decides to keep. Every period, a company may pay out dividends from its net income. Any amount remaining (or exceeding) is added to (deducted from) retained earnings.

This is how a balance sheet typically looks. For understanding, Balance sheet of M/s. Reliance Industries is being shared.

Balance Sheet

As at 31st March, 2020

Reliance Industries Limited
Integrated Annual Report 2019-20

(₹ in crore)

	Notes	As at 31st March, 2020	As at 31st March, 2019
ASSETS			
NON-CURRENT ASSETS			
Property, Plant and Equipment	1	2,97,847	1,94,895
Capital Work-in-Progress	1	15,638	1,05,155
Intangible Assets	1	8,624	8,293
Intangible Assets Under Development	1	12,327	6,402
Financial Assets			
Investments	2	4,19,073	2,72,043
Loans	3	44,348	31,806
Other Non-Current Assets	4	4,458	4,287
Total Non-Current Assets		**8,02,315**	**6,22,881**
CURRENT ASSETS			
Inventories	5	38,802	44,144
Financial Assets			
Investments	6	70,030	59,640
Trade Receivables	7	7,483	12,110
Cash and Cash Equivalents	8	8,443	3,768
Loans	9	15,028	4,876
Other Financial Assets	10	16,100	17,127
Other Current Assets	12	10,711	11,199
Total Current Assets		**1,66,597**	**1,52,864**
Total Assets		**9,68,912**	**7,75,745**
EQUITY AND LIABILITIES			
EQUITY			
Equity Share capital	13	6,339	6,339
Other Equity	14	4,18,245	3,98,983
Total Equity		**4,24,584**	**4,05,322**
LIABILITIES			
Non-Current Liabilities			
Financial Liabilities			
Borrowings	15	1,78,751	1,18,098
Other Financial Liabilities	16	2,924	-
Provisions	17	1,410	2,483
Deferred Tax Liabilities (Net)	18	50,556	47,317
Other Non-Current Liabilities	19	504	504
Total Non-Current Liabilities		**2,34,145**	**1,68,402**
Current Liabilities			
Financial Liabilities			
Borrowings	20	51,276	39,097
Trade Payables Due to:	21		
Micro and Small Enterprises		116	229
Other than Micro and Small Enterprises		70,932	88,012
Other Financial Liabilities	22	1,20,618	27,675
Other Current Liabilities	23	66,169	46,225
Provisions	24	1,072	783
Total Current Liabilities		**3,10,183**	**2,02,021**
Total Liabilities		**5,44,328**	**3,70,423**
Total Equity and Liabilities		**9,68,912**	**7,75,745**
Significant Accounting Policies			
See accompanying Notes to the Financial Statements	1 to 43		

Profit & Loss Account

The P&L statement also called income statement will include all the expenses made and revenue earned for that period. It shows the company's performance over a specific time frame, usually a financial year or a period of 12 months. It presents information relating to

- Revenue (or Sales)
- Cost of Goods Sold (or Cost of Sales)
- Selling, General & Administrative (SG&A) Expenses
- Marketing and Advertising
- Technology/Research & Development
- Interest Expense
- Taxes
- Net Income

This is how a P&L statement would look like. We have shared the P&L statement of M/s. Reliance Industries (downloaded from their website).

Statement of Profit and Loss

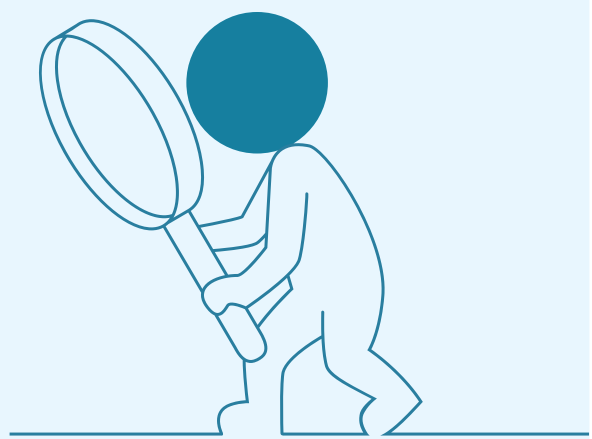
For the year ended 31st March, 2020

(₹ in crore)

	Notes	2019-20	2018-19
INCOME			
Value of Sales		3,62,869	4,00,139
Income from Services		2,333	1,444
Value of Sales & Services (Revenue)		**3,65,202**	**4,01,583**
Less: GST Recovered		14,322	16,082
REVENUE FROM OPERATIONS	25	**3,50,880**	**3,85,501**
Other Income	26	14,541	8,822
Total Income		**3,65,421**	**3,94,323**
EXPENSES			
Cost of Material Consumed		2,37,342	2,65,288
Purchase of Stock-in-Trade		7,292	8,289
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade	27	77	(3,294)
Excise Duty		14,902	13,885
Employee Benefits Expense	28	6,067	5,834
Finance Costs	29	12,105	9,751
Depreciation/Amortisation and Depletion Expense	1	9,728	10,558
Other Expenses	30	33,347	36,645
Total Expenses		**3,20,860**	**3,46,956**
Profit Before Exceptional Item and Tax		**44,561**	**47,367**
Exceptional Item (Net of Tax)	30.3	4,245	–
Profit Before Tax*		**40,316**	**47,367**
TAX EXPENSES*			
Current Tax	11	7,200	9,440
Deferred Tax	18	2,213	2,764
Profit for the Year		**30,903**	**35,163**
OTHER COMPREHENSIVE INCOME			
i. Items that will not be reclassified to Profit or Loss	26.1	(392)	76,892
ii. Income tax relating to items that will not be reclassified to Profit or Loss		(944)	(16,569)
iii. Items that will be reclassified to Profit or Loss	26.2	(6,921)	(827)
iv. Income tax relating to items that will be reclassified to Profit or Loss		1,183	178
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		**(7,074)**	**59,674**
Total Comprehensive Income for the Year		**23,829**	**94,837**
EARNINGS PER EQUITY SHARE OF FACE VALUE OF ₹ 10 EACH			
Basic (in ₹) – Before Exceptional Item	31	55.45	55.48
Basic (in ₹) – After Exceptional Item	31	48.75	55.48
Diluted (in ₹) – Before Exceptional Item	31	55.44	55.47
Diluted (in ₹) – After Exceptional Item	31	48.75	55.47
Significant Accounting Policies			
See accompanying Notes to the Financial Statements	1 to 43		

Cash Flow Statement

Cash flow statement shows the amount of cash and cash equivalents that enter and leave a company. Just like P&L statement, the cash flow statement shows cash transactions during a particular time frame. A company can generate or lose cash through its core operations. It can use cash for investing in assets or receive cash through sales of assets or through dividends. The cash flow statement allows investors to understand how a particular company's business is running, how it has raised capital and how the same is being utilised.



Importance of Ratio Analysis in Balance Sheet

Ratio analysis helps to understand the financial statements, from identifying trends over time and from measuring the overall financial state of the business.

In addition, lenders and potential investors often rely on these ratio analyses when making lending and investing decisions.

The following are the most important ratios that are to be known by the investors:

- **Net worth:**

  Net worth is a quantitative concept that measures the value of an entity and can apply to individuals, corporations, sectors, and even countries. It provides a snapshot of an entity's current financial position. In business, net worth is also known as book value or shareholders' equity. Positive and increasing net worth indicates good financial health. Decreasing net worth, on the other hand, is cause for concern as it might signal a decrease in assets relative to liabilities.

Networth Formula:

Net worth = Equity capital + Accumulated reserves - Revaluation reserves - Goodwill - Accumulated loss

Ratio Analysis

- **Book value per share:**

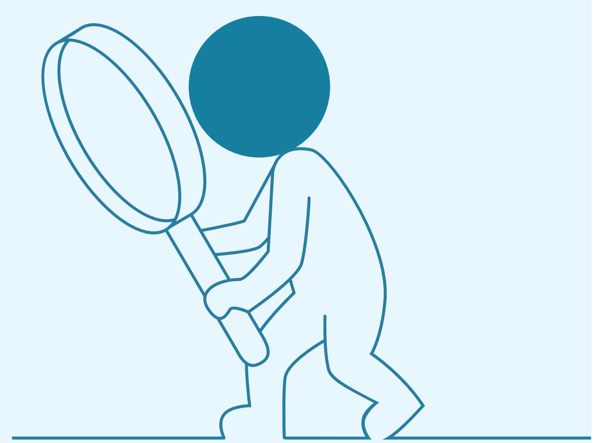
  Book value of equity per share (BVPS) is the ratio of equity available to common shareholders divided by the number of outstanding shares. This figure represents the minimum value of a company's equity and measures the book value of a firm on a per-share basis.

  This ratio helps the investors in knowing whether a stock price is undervalued by comparing it to the firm's market value per share. This is used mainly by investors to evaluate a company's stock price.

  If the company's BVPS is higher than its market value per share then the stock is considered undervalued. If the firm's BVPS increases, the stock should be perceived as more valuable, and the stock price should increase.

Book Value per Share Formula:

$$\frac{\text{Net worth}}{\text{No. of outstanding shares}}$$



Ratio Analysis

Return on Networth Formula:

$$\frac{\text{Net Income}}{\text{Share holder's Equity}}$$

- **Return on net worth:**

  The Return on Net worth Ratio (RoNW) is the same as the return on equity ratio. The ratio shows how much profit a company generates with the invested money of equity shareholders. Hence, you can also call it a Return on Equity Ratio. This ratio is helpful for comparing the profitability or annual return of a company to that of others in the same industry.

  A rising RoNW reflects that a company is increasing its ability to generate profit without having as much capital. It also means how well a company's management is using the shareholders' capital. In other terms, the higher the RoNW the better and vice-versa.

Ratio Analysis

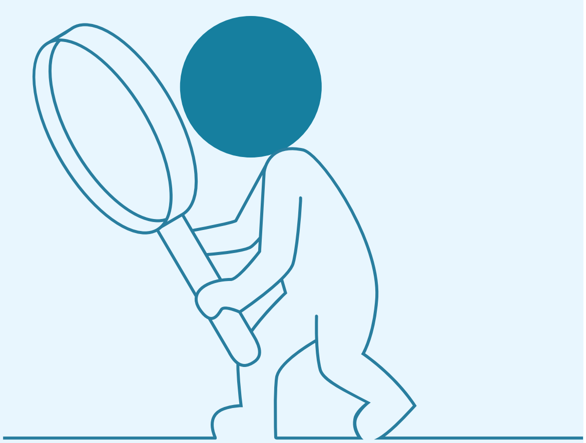
- **Cash Per share:**

  Cash per share is the percentage of a company's share price available to spend on strengthening the business, paying down debt, returning money to shareholders, and other positive campaigns. This ratio is considered as an attractive investment by most investors. It is used to determine a firm's liquidity and is a good indicator of the overall financial health of a company. Value investors often compare this ratio to the current stock quote, and if it exceeds the stock price they would invest in it.

  It is also considered a much more reliable indicator of financial health than earnings per share (EPS). A high level of cash per share suggests that a company is performing well. It reassures shareholders that there is enough of a financial cushion to cover any emergencies and that the company has adequate capital with which to reinvest in the business, return money to investors, or do both.

Cash holding per share Formula:

$$\frac{\text{Total cash and cash equivalents}}{\text{No. of outstanding shares}}$$



Ratio Analysis

Assets Turnover Formula:

$$\frac{\text{Sales}}{\text{Average Total Assets}}$$

- **Assets turnover ratio:**

  Asset turnover (total asset turnover) is a financial ratio that measures the efficiency of a company's use of its assets to product sales. It is a measure of how efficiently management is using the assets at its disposal to promote sales. The ratio helps to measure the productivity of a company's assets. Investors use the asset turnover ratio to compare similar companies in the same sector or group.

  A company's asset turnover ratio can be impacted by large asset sales as well as significant asset purchases in a given year. The higher the asset turnover ratio, the more efficient a company is at generating revenue from its assets. Conversely, if a company has a low asset turnover ratio, it indicates it is not efficiently using its assets to generate sales.

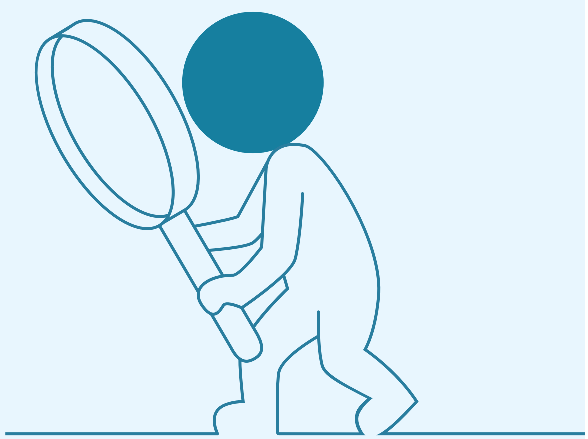
Ratio Analysis

- **Return on Assets:**

  Return on assets is a profitability ratio that provides how much profit a company is able to generate from its assets. In other words, return on assets (ROA) measures how efficient a company's management is in generating earnings from their economic resources or assets on their balance sheet. If the ROA is higher in number, the more efficient a company's management is at managing its balance sheet to generate profits. Investors use this ratio as tool for comparing similar companies or comparing a company to its previous performance.

Return on Assets Formula:

$$\frac{\text{Net Income}}{\text{Total Assets}}$$



Ratio Analysis

Debt Equity Ratio Formula:

$$\frac{\text{Total Liabilities}}{\text{Total Shareholder's Equity}}$$

- **Debt Equity Ratio:**

  The ratio is used to evaluate a company's financial leverage. It is a measure of the degree to which a company is financing its operations through debt versus wholly-owned funds. It reflects the ability of shareholder equity to cover all outstanding debts in the event of a business downturn. This ratio comes under the type of gearing ratio.

  The higher the leverage ratios, it tends to indicate a company or stock with higher risk to shareholders. Investors will often modify the D/E ratio to focus on long-term debt only because of the risk in long-term liabilities are different than for short-term debt and payables.

Ratio Analysis

- **Return on capital employed:**

  Return on capital employed (ROCE) is a financial ratio that is used in assessing a company's profitability and capital efficiency. In other words, this ratio helps to understand how well a company is generating profits from its capital. This ratio is similar to Return on invested capital (ROIC).

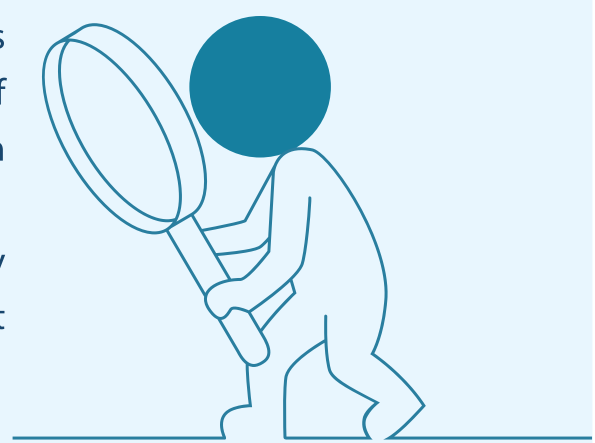
  In companies the ROCE trend over the years that is also considered as an important indicator of performance. Investors tend to favour companies with stable and rising ROCE levels over companies where ROCE is volatile or trending lower.

Return on Capital Employed Formula:

$$\frac{\text{EBIT}}{\text{Capital Employed}}$$

EBIT (Earnings before Interest and Tax) is calculated by subtracting the cost of goods sold and operating expenses from revenues.

Capital employed is calculated by subtracting total assets from current liabilities.



Ratio Analysis

Free Cash Flow (FCF) Formula:

Net income + Non-cash expenses like Depn. & amortisation + change in Working Capital - Capital Expenditures

- **Free cash flow:**

  Free cash flow (FCF) represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets. This ratio is a measure of profitability that excludes the non-cash expenses of the income statement and includes spending on equipment and assets as well as changes in working capital from the balance sheet.

  In case of high free cash flow means that the company is generating more cash than it needs for growth. Investors prefer FCF as a measure of profitability because it removes non-cash items from the income statement.

Ratio Analysis

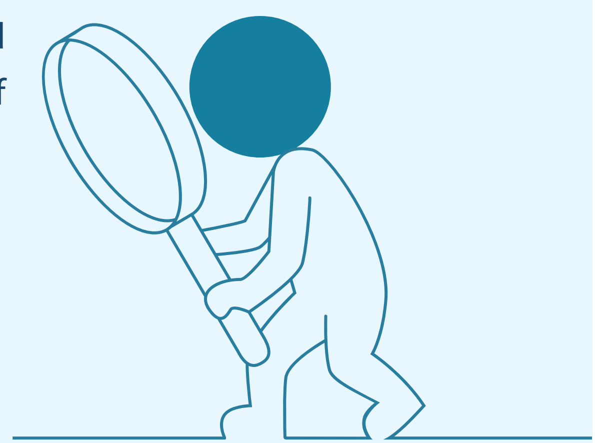
- **Current Ratio:**

  The current ratio is a liquidity ratio that measures a company's ability to pay short-term obligations or those due within one year. It tells investors and analysts how a company maximize the current assets on its balance sheet to satisfy its current debt and other payables. The current ratio is also referred to as the "working capital" ratio and helps the investors to understand more about a company's ability to cover its short-term debt with its current assets.

  Weaknesses of the current ratio include the difficulty of comparing the measure across industry groups, over-generalization of the specific asset and liability balances, and the lack of trending information.

Current Ratio Formula:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$



Ratio Analysis

Quick Ratio Formula:

$$\frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$$

- **Quick ratio:**

  The quick ratio is an indicator of the company's short-term liquidity position and indicates the company's capacity to pay its current liabilities without needing to sell its inventory or get additional financing. Since it indicates the company's ability to instantly to its near-cash assets that can be converted quickly to cash to pay down its current liabilities, it is also called the Acid Test Ratio.

  The higher the ratio result, the better a company's liquidity and financial health; the lower the ratio, the more likely the company will struggle with paying debts.

About IFE Academy

IFE Academy was established in 2011 as a Not-for-Profit entity to promote Financial Education. IFE Academy conducts Investor Awareness Programs across the country with the support of other market participants. www.ifea.in is a comprehensive website on Financial Education. It has various sections such as Videos, Puzzles & Games, Financial Calculators and Library. It gives a holistic view on financial education combining various aspects such as Savings, Investments, Credit, Insurance and Pension at a single place. IFE Academy periodically publishes Investor Educational materials and distributes it to general public.

IFE Academy

Education Simplified

Investors Financial Education Academy

Regd. office : Park View, Basement, 85/17, G.N.Chetty Road, T.Nagar, Chennai - 600 017.
email : bulletin@ifea.in   www.ifea.in