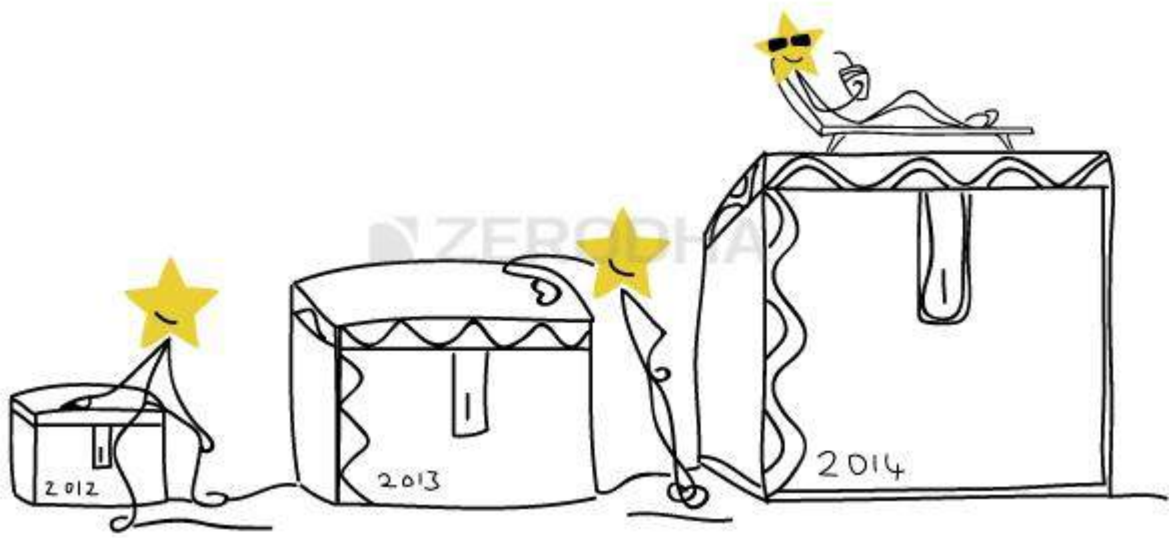
Understanding Balance Sheet Statement (Part 1)



6.1 – The balance sheet equation

While the P&L statement gives us information pertaining to the profitability of the company, the balance sheet gives us information pertaining to the assets, liabilities, and the shareholders equity. The P&L statement as you understood, discusses about the profitability for the financial year under consideration, hence it is good to say that the P&L statement is a standalone statement. The balance sheet however is prepared on a flow basis, meaning, it has financial information pertaining to the company right from the time it was incorporated. Thus while the P&L talks about how the company performed in a particular financial year; the balance sheet on the other hand discusses how the company has evolved financially over the years.

Have a look at the balance sheet of Amara Raja Batteries Limited (ARBL):

Balance Sheet as at March 31, 2014 ₹ million

Particulars	Note No.	As at March 31, 2014		As at March 31, 2013	
EQUITY AND LIABILITIES					
Shareholders' funds					
Share capital	2	170.81		170.81	
Reserves and surplus	3	13,456.20		10,427.33	
			13,627.01		10,598.14
Non-current liabilities					
Long-term borrowings	4	759.47		773.13	
Deferred tax liabilities (net)	5	301.33		195.09	
Long-term provisions	6	369.57		376.41	
			1,430.37		1,344.63
Current liabilities					
Short-term borrowings	7	83.83		98.63	
Trade payables	8	1,277.79		1,362.84	
Other current liabilities	9	2,156.68		1,807.26	
Short-term provisions	6	2,818.73		2,493.20	
			6,337.03		5,761.93
Total			21,394.41		17,704.70
ASSETS					
Non-current assets					
Fixed assets	10				
Tangible assets		6,198.94		3,554.97	
Intangible assets		32.96		33.69	
Capital work-in-progress		1,443.60		1,024.97	
Intangible assets under development		3.14		4.84	
		7,678.64		4,618.47	
Non-current investments	11	160.76		160.76	
Long-term loans and advances	12	567.69		353.52	
Other non-current assets	13	1.22		3.43	
			8,408.31		5,136.18
Current assets					
Inventories	14	3,350.08		2,928.58	
Trade receivables	15	4,527.89		3,806.77	
Cash and bank balances	16	2,945.67		4,107.90	
Short-term loans and advances	12	2,119.30		1,656.78	
Other current assets	13	43.16		68.49	
			12,986.10		12,568.52
Total			21,394.41		17,704.70
Significant accounting policies	1				

Statement on significant accounting policies and notes are an integral part of the financial statements

As you can see the balance sheet contains details about the assets, liabilities, and equity.

We had discussed about assets in the previous chapter. **Assets**, both tangible and intangible are owned by the company. An asset is a resource controlled by the company, and is expected to have an economic value in the future. Typical examples of assets include plants, machinery, cash, brands, patents etc. Assets are of two types, current and non-current, we will discuss these later in the chapter.

Liability on the other hand represents the company's obligation. The obligation is taken up by the company because the company believes these obligations will provide economic value in the long run. Liability in simple words is the loan that the company has taken and it is therefore obligated to repay back. Typical examples of obligation include short term borrowing, long term borrowing, payments due etc. Liabilities are of two types namely current and non-current. We will discuss about the kinds of liabilities later on in the chapter.

In any typical balance sheet, the total assets of company should be equal to the total liabilities of the company. Hence,

Assets = Liabilities

The equation above is called the balance sheet equation or the accounting equation. In fact this equation depicts the key property of the balance sheet i.e the balance sheet should always be balanced. In other word the Assets of the company should be equal to the Liabilities of the company. This is because everything that a company owns (Assets) has to be purchased either from either the owner's capital or liabilities.

Owners Capital is the difference between the Assets and Liabilities. It is also called the 'Shareholders Equity' or the 'Net worth'. Representing this in the form of an equation :

Share holders equity = Assets – Liabilities

6.2 –A quick note on shareholders' funds

As we know the balance sheet has two main sections i.e. the assets and the liabilities. The liabilities as you know represent the obligation of the company. The shareholders' fund, which is integral to the liabilities side of the balance sheet, is highlighted in the snapshot below. Many people find this term a little confusing.

Balance Sheet as at March 31, 2014 ₹ million

Particulars	Note No.	As at March 31, 2014		As at March 31, 2013	
EQUITY AND LIABILITIES					
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			6,337.03		5,761.93
Total			21,394.41		17,704.70

If you think about it, on one hand we are discussing about liabilities which represent the obligation of the company, and on the other hand we are discussing the shareholders' fund which represents the shareholders' wealth. This is quite counter intuitive isn't it? How can liabilities and shareholders' funds appear on the 'Liabilities' side of balance sheet? After all the shareholders funds represents the funds belonging to its shareholders' which in the true sense is an asset and not really a liability.

To make sense of this, you should change the perceptive in which you look at a company's financial statement. Think about the entire company as an individual, whose sole job is run its core operation and to create wealth to its shareholders'. By thinking this way, you are in fact separating out the shareholders' (which also includes its promoters) and the company. With this new perspective, now think about the financial statement. You will appreciate that, the financial statements is a statement published by the company (which is an entity on its own) to communicate to the world about its financial well being.

This also means the shareholders' funds do not belong to the company as it rightfully belongs to the company's shareholders'. Hence from the company's perspective the shareholders' funds are an obligation payable to shareholders'. Hence this is shown on the liabilities side of the balance sheet.

6.3 –The liability side of balance sheet

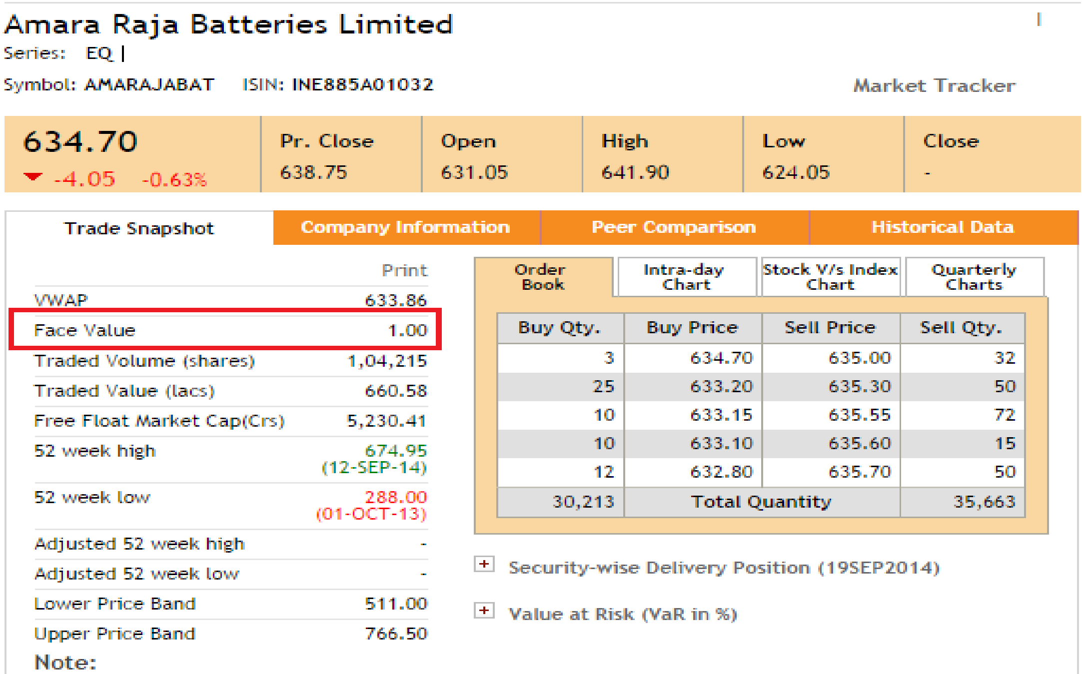
The liabilities side of the balance sheet details out all the liabilities of the company. Within liabilities there are three sub sections – shareholders' fund, non-current liabilities, and current liabilities. The first section is the shareholders' funds.

Balance Sheet as at March 31, 2014 ₹ million

Particulars	Note No.	As at March 31, 2014		As at March 31, 2013	
EQUITY AND LIABILITIES					
Shareholders' funds					
Share capital	2	170.81		170.81	
Reserves and surplus	3	13,456.20		10,427.33	
			13,627.01		10,598.14

To understand share capital, think about a fictional company issuing shares for the first time. Imagine, Company ABC issues 1000 shares, with each share having a face value of Rs.10 each. The share capital in this case would be Rs.10 x 1000 = Rs.10,000/- (Face value X number of shares).

In the case of ARBL, the share capital is Rs.17.081 Crs (as published in the Balance Sheet) and the Face Value is Rs.1/-. I got the FV value from the NSE's website:



I can use the FV and share capital value to calculate the number of shares outstanding. We know:

Share Capital = FV * Number of shares

Therefore,

Number of shares = Share Capital / FV

Hence in case of ARBL,

Number of shares = 17,08,10,000 / 1

= 17,08,10,000 shares

The next line item on the liability side of the Balance Sheet is the 'Reserves and Surplus'. Reserves are usually money earmarked by the company for specific purposes. Surplus is where all the profits of the company reside. The reserves and surplus for ARBL stands at Rs.1,345.6 Crs. The reserves and surplus have an associated note, numbered 3. Let us look into the same.

NOTE 3: RESERVES AND SURPLUS ₹ million

Particulars	As at March 31, 2014		As at March 31, 2013	
Capital reserve		0.01		0.01
Securities premium account		311.86		311.86
General reserve				
As per last Balance Sheet	1,817.27		1,530.56	
Add: Transfer from surplus in the Statement of Profit and Loss	367.44		286.71	
		2,184.71		1,817.27
Surplus in the Statement of Profit and Loss				
As per last Balance Sheet	8,298.19		6,221.45	
Add: Profit for the year	3,674.36		2,867.05	
Amount available for appropriation	11,972.55		9,088.50	
Less: Appropriations				
Transfer to general reserve	367.44		286.71	
Proposed dividend	551.72		430.45	
Dividend tax on proposed dividend	93.77		73.15	
		10,959.62		8,298.19
Total		13,456.20		10,427.33

As you can notice from the note, the company has earmarked funds across three kinds of reserves:

1. **Capital reserves** – Usually earmarked for long term projects. Clearly ARBL does not have much amount here. This amount belongs to the shareholders, but cannot be distributed to them.
2. **Securities premium reserve / account** – This is where the premium over and above the face/par value of the shares sits. ARBL has a Rs.31.18 Crs under this reserve
3. **General reserve** – This is where all the accumulated profits of the company which is not yet distributed to the shareholder reside. The company can use the money here as a buffer. As you can see ARBL has Rs.218.4 Crs in general reserves.

The next section deals with the surplus. As mentioned earlier, surplus holds the profits made during the year. Couple of interesting things to note:

1. As per the last year (FY13) balance sheet the surplus was Rs.829.8Crs. This is what is stated as the opening line under surplus. See the image below:

NOTE 3: RESERVES AND SURPLUS ₹ million

Particulars	As at March 31, 2014		As at March 31, 2013	
Capital reserve		0.01		0.01
Securities premium account		311.86		311.86
General reserve				
As per last Balance Sheet	1,817.27		1,530.56	
Add: Transfer from surplus in the Statement of Profit and Loss	367.44		286.71	
		2,184.71		1,817.27
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Proposed dividend	551.72		430.45	
Dividend tax on proposed dividend	93.77		73.15	
		10,959.62		8,298.19
Total		13,456.20		10,427.33

1. The current year (FY14) profit of Rs.367.4 Crs is added to previous years closing balance of surplus. Few things to take note here:
    1. Notice how the bottom line of P&L is interacting with the balance sheet. This highlights a very important fact – all the three financial statements are closely related
    2. Notice how the previous year balance sheet number is added up to this year's number. This highlights the fact that the balance sheet is prepared on a flow basis, adding the carrying forward numbers year on year
2. Previous year's balance plus this year's profit adds up to Rs.1197.2 Crs. The company can choose to apportion this money for various purposes.
    1. The first thing a company does is it transfers some money from the surplus to general reserves so that it will come handy for future use. They have transferred close to Rs.36.7 Crs for this purpose
    2. After transferring to general reserves they have distributed Rs.55.1 Crs as dividends over which they have to pay Rs.9.3 Crs as dividend distribution taxes.
3. After making the necessary apportions the company has Rs.1095.9 Crs as surplus as closing balance. This as you may have guessed will be the opening balance for next year's (FY15) surplus account.
4. Total Reserves and Surplus = Capital reserve + securities premium reserve + general reserves + surplus for the year. This stands at Rs.1345.6 Crs for the FY 14 against Rs.1042.7 Crs for the FY13

    The total shareholders' fund is a sum of share capital and reserves & surplus. Since this amount on the liability side of the balance sheet represents the money belonging to shareholders', this is called the 'shareholders funds'.

6.4 – Non Current Liabilities

Non-current liabilities represent the long term obligations, which the company intends to settle/ pay off not within 365 days/ 12 months of the balance sheet date. These obligations stay on the books for few years. Non-current liabilities are generally settled after 12 months after the reporting period.

Here is the snapshot of the non-current liabilities of Amara Raja batteries Ltd.

Non-current liabilities					
Long-term borrowings	4	759.47		773.13	
Deferred tax liabilities (net)	5	301.33		195.09	
Long-term provisions	6	369.57		376.41	
			1,430.37		1,344.63

The company has three types of non-current liabilities; let us inspect each one of them.

The long term borrowing (associated with note 4) is the first line item within the non-current liabilities. Long term borrowing is one of the most important line item in the entire balance sheet as it represents the amount of money that the company has borrowed through various sources. Long term borrowing is also one of the key inputs while calculating some of the financial ratios. Subsequently in this module we will look into the financial ratios.

Let us look into the note associated with 'Long term borrowings':

NOTE 4: LONG-TERM BORROWINGS

₹ million

Particulars	Non-current portion		Current maturities	
	As at March 31, 2014	As at March 31, 2013	As at March 31, 2014	As at March 31, 2013
Deferred payment liabilities				
Interest free sales tax deferment (Unsecured)	759.47	773.13	13.66	9.27
Total	**759.47**	**773.13**	**13.66**	**9.27**

Interest free sales tax deferment

The Company has availed interest free sales tax deferment under Andhra Pradesh sales tax deferment scheme (Target 2000) from the financial year 1997-98 as per the eligibility norms in respect of expanded capacities. The Company has availed total deferment of ₹811.40 million since March,1998, which is repayable after a period of 14 years from the date of each availment in annual installments.

- Eligible amount of interest free sales tax deferment - ₹813.33 million
- Period eligible for availment - January 1998 till September 2015

From the note it is quite clear that the 'Long term borrowings' is in the form of 'interest free sales tax deferment'. To understand what interest free sales tax deferment really means, the company has explained just below the note (I have highlighted the same in a red box). It appears to be some sort of tax incentive from the state government. The company plans to settle this amount over a period of 14 years.

You will find that there are many companies which do not have long term borrowings (debt). While it is a good to know that the company has no debt, you must also question as to why there is no debt? Is it because the banks are refusing to lend to the company? or is it because the company is not taking initiatives to expand their business operations. Of course, we will deal with the analysis part of the balance sheet later in the module.

Do recollect, we looked at 'Finance Cost' as a line item when we looked at the P&L statement. If the debt of the company is high, then the finance cost will also be high.

The next line item within the non-current liability is '**Deferred Tax Liability**'. The deferred tax liability is basically a provision for future tax payments. The company foresees a situation where it may have to pay additional taxes in the future; hence they set aside some funds for this purpose. Why do you think the company would put itself in a situation where it has to pay more taxes for the current year at some point in the future?

Well this happens because of the difference in the way depreciation is treated as per Company's act and Income tax. We will not get into this aspect as we will digress from our objective of becoming users of financial statements. But do remember, deferred tax liability arises due to the treatment of depreciation.

The last line item within the non-current liability is the **'Long term provisions'**. Long term provisions are usually money set aside for employee benefits such as gratuity; leave encashment, provident funds etc.

6.5 – Current liabilities

Current liabilities are a company's obligations which are expected to be settled within 365 days (less than 1 year). The term 'Current' is used to indicate that the obligation is going to be settled soon, within a year. Going by that 'non-current' clearly means obligations that extend beyond 365 days.

Think about this way – if you buy a mobile phone on EMI (via a credit card) you obviously plan to repay your credit card company within a few months. This becomes your 'current liability'. However if you buy an apartment by seeking a 15 year home loan from a housing finance company, it becomes your 'non-current liability'.

Here is the snapshot of ARBL's current liabilities:

Current liabilities					
Short-term borrowings	7	83.83		98.63	
Trade payables	8	1,277.79		1,362.84	
Other current liabilities	9	2,156.68		1,807.26	
Short-term provisions	6	2,818.73		2,493.20	

As you can see there are 4 line items within the current liabilities. The first one is the short term borrowings. As the name suggests, these are short term obligations of the company usually undertaken by the company to meet day to day cash requirements (also called working capital requirements). Here is the extract of note 7, which details what short term borrowings mean:

NOTE 7: SHORT-TERM BORROWINGS

₹ million

Particulars	As at March 31, 2014	As at March 31, 2013
Loans repayable on demand		
Cash credit from banks (Secured)		
State Bank of India	56.57	98.63
Andhra Bank	27.26	-
Total	83.83	98.63

The working capital facilities from State Bank of India, State Bank of Hyderabad, Andhra Bank and The Bank of Nova Scotia are secured by hypothecation of all current assets of the Company. The fixed assets of the Company are provided as collateral security by way of pari-passu second charge for the working capital facilities availed from State Bank of India.

Clearly as you can see, these are short term loans availed from the State bank of India and Andhra Bank towards meeting the working capital requirements. It is interesting to note that the short term borrowing is also kept at low level, at just Rs.8.3Crs.

The next line item is Trade Payable (also called account payable) which is at Rs.127.7 Crs. These are obligations payable to vendors who supply to the company. The vendors could be raw material suppliers, utility companies providing services, stationary companies etc. Have a look at note 8 which gives the details:

NOTE 8: TRADE PAYABLES

₹ million

Particulars	As at March 31, 2014	As at March 31, 2013
(Unsecured)		
Trade payables		
i) Dues to Micro, Small and Medium Enterprises	4.87	7.17
ii) Others	1,272.92	1,355.67
Total	**1,277.79**	**1,362.84**

Notes relating to Micro, Small and Medium Enterprises

Based on, and to the extent of information received from the suppliers with regard to their status under Micro, Small and Medium Enterprises Development Act, 2006 (MSMED Act), on which the auditors have relied, the disclosure requirements of Schedule VI to the Companies Act, 1956 with regard to the payments made/due to Micro, Small and Medium Enterprises are given below:

The next line item just says 'Other current liabilities' which stands at Rs.215.6 Crs. Usually 'Other current Liabilities' are obligations associated with the statutory requirements and obligations that are not directly related to the operations of the company. Here is note 9 associated with 'Other current liabilities':

Notes forming part of the Financial Statements

NOTE 9: OTHER CURRENT LIABILITIES

₹ million

Particulars	As at March 31, 2014		As at March 31, 2013	
(Unsecured)				
Unclaimed dividends*		17.04		13.22
Other payables				
a) Employee related payables	370.12		311.60	
b) Outstanding liabilities	860.06		643.10	
c) Commission payable to Non-Executive Chairman	175.99		140.88	
d) Excise duty/Service tax payable	15.36		4.17	
e) Sales tax payables	169.88		200.39	
f) TDS/TCS payables	31.31		14.48	
g) Advances from customers	25.02		42.52	
h) Creditors for capital goods/services	176.30		214.15	
i) Other non-trade payables	301.94	2,125.98	213.48	1,784.77
Sub-Total		2,143.02		1,797.99
Add: Current maturities of long-term debt (Refer Note No. 4)				
Interest free sales tax deferment (Unsecured) repayable within 12 months		13.66		9.27
Total		2,156.68		1,807.26

*The unclaimed dividends represent those relating to the years 2006-07 to 2012-13 (for previous year from 2005-06 to 2011-12) and no part thereof has remained unpaid or unclaimed for a period of seven years or more from the date they became due for payment requiring transfer to the Investor Education and Protection Fund.

The last line item in current liabilities is the 'Short term provisions' which stands at Rs.281.8 Crs. Short term provisions is quite similar to long term provisions, both of which deals with setting aside funds for employee benefits such as gratuity, leave encashment, provident funds etc. Interestingly the note associated with 'Short term Provisions' and the 'Long term provisions' is the same. Have a look at the following:

Non-current liabilities					
Long-term borrowings	4	759.47		773.13	
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Long-term provisions	6	369.57		376.41	
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Since note 6 is detailing both long and short term provisions it runs into several pages, hence for this reason I will not represent an extract of it. For those who are curious to look into the same can refer to pages 80, 81, 82 and 83 in the FY14 Annual report for Amara Raja Batteries Limited.

However, from the user of a financial statement perspective all you need to know is that these line items (short and long term provisions) deal with the employee and related benefits. Please note, one should always look at the associated note to run through the details.

We have now looked through half of the balance sheet which is broadly classified as the Liabilities side of the Balance sheet. Let us relook at the balance sheet once again to get a perspective:

Balance Sheet as at March 31, 2014

₹ million

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Other current assets	13	43.16		68.49	
			12,986.10		12,568.52
Total			21,394.41		17,704.70
Significant accounting policies	1				

Statement on significant accounting policies and notes are an integral part of the financial statements

Clearly,

Total Liability = Shareholders' Funds + Non Current Liabilities + Current Liabilities

= 1362.7 + 143.03 + 633.7

Total Liability = Rs.2139.4 Crs

Key takeaways from this chapter

1. A Balance sheet also called the Statement of Financial Position is prepared on a flow basis which depicts the financial position of the company at any given point in time. It is a statement which shows what the company owns (assets) and what the company owes (liabilities)
2. A business will generally need a balance sheet when it seeks investors, applies for loans, submits taxes etc.
3. Balance sheet equation is Assets = Liabilities + Shareholders' Equity
4. Liabilities are obligations or debts of a business from past transactions and Share capital is number of shares * face value
5. Reserves are the funds earmarked for a specific purpose, which the company intends to use in future
6. Surplus is where the profits of the company reside. This is one of the points where the balance sheet and the P&L interact. Dividends are paid out of the surplus
7. Shareholders' equity = Share capital + Reserves + Surplus. Equity is the claim of the owners on the assets of the company. It represents the assets that remain after deducting the liabilities. If you rearrange the Balance Sheet equation, Equity = Assets – Liabilities.
8. Non-current liabilities or the long term liabilities are obligations which are expected to be settled in not less than 365 days or 12 months of the balance sheet date
9. Deferred tax liabilities arise due to the discrepancy in the way the depreciation is treated. Deferred tax liabilities are amounts of income taxes payable in the future with respect to taxable differences as per accounting books and tax books.
10. Current liabilities are the obligations the company plans to settle within 365 days /12 months of the balance sheet date.
11. In most cases both long and short term provisions are liabilities dealing with employee related matters
12. Total Liability = Shareholders' Funds + Non Current Liabilities + Current Liabilities. . Thus, total liabilities represent the total amount of money the company owes to others