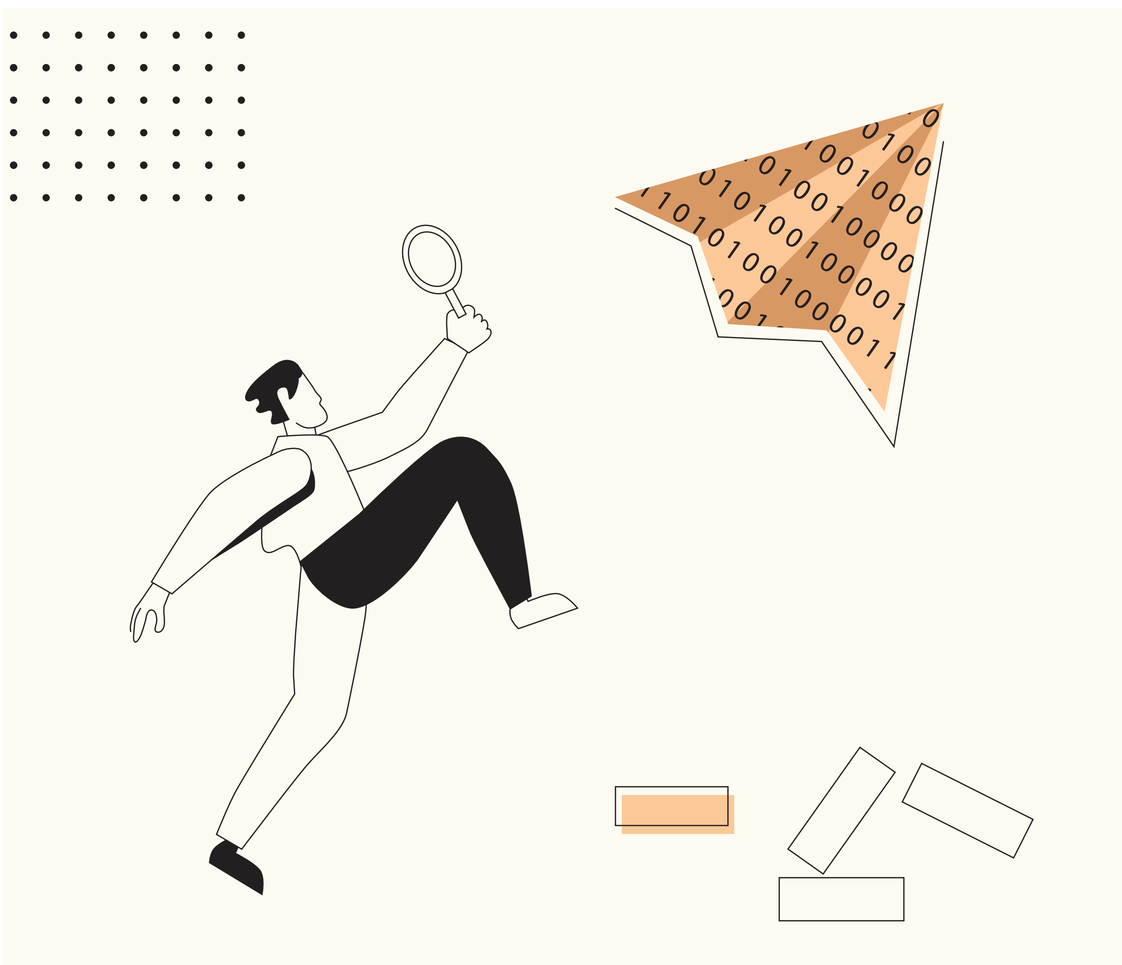
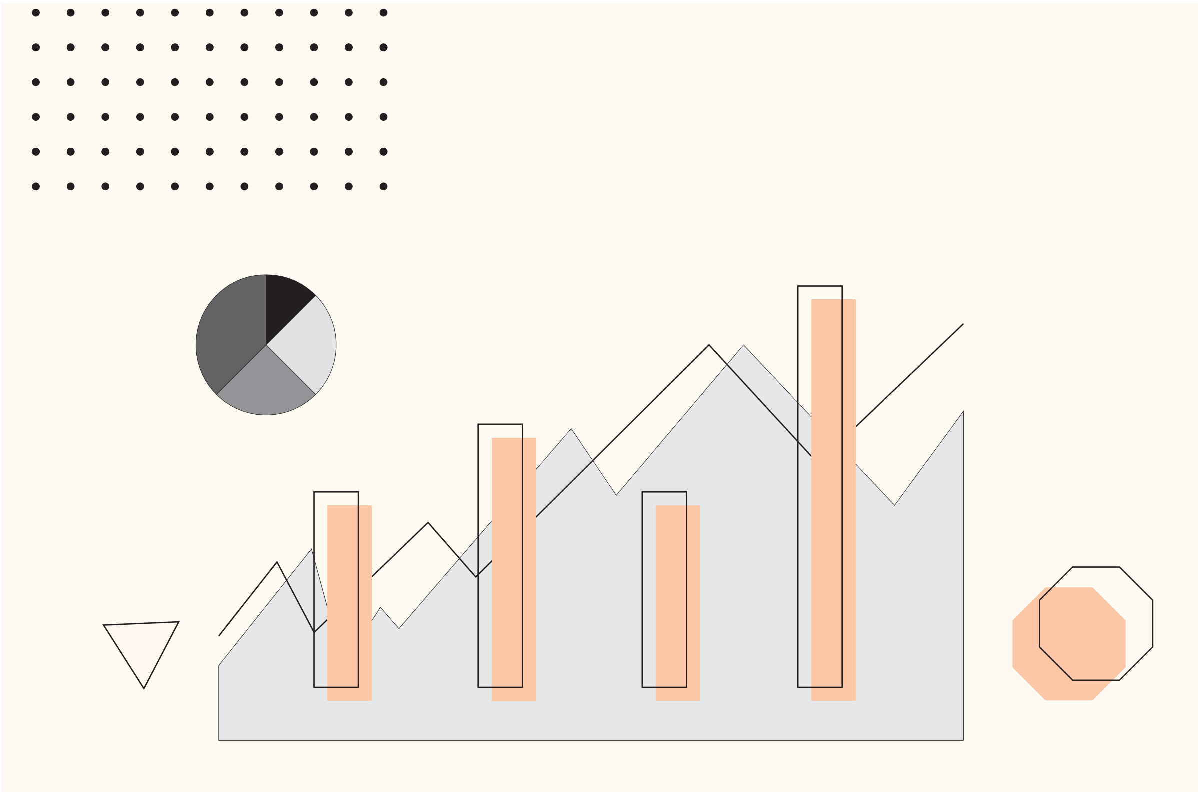
Value Research

HOW TO READ THE BALANCE SHEET

When it comes to evaluating a business, understanding the balance sheet is very important. As a financial statement, a balance sheet reports three things – assets, liabilities and shareholders' equity of a company.



Contents



Introduction

A very simple financial statement, the balance sheet gives information about three things – the money available, outstanding loans and the difference between these two.

The balance sheet is one of the most important financial statements for an investor to take into consideration. Although this accounting statement may seem difficult to comprehend at the first glance, it is actually a very simple statement if you know what you're looking for. Before we start discussing how to read a balance sheet, we should first know what exactly a balance sheet is.

So, what is a balance sheet?

A balance sheet is a very simple financial statement designed to give readers information about three things – the money available to the company, outstanding loans and the difference between these two.

Let's look at a simple balance sheet of an imaginary company – ABC Limited:

Bank balance = ₹10,000; money borrowed from a friend = ₹2500 and the difference between these two numbers is ₹7,500.

This simple balance sheet tells us that the company ABC Limited has ₹10,000 but has to repay ₹2500 to its friend and therefore, has a net amount of ₹7,500.

Sounds simple? That's all about the balance sheet. Investors should remember that though complicated terms, such as assets (which refers to ₹10,000 here), liabilities (₹2,500 owed to the friend) and shareholder's equity (the difference between these two numbers) are used, the core mathematical principle is that assets = liabilities + shareholders' equity. And if that seems like stating the obvious, it definitely is.

An important characteristic of a balance sheet is that it gives financial information of a particular moment.

In fact, the word balance in the balance sheet has been derived from the requirement that the left side of the equation (assets) should be equal to the right side of the equation (liabilities + shareholders' equity).

The format of a balance sheet:

Assets (A)	Liabilities (B)	Shareholders' Equity (C) = (A) - (B)
₹10,000	₹2,500	₹7,500

Characteristics of a balance sheet

An important characteristic of a balance sheet is that it gives financial information of a particular moment. It's very similar to a photograph – it only reflects things as of that instant. And that's why a balance sheet is a 'snapshot in time'. And since the quantum of assets and liabilities can vary on a day-to-day basis (or even a minute-to-minute basis), it is important to keep in mind the date of preparing the balance sheet.

Another important feature of a balance sheet is that most transactions will not affect just one side. This feature is actually the characteristic of the current accounting system and can be best explained with an example. If a company purchases an asset for ₹100, it cannot be the case that only the assets of the company increased. If that were the case, it would have violated the basic equation.

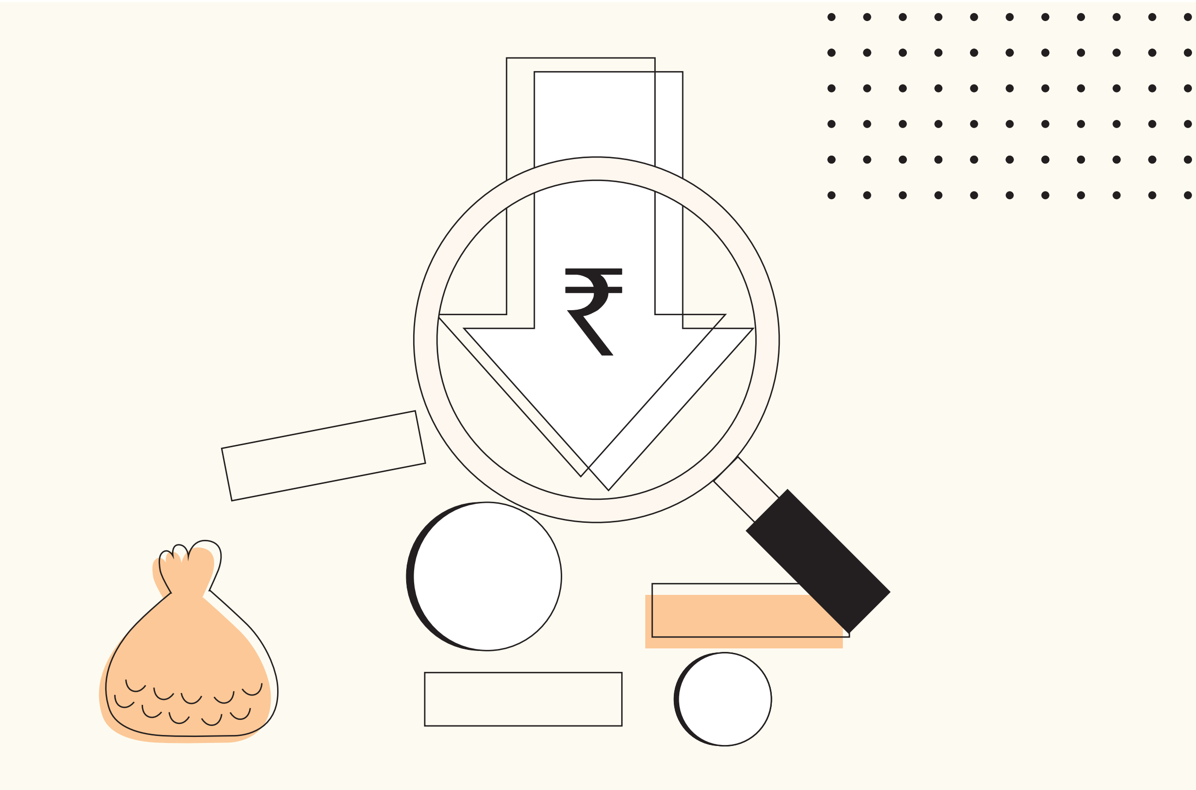
To ensure that the equation is balanced, we need to see the source of that asset (worth ₹100). Broadly, there are only two ways through which the company could acquire the money to purchase that asset. The first method is through debt (which means the money needs to be repaid at some point in the future). The company may have taken a bank loan. In that case, the right-hand side of the equation – i.e liabilities – would also increase by ₹100, thereby maintaining the balance. The second is through the company's own funds. Perhaps, it has made a profit of ₹100 or shareholders have given extra money to the company. In either case, the right-hand side would still increase but this time, the shareholders' equity would increase, too.

The only exception is a case wherein the company used money from its own cash reserve to purchase the asset. In such a scenario, the amount of cash with the company would go down to the same extent as the increase in asset size. This transaction would not affect liabilities and shareholders' equity portions i.e the right-hand side of the balance sheet. This is because only the left-hand side is modified to the extent of redistribution among different asset classes.

Interpretation

Since the principle of balance is maintained, one look at a balance sheet should broadly tell you two things – how big the company is (which can be ascertained by looking at the assets) and how indebted a company is, which is in terms of the size of its liabilities. This information is also given on Value Research's website under the 'Financial' tab. In most cases, the size of the assets will be greater than the size of liabilities, but when a company goes through difficult times, it is possible that the size of liabilities exceeds the asset size, thereby having negative net-worth. Some aviation companies exemplify this possibility. As a rule of thumb, it is better to stay away from companies having negative net worth, as these companies are likely to go through bankruptcy (in that case, shareholders are likely to lose all their money).

Now that we have covered the basics of a balance sheet, let us try to understand more about individual balance sheet items, comprising assets, liabilities and shareholders' equity.



Understanding assets

Let's delve deeper into the assets part of the balance sheet to understand what it communicates and how to make use of it

The asset side of a balance sheet, as the name indicates, is just a list of all the valuable items owned by a company. But it is generally classified into two broad categories – current and non-current assets.

Current assets

In layman's terms, the key feature of current assets is that these assets can be converted into cash easily. Therefore, items like bank balances, fixed deposits, liquid funds and other short-term investments are usually classified as current assets. Besides, those assets that are primarily held for trading purposes and expected to be converted into cash in the normal operating cycle, fall into this category. These include items like inventory, trade receivables, etc.

Uses of current assets

The current assets section of a balance sheet is designed to help the reader understand how easy or difficult it is for the company to carry out its day-to-day operations. Since borrowing money is a costly and time-consuming process, it is important for a company to have a sufficient amount of liquid assets to conduct its day-to-day operations. Especially during economic uncertainty when banks become more risk-averse and are unwilling to give loans, having liquid assets holds more importance for a company.

So, at the very least, investors need to make sure that there is sufficient cash for running the company for two-three months. In fact, you can find the amount of cash available with a company on the website of Value Research. Once you search for a company, the amount of cash is given on the right-hand side under the table 'Key Facts'.

Investors need to make sure that there is sufficient cash for running the company for two-three months.

Let's take the example of two hypothetical airline companies RedJet and BlueFlight. When an investor checks the asset sides of these two companies' balance sheets, it may be possible that RedJet has only around Rs 50 crore of cash, while BlueFlight has more than Rs 20,000 crore of cash. This would give the investor more certainty about BlueFlight's ability to continue flying because RedJet may face difficulties making payments as and when they come due (fuel vendors, parking charges, salaries, etc.)

Accounts/trade receivables: An important element to watch out

This term refers to the amount that is due from the customers of a company. This situation arises when a company doesn't receive money immediately after selling its products and services. Its customers are normally given some time, say between one-three months, for making the payment.

Investors have to monitor this number to ensure that it is not going up at a very fast pace. Even though giving credit is not an unhealthy trade practice, customers' creditworthiness should be taken into account. It is okay if the account's receivable goes up slightly, owing to certain seasonal fluctuations, but if it increases at a fast pace, it is likely that the company is being very aggressive in its sales efforts, which is a potential cause of worry.

Non-current assets

Any asset that does not fall into the definition of current assets is classified as non-current assets. Usually, the bulk of a company's operating assets are classified as non-current assets. Factories, land, plant and equipment all normally fall into this category. Since they are long-term assets, it is expected that they would take more time to sell. Therefore, it would be difficult for a company to immediately raise money without perhaps, giving a substantial discount.

Investors may also find that a particular asset class may fall into both categories. For example, an FD which matures in the next month would be classified as current assets, but if the same FD matures only after five years, then it would be classified as a non-current asset.

Uses of non-current assets

The non-current assets give us a much better understanding of a company's business. Since non-current assets are used for running a company's operations, it reflects its underlying business. For example, the type of assets owned by a cement-manufacturing company, such as UltraTech Cement (factories, land, mines, furnaces, etc.) would be very different from those owned by a media company, such as intellectual property, studios, etc.

While reading the asset side of a balance sheet can be useful for other purposes, it should not be forgotten that at the end of the day, it is still a simple list.

Understanding liabilities

Insights into the liabilities part of the balance sheet to know what it communicates and how to make use of it

“10% of the borrowers in the world use debt to get richer; 90% use debt to get poorer.”
Robert Kiyosaki

Like the asset side of the balance sheet, the liabilities side is an enumeration of all the different forms of liabilities that are payable by a company. It is arguably even more important than the asset side, as the asset side represents optimism, while the liability side, more often than not, pulls a company back to ground reality. Debt is the primary reason behind companies going bankrupt. After all, if a company does not have any debt, it will simply never go bankrupt.

As we have mentioned in the introduction, the liabilities side of the balance sheet gives a better understanding of how much of the total assets owned by a company has actually been paid for with the company’s own money as against borrowed money.

Like assets, liabilities of a company are also classified into two categories – current liabilities and non-current liabilities.

Current liabilities

The current liabilities section contains the debts that are payable by a company in the normal course of its operating cycle and that have to be settled in the next 12 months. Apart from short-term borrowings, this section includes portions of long-term obligations which are payable in the near future. Short-term provisions, trade payables and rent obligations are normally classified as current liabilities.

The activity of monitoring the liabilities should be done at regular intervals throughout the duration of the investment period.

What current liabilities tell us

The study of the current liabilities section helps gauge immediate threats to the company's ability to function. When there are disruptions in the market environment, it is important to understand the magnitude of a company's short-term obligations. Current liabilities have to be studied in conjunction with current assets to get a clearer picture of the company's financial position and make sure that there are adequate assets to pay off the liabilities as and when they arise. Companies should ideally make their business plans in such a way that their investments mature around the same time as the liabilities come due.

Non-current liabilities

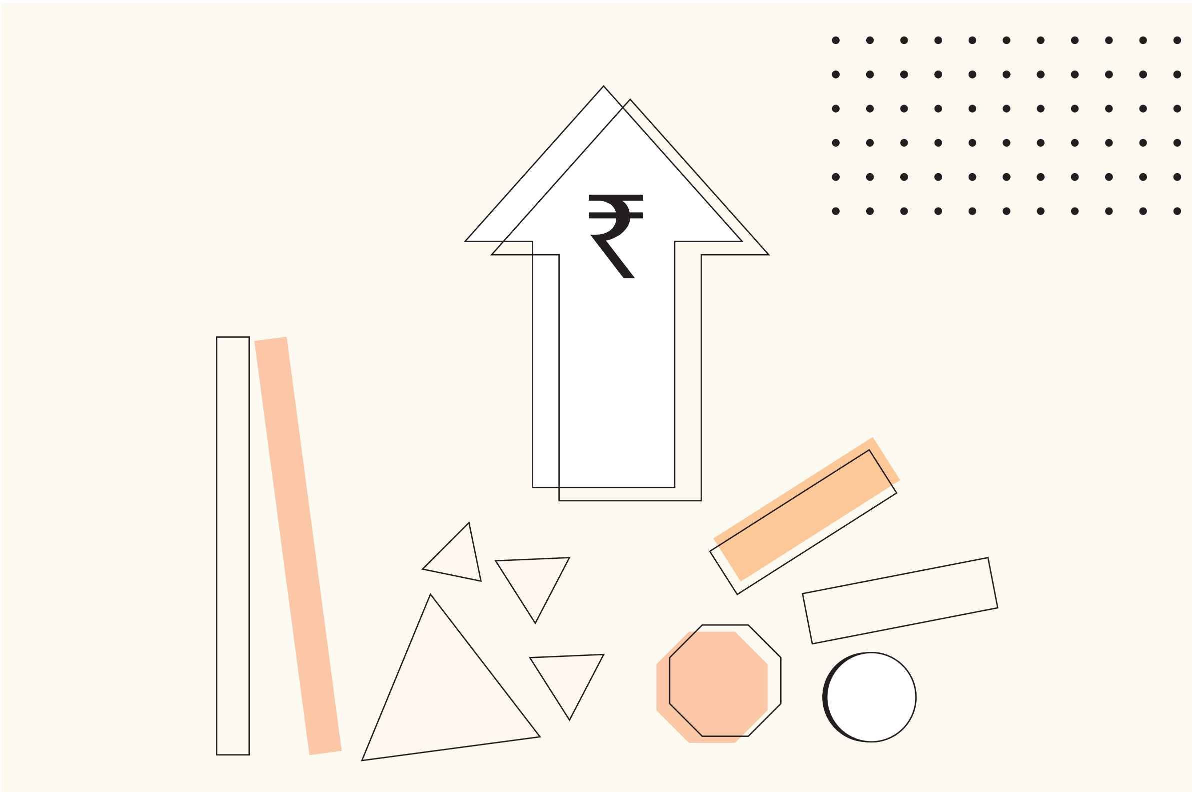
As the name implies, all those liabilities that are not classified as current liabilities are classified as non-current liabilities. These liabilities have a much longer time horizon and represent more stable sources of borrowing. When companies invest in large operational assets (think of factories, roads, aircraft, etc.) which usually have a long lifetime, they should ideally be funded with long-term liabilities so as to avoid the risk of refinancing at unfavourable conditions.

What non-current liabilities tell us

Paying attention to this section is important for two reasons – (1) non-current liabilities, together with the current liabilities, give the true picture of how indebted a company is and (2) this section, when read with the asset section and considering the nature of assets and the proportion of assets funded by long-term sources, helps us understand the stability of the capital structure and the degree of asset-liability mismatches if any. While mismatches can happen in both current and non-current portions of assets and liabilities, it would be more difficult to correct long-term mismatches than short-term ones.

Investor takeaways

For investors, examining the liabilities side of the balance sheet is not a one-time exercise at the time of investment. Instead, this activity of monitoring the liabilities should be done at regular intervals throughout the duration of the investment period. It is noteworthy that the figures are easily accessible on the website of Value Research. The general thumb-rule is that less debt is better than more debt. And of all types of liabilities, long-term debt is preferable to short-term debt.



Understanding equity

Insights into the equity part of the balance sheet to know what it communicates and how to make use of it

The final part of the balance sheet deals with an issue that is probably the simplest part of this financial statement. Shareholders' Equity or just Equity is all that actually matters. Conceptually, it is the difference between the assets and liabilities owned by the company and therefore, represents the company's net worth.

But before we understand the components of Shareholders' Equity, let's first understand what equity actually means. Every business needs capital, which can be of two types – debt capital and equity capital. Since a start-up is unlikely to have debt capital, the only capital available to it is equity capital. And suppliers of this capital are residual owners of the company. This term (residual owners) implies that if the company goes bankrupt, its shareholders will get money from the sale of assets only after all the claims of debt holders are fully satisfied.

This structure underscores the basic principles of finance: the greater the risk, the greater the expected return. Even if a company performs really well, debt holders will receive only the interest (along with the principal), but shareholders will see the value of their investments grow manifold. The flipside of this is that if the business prospects don't materialise and the company starts making losses, such losses will be borne by shareholders first. Only if the losses exceed the entire shareholders' capital, the debt holders will even bear the first rupee of loss. For example, let's assume that a company has ₹100 in equity and ₹300 in debt. If the company makes ₹40 in losses, the equity will come down to ₹60 (₹100 - ₹40) but the debt will remain at ₹300. But if the company makes a loss of ₹101, equity will become zero and debt will come down to ₹299.

> Investors need to keep an eye on equity without fretting over its components.

Components

Shareholders' Equity sheds light on the total amount of shareholder capital that a company has. Broadly, it has two categories – paid-up capital and reserves.

Paid-up capital: Paid-up capital, as the name implies, is the amount of capital actually invested in the company. While you may see some more complicated terms like authorised capital and issued capital, investors don't need to worry about them. Paid-up capital refers to the money that has been infused into the company at the time of its incorporation, as well as the money given to the company throughout its lifetime. The authorised capital, on the other hand, refers to the outer limit of how much capital a company is permitted to raise and this limit is always higher or equal to that of the paid-up capital. Although this outer limit can be increased at any point in time, it is not routinely done, as it involves tedious procedures.

Reserves: All other components of Shareholders' Equity are some forms of reserves. Reserves can be of different kinds, such as share premium reserves, general reserves, revaluation reserves, etc. What investors need to understand is that though accounting standards require this demarcation, there is absolutely no difference when viewed from a financial perspective.

Difference between these two

From an accounting perspective, paid-up capital is considered to be the core capital of a company, which means that it is necessary for running the company's operations and therefore, always has to remain with the company. This is in stark contrast to reserves, which predominantly comprise retained earnings. This term, retained earnings, refers to that portion of the company's profits (if any) earned during its previous years which has NOT been distributed as dividends. And since this is not considered to be a part of the core capital, reserves can generally be distributed to shareholders.

Investor takeaways

Investors need to keep an eye on equity without fretting over its components. Promoters, who tend to carry out debt-fueled expansion plans, would not be able to influence Shareholders' Equity significantly, as any increase in assets would result in a corresponding increase in liabilities. Also, any accounting changes, like simply shifting the money between different heads of shareholders' equity, such as share split, bonus shares, etc., are mere jugglery of numbers (You can read more about it in our article "Much ado about nothing").

And even though certain balance sheets are presented in a manner where shareholders' equity is clubbed with liabilities, investors need to clearly differentiate liabilities from Shareholders' Equity. Please do remember that no matter what sub-classifications are used, all the money (including paid-up capital, reserves, etc.) ultimately belongs to shareholders. The total Shareholders' Equity is, in effect, the ground reality.

Conclusion

The balance sheet is a very useful financial statement. Since it conveys the company's financial picture at a particular point in time, it has a multitude of users. Apart from investors, it is used by banks, vendors, regulatory bodies, etc., for various purposes, such as assessing creditworthiness, determining the impact of risks and so on. But at the same time, investors must also be aware of certain inherent limitations of the balance sheet. It does not say anything about the management quality, it is susceptible to fudging by unscrupulous managers and the values of various assets, which are recorded using accounting rules, can be very different from the ground reality. Despite these limitations, the balance sheet is still an important document which needs to be thoroughly studied before making any investment decisions.