ZERODHA

Fundamental Analysis - Part 1

ZERODHA.COM/VARSITY

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CHAPTER 1

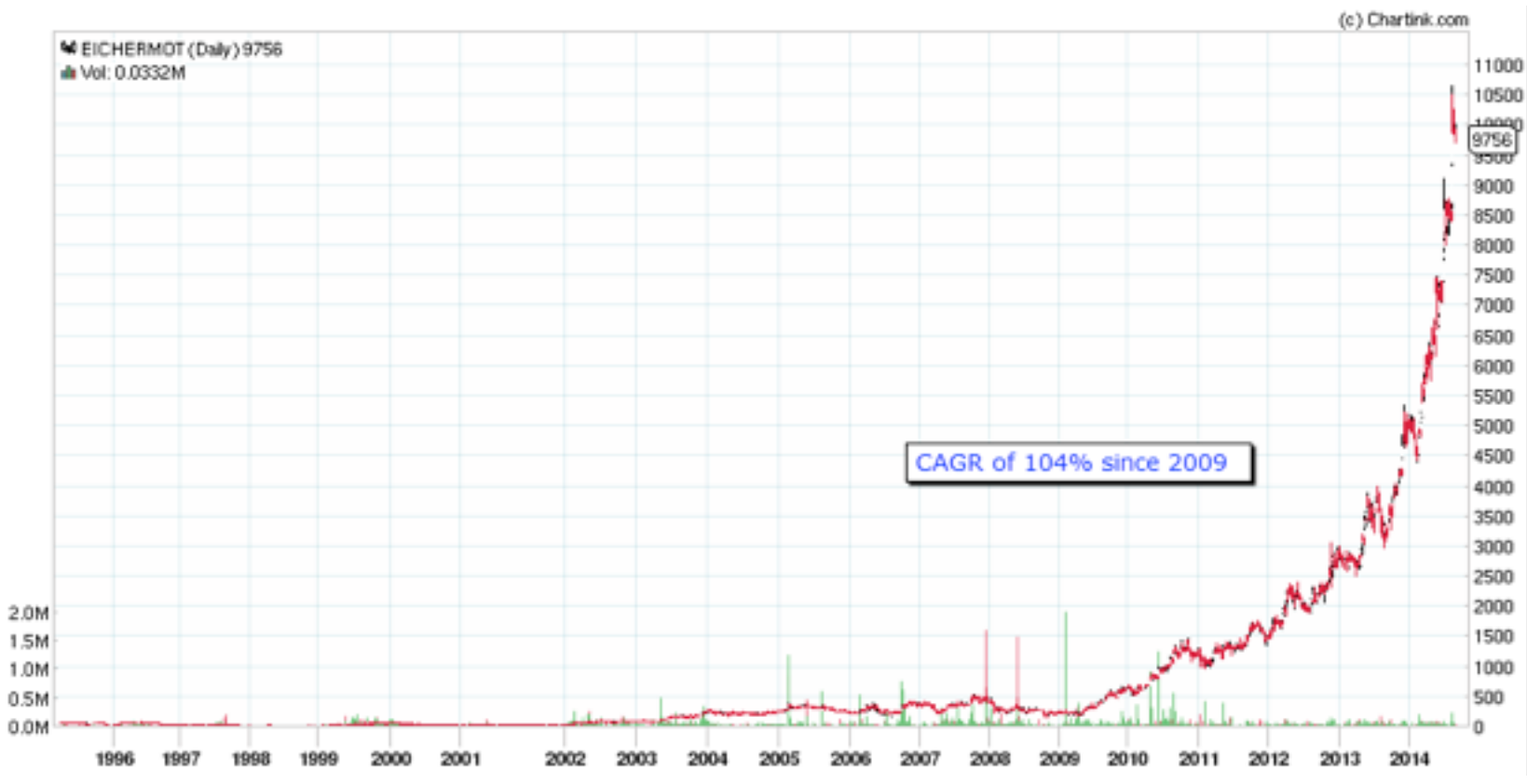
Introduction to Fundamental Analysis

1.1 Overview

Fundamental Analysis (FA) is a holistic approach to study a business. When an investor wishes to invest in a business for a long term (say 3 – 5 years) it becomes extremely essential to understand the business from various perspectives. It is critical for an investor to separate the daily short term noise in the stock prices and concentrate on the underlying business performance. Over a long term, the stock prices of a fundamentally strong company tend to appreciate, thereby creating wealth for its investors.

We have many such examples in the Indian market. To name a few, one can think of companies such as Infosys Limited, TCS Limited, Page Industries, Eicher Motors, Bosch India, Nestle India, TTK Prestige etc. Each of these companies have delivered on an average over 20% compounded annual growth return (CAGR) year on year for over 10 years. To give you a perspective, at a 20% CAGR the investor would double his money in roughly about 3.5 years. Higher the CAGR faster is the wealth creation process. Some companies such as Bosch India Limited have delivered close to 30% CAGR. Therefore, you can imagine the magnitude, and the speed at which wealth is created if one would invest in fundamentally strong companies.

Here are long term charts of Bosch India, Eicher Motors, and TCS Limited that can set you thinking about long term wealth creation. Do remember these are just 3 examples amongst the many that you may find in Indian markets.



At this point you may be of the opinion that I am biased as I am selectively posting charts that look impressive. You may wonder how the long term charts of companies such as Suzlon Energy, Reliance Power, and Sterling Biotech may look? Well here are the long term charts of these companies:

These are just 3 examples of the wealth destructors amongst the many you may find in the Indian Markets.

The trick has always been to separate the investment grade companies which create wealth from the companies that destroy wealth. All investment grade companies have a few common attributes that sets them apart. Likewise all wealth destructors have a few common traits which is clearly visible to an astute investor.

Fundamental Analysis is the technique that gives you the conviction to invest for a long term by helping you identify these attributes of wealth creating companies.

1.2 – Can I be a fundamental analyst?

Of course you can be. It is a common misconception that only chartered accountants and professionals from a commerce background can be good fundamental analysts. This is not true at all. A fundamental analyst just adds 2 and 2 to ensure it sums up to 4. To become a fundamental analyst you will need few basic skills:

1. Understanding the basic financial statements

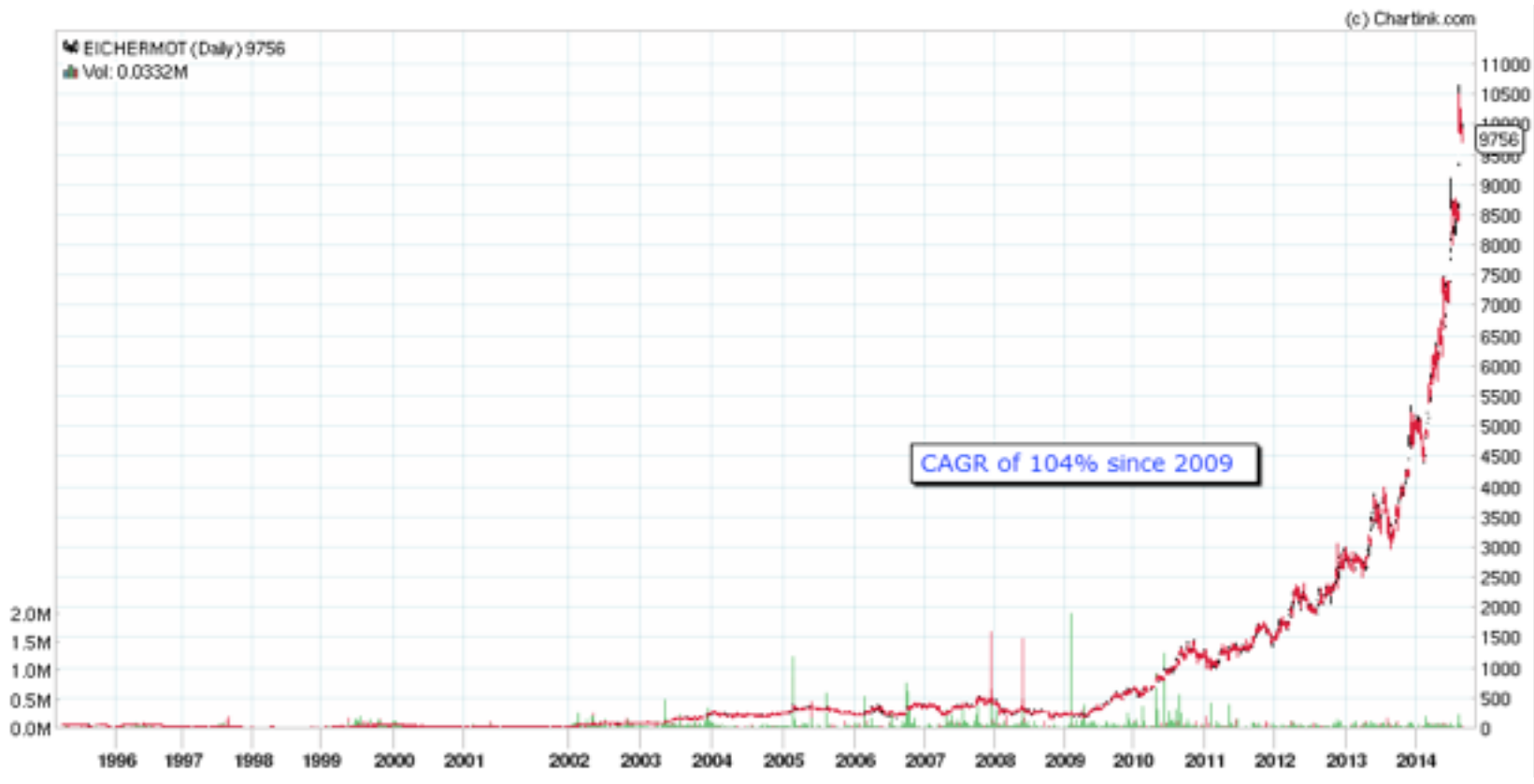
2. Understand businesses with respect to the industry in which it operates

3. Basic arithmetic operations such as addition, subtraction, division, and multiplication

The objective of this module on Fundamental Analysis is to ensure that you gain the first two skill sets.

1.3 – I'm happy with Technical Analysis, so why bother about Fundamental Analysis?

Technical Analysis (TA) helps you garner quick short term returns. It helps you time the market for a better entry and exit. However TA is not an effective approach to create wealth. Wealth is created only by making intelligent long term investments. However, both TA & FA must coexist in your market strategy. To give you a perspective, let me reproduce the chart of Eicher Motors:



Let us say a market participant identifies Eicher motors as a fundamentally strong stock to invest, and therefore invests his money in the stock in the year 2006. As you can see the stock made a relatively negligible move between 2006 and 2010. The real move in Eicher Motors started only from 2010. This also means FA based investment in Eicher Motors did not give the investor any meaningful return between 2006 and 2010. The market participant would have been better off taking short term trades during this time. Technical Analysis helps the investor in taking short term trading bets. Hence both TA & FA should coexist as a part of your market strategy. In fact, this leads us to an important capital allocation strategy called "The Core Satellite Strategy".

Let us say, a market participant has a corpus of Rs.500,000/-. This corpus can be split into two unequal portions, for example the split can be 60 – 40. The 60% of capital which is Rs.300,000/- can be invested for a long term period in fundamentally strong companies. This 60% of the investment makes up the core of the portfolio. One can expect the core portfolio to grow at a rate of at least 12% to 15% CAGR year on year basis.

The balance 40% of the amount, which is Rs.200,000/- can be utilized for active short term trading using Technical Analysis technique on equity, futures, and options. The Satellite portfolio can be expected to yield at least 10% to 12% absolute return on a yearly basis.

1.4 – Tools of FA

The tools required for fundamental analysis are extremely basic, most of which are available for free. Specifically you would need the following:

1. Annual report of the company – All the information that you need for FA is available in the annual report. You can download the annual report from the company's website for free

2. Industry related data – You will need industry data to see how the company under consideration is performing with respect to the industry. Basic data is available for free, and is usually published in the industry's association website

3. Access to news – Daily News helps you stay updated on latest developments happening both in the industry and the company you are interested in. A good business news paper or services such as Google Alert can help you stay abreast of the latest news

4. MS Excel – Although not free, MS Excel can be extremely helpful in fundamental calculations

With just these four tools, one can develop fundamental analysis that can rival institutional research. You can believe me when I say that you don't need any other tool to do good fundamental research. In fact even at the institutional level the objective is to keep the research simple and logical.

Key takeaways from this chapter

1. Fundamental Analysis is used to make long term investments
2. Investment in a company with good fundamentals creates wealth
3. Using Fundamental Analysis one can separate out an investment grade company from a junk company
4. All investment grade companies exhibit few common traits. Likewise all junk companies exhibit common traits
5. Fundamental analysis helps the analysts identify these traits
6. Both Technical analysis and fundamental analysis should coexist as a part of your market strategy
7. To become a fundamental analyst, one does not require any special skill. Common sense, basic mathematics, and a bit of business sense is all that is required
8. A core satellite approach to the capital allocation is a prudent market strategy
9. The tools required for FA are generally very basic, most of these tools are available for free.

CHAPTER 2

Mindset of an Investor

2.1– Speculator Vs Trader Vs Investor

Depending on how you would like to participate in the market, you can choose to speculate, trade or invest. All the three types of participation are different from one another. One has to take a stance on the type of market participant he would like to be. Having clarity on this can have a huge impact on his Profit & Loss account.

To help you get this clarity, let us consider a market scenario and identify how each one of the market participants (speculator, trader, and investor) would react to it.

SCENARIO

RBI in the next two days is expected to convene to announce their latest stance on the monetary policy. Owing to the high and sticky inflation, RBI has hiked the interest rates during the previous 4 monetary policy reviews. Increase in interest rates, as we know means tougher growth prospects for Corporate India – hence corporate earnings would take a hit.

Assume there are three market participants – Sunil, Tarun, and Girish. Each of them view the above scenario differently, and hence would take different actions in the market. Let us go through their thought process.

(Please note: I will briefly speak about option contracts here, this is only for illustration purpose. We will understand more about derivatives in the subsequent modules)

Sunil: He thinks through the situation and his thought process is as follows:

★ He feels the interest rate are at an unsustainably high level

★ High interest rates hampers the growth of corporate India

★ He also believes that RBI has hiked the interest rates to a record high level and it would be really tough for RBI to hike the rate again

★ He looks at what the popular analysts on TV are opinionating about the situation, and he is happy to note that his thoughts and the analyst thoughts are similar

★ He concludes that RBI is likely to cut the rates if not for keeping the interest rates flat

★ As an outcome, he expects the market to go up

To put his thoughts into action, he buys call options of State Bank of India.

Tarun: He has a slightly different opinion about the situation. His thought process is as below:

★ He feels expecting RBI to cut the rates is wishful thinking. In fact he is of the opinion that nobody can clearly predict what RBI is likely to do

★ He also identifies that the volatility in the markets is high, hence he believes that option contracts are trading at very high premiums

★ He knows from his previous experience (via back testing) that the volatility is likely to drop drastically just after RBI makes its announcement

To put his thoughts into action, he sells 5 lots of Nifty Call options and expects to square off the position just around the announcement time.

Girish: He has a portfolio of 12 stocks which he has been holding for over 2 years. Though he is a keen observer of the economy he has no view on what RBI is likely to do. He is also not worried about the outcome of the policy as he anyway plans to hold on to his shares for a long period of time. Hence with this perspective he feels the monetary policy is yet another short term passing tide in the market and will not have a major impact on his portfolio. Even if it does, he has both the time and patience to hold on to his shares.

However, Girish plans to buy more of his portfolio shares if the market overreacts to the RBI news and his portfolio stocks falls steeply after the announcement is made.

Now, what RBI will eventually decide and who makes money is not our concern. The point is to identify who is a speculator, a trader, and an investor based on their thought process. All the three men seem to have logic based on which they have taken a market action. Please note, Girish's decision to do nothing itself is a market action.

Sunil seems to be highly certain on what RBI is likely to do and therefore his market actions are oriented towards a rate cut. In reality it is quite impossible to call a shot on what RBI (or for that matter any regulator) will do. These are complex matters and not straightforward to analyze. Betting on blind faith, without a rational reasoning backing ones decision is speculation. Sunil seems to have done just that.

Tarun has arrived at what needs to be done based on a plan. If you are familiar with options, he is simply setting up a trade to take advantage of the high options premium. He is clearly not speculating on what RBI is likely to do as it does not matter to him. His view is simple – volatility is high; hence the premiums are attractive for an options seller. He is expecting the volatility to drop just prior to the RBI decision.

Is he speculating on the fact that the volatility will drop? Not really, because he seems to have back tested his strategy for similar scenarios in the past. A trader designs all his trades and not just speculates on an outcome.

Girish, the investor on the other hand seems to be least bit worked up on what RBI is expected to do. He sees this as a short term market noise which may not have any major impact on his portfolio. Even if it did have an impact, he is of the opinion that his portfolio will eventually recover from it. Time is the only luxury markets offer, and Girish is keen on leveraging this luxury to the maximum. In fact he is even prepared to buy more of his portfolio stocks in case the market overreacts. His idea is to hold on to his positions for a long period of time and not get swayed by short term market movements.

All the three of them have different mindsets which leads them to react differently to the same situation. The focus of this chapter is to understand why Girish, the investor has a long term perspective and not really bothered about short term movements in the market.

2.2 – The compounding effect

To appreciate why Girish decided to stay invested and not really react to short term market movement, one has to understand how money compounds. Compounding in simple terms is the ability of money to grow when the gains of year 1 is reinvested for year 2.

For example consider you invest Rs.100 which is expected to grow at 20% year on year (recall this is also called the CAGR). At the end of the first year the money is expected to grow to Rs.120. At the end of year 1 you have two options:

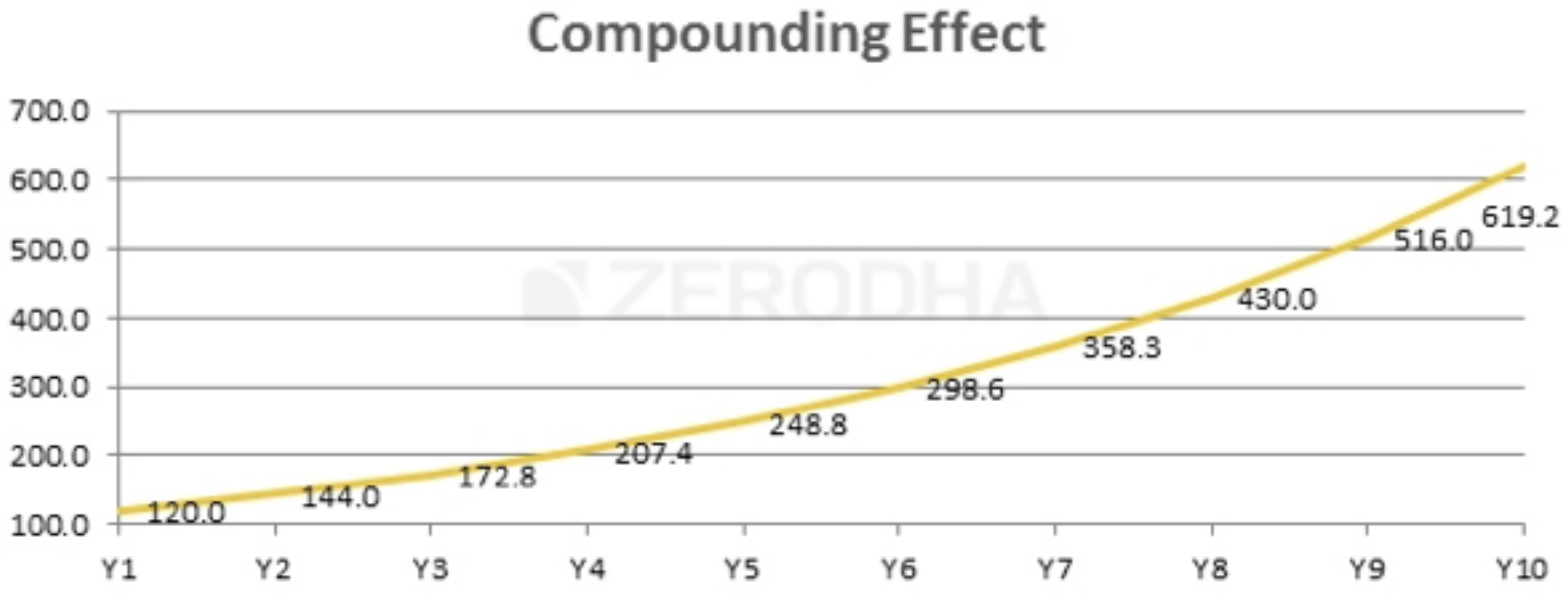
1. Let Rs.20 in profits remain invested along with the original principal of Rs.100 or

2. Withdraw the profits of Rs.20.

You decide not withdraw Rs.20 profit; instead you decide to reinvest the money for the 2nd year. At the end of 2nd year, Rs.120 grows to Rs.144. At the end of 3rd year Rs.144 grows to Rs.173. So on and so forth.

Compare this with withdrawing Rs.20 profits every year. Had you opted to withdraw Rs.20 every year then at the end of 3rd year the profits would have been just Rs. 60.

However since you decided to stay invested, the profits at the end of 3 years is Rs.173. A good Rs.13 or 21.7% over Rs.60 is generated just because you opted to do nothing and decided to stay invested. This is called the compounding effect. Let us take this analysis a little further, have a look at the chart below:



The chart above shows how Rs.100 invested at 20% grows over a 10 year period. If you notice, it took 4 years for the money to grow from Rs.100 to Rs.207 (about 107% absolute return). However as time progressed, from the 7th year onwards the acceleration increased and it took only 3 years for a return of 107% to be generated (from 298 to 620).

This is in fact the most interesting property of the compounding effect. The longer you stay invested, the harder the money works for you. This is exactly why Girish decided to stay invested – to exploit the luxury of time that the market offers.

All investments made based on fundamental analysis require the investors to stay committed for the long term. The investor has to develop this mindset while he chooses to invest.

2.3 – Does investing work?

Think about a sapling – if you give it the right amount of water, manure, and care would it not grow? Of course it will. Likewise, think about a good business with healthy sales, great margins, innovative products, and an ethical management. Is it not obvious that the share price of such companies would appreciate? In some situations the price appreciation may delay (recall the Eicher Motors chart from previous chapter), but it certainly will always appreciate. This has happened over and over again across markets in the world, including India.

An investment in a good company defined by **investable grade attributes** will always yield results. However, one has to develop the appetite to digest short term market volatility.

2.4 – Investible grade attributes? What does that mean?

Like we discussed briefly in the previous chapter, an investible grade company has a few distinguishable characteristics. These characteristics can be classified under two heads namely the 'Qualitative aspect' and the 'Quantitative aspects'. The process of evaluating a fundamentally strong company includes a study of both these aspects. In fact in my personal investment practice, I give the qualitative aspects a little more importance over the quantitative aspects.

The Qualitative aspect mainly involves understanding the non numeric aspects of the business. This includes many factors such as:

1. **Management's background** – Who are they, their background, experience, education, do they have the merit to run the business, any criminal cases against the promoters etc
2. **Business ethics** – is the management involved in scams, bribery, unfair business practices

3. **Corporate governance** – Appointment of directors, organization structure, transparency etc

4. **Minority shareholders –** How does the management treat minority shareholders, do they consider their interest while taking corporate actions

5. **Share transactions** – Is the management buying/selling shares of the company through clandestine promoter groups

6. **Related party transactions** – Is the company tendering financial favors to known entities such as promoter's relatives, friends, vendors etc at the cost of the shareholders funds?

7. **Salaries paid to promoters** – Is the management paying themselves a hefty salary, usually a percentage of profits

8. **Operator activity in stocks** – Does the stock price display unusual price behavior especially at a time when the promoter is transacting in the shares

9. **Shareholders** – Who are the significant shareholders in the firm, who are the people with above 1% of the outstanding shares of the company

10. **Political affiliation** – Is the company or its promoters too close to a political party? Does the business require constant political support?

11. **Promoter lifestyle** – Are the promoters too flamboyant and loud about their lifestyle? Do they like to display their wealth?

A red flag is raised when any of the factors mentioned above do not fall in the right place. For example, if a company undertakes too many related party transactions then it would send a signal of favoritism and malpractice by the company. This is not good in the long run. So even if the company has great profit margins, malpractice is not acceptable. It would only be a matter of time before the market discovers matters pertaining to 'related party transactions' and punishes the company by bringing the stock price lower. Hence an investor would be better off not investing in companies with great margins if such a company scores low on corporate governance.

Qualitative aspects are not easy to uncover because these are very subtle matters. However a diligent investor can easily figure this out by paying attention to annual report, management interviews, news reports etc. As we proceed through this module we will highlight various qualitative aspects.

The quantitative aspects are matters related to financial numbers. Some of the quantitative aspects are straightforward while some of them are not. For example cash held in inventory is straight forward however 'inventory number of days' is not. This is a metric that needs to be cal-

culated. The stock markets pay a lot of attention to quantitative aspects. Quantitative aspects include many things, to name few:

1. Profitability and its growth

2. Margins and its growth

3. Earnings and its growth

4. Matters related to expenses

5. Operating efficiency

6. Pricing power

7. Matters related to taxes

8. Dividends payout

9. Cash flow from various activities

10. Debt – both short term and long term

11. Working capital management

12. Asset growth

13. Investments

14. Financial Ratios

The list is virtually endless. In fact, each sector has different metrics. For example:

Sl No.	For a Retail Industry:	For an Oil and Gas Industry:
1	Total number of stores	Oil to Natural Gas revenue ratio
2	Average sales per store	Exploration costs
3	Total sales per square foot	Opening oil balance (inventory)
4	Merchandise margins	Developed reserves
5	Owned store to franchisee ratio	Total production growth

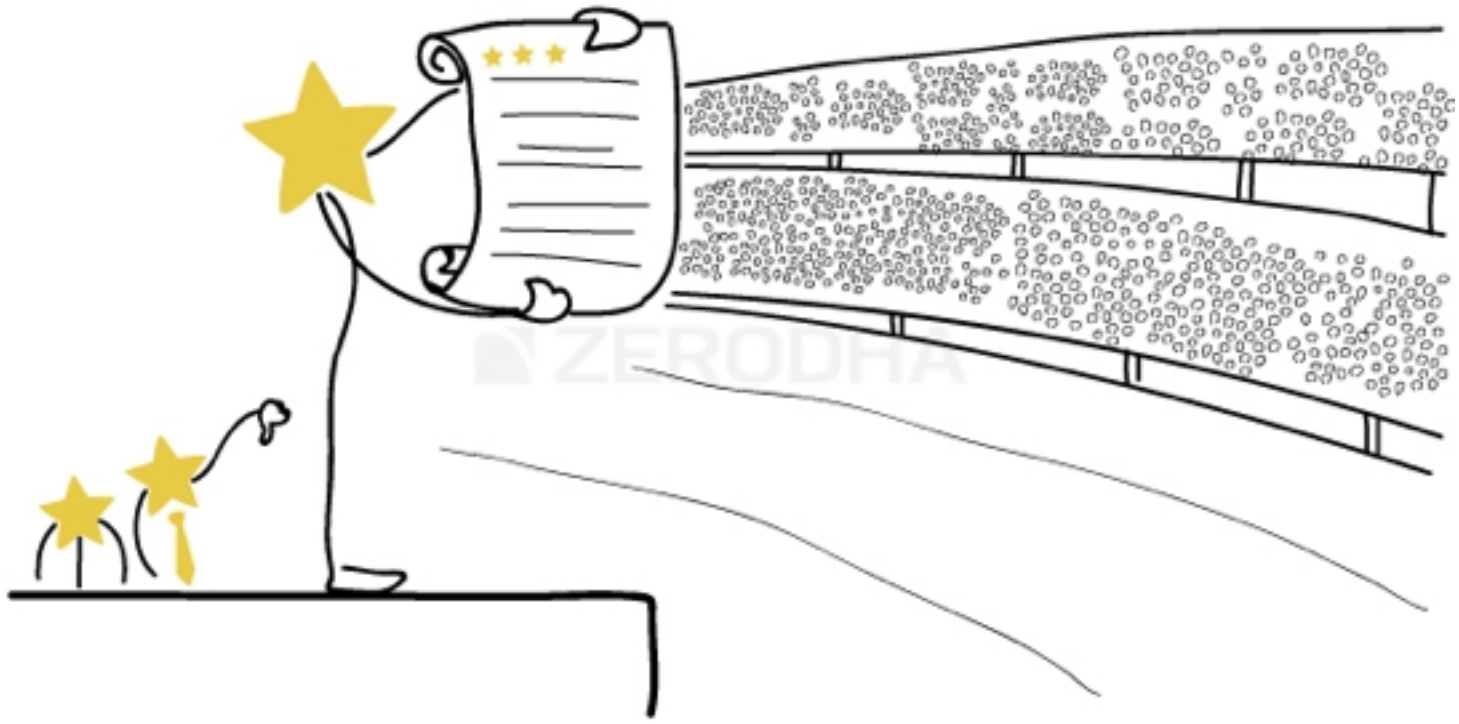
Over the next few chapters we will understand how to read the basic financial statements, as published in the annual report. As you may know, the financial statement is the source for all the number crunching as required in the analysis of quantitative aspects.

Key takeaways from this chapter:

1. The mindset of a trader and an investor is different
2. The investor has to develop an investment mindset if he is serious about investing
3. The investor should stay invested for a long period of time for the returns to compound
4. The speed at which the money doubles increases drastically the more time you stay invested. This is one of the properties of compounding
5. Every investment has to be evaluated on two aspects – qualitative & quantitative
6. Qualitative aspects revolve around the non numeric information related to the company
7. The quantitative aspects involve analyzing numeric data. The financial statements are the important source of finding the quantitative data.

CHAPTER 3

How to Read the Annual Report of a Company



3.1 – What is an Annual Report?

The annual report (AR) is a yearly publication by the company and is sent to the shareholders and other interested parties. The annual report is published by the end of the Financial Year, and all the data made available in the annual report is dated to 31st March. The AR is usually available on the company's website (in the investors section) as a PDF document or one can contact the company to get a hard copy of the same.

Since the annual report is published by the company, whatever is mentioned in the AR is assumed to be official. Hence, any misrepresentation of facts in the annual report can be held against the company. To give you a perspective, AR contains the auditor's certificates (signed, dated, and sealed) certifying the sanctity of the financial data included in the annual report.

Potential investors and the present shareholders are the primary audience for the annual report. Annual reports should provide the most pertinent information to an investor and should also communicate the company's primary message. For an investor, the annual report must be the default option to seek information about a company. Of course there are many media websites

claiming to give the financial information about the company; however the investors should avoid seeking information from such sources. Remember the information is more reliable if we get it get it directly from the annual report.

Why would the media website misrepresent the company information you may ask? Well, they may not do it deliberately but they may be forced to do it due to other factors. For example the company may like to include 'depreciation' in the expense side of P&L, but the media website may like to include it under a separate header. While this would not impact the overall numbers, it does interrupt the overall sequencing of data.

3.2 – What to look for in an Annual Report?

The annual report has many sections that contain useful information about the company. One has to be careful while going through the annual report as there is a very thin line between the facts presented by the company and the marketing content that the company wants you to read.

Let us briefly go through the various sections of an annual report and understand what the company is trying to communicate in the AR. For the sake of illustration, I have taken the Annual Report of Amara Raja Batteries Limited, belonging to Financial Year 2013-2014. As you may know Amara Raja Batteries Limited manufactures automobile and industrial batteries. You can download ARBL's FY2014 AR from here (http://www.amararaja.co.in/annual_reports.asp)

Please remember, the objective of this chapter is to give you a brief orientation on how to read an annual report. Running through each and every page of an AR is not practical; however, I would like to share some insights into how I would personally read through an AR, and also help you understand what kind of information is required and what information we can ignore.

For a better understanding, I would urge you to download the Annual Report of ARBL and go through it simultaneously as we progress through this chapter.

ARBL's annual report contains the following 9 sections:

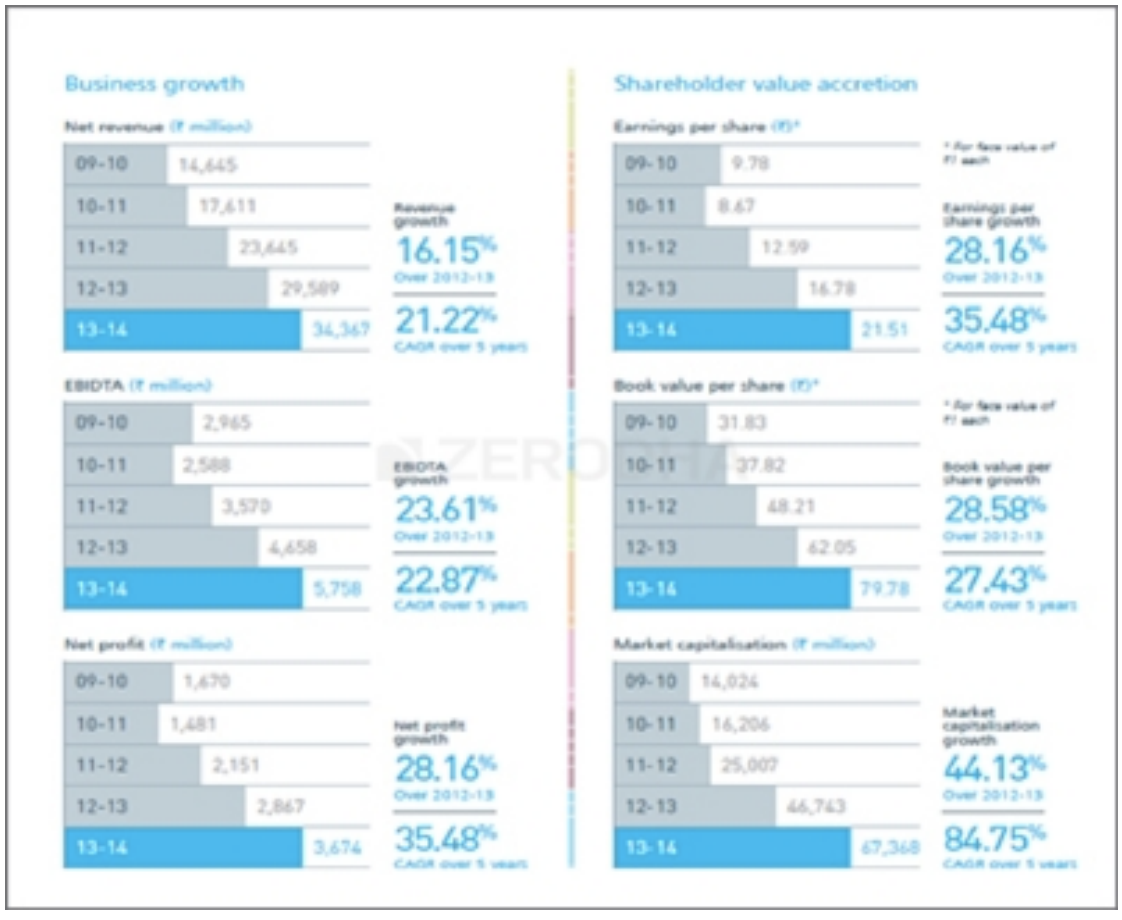
- Financial Highlights
- The Management Statement
- Management Discussion & Analysis
- 10 year Financial highlights
- Corporate Information
- Director's Report

- Report on Corporate governance
- Financial Section, and
- Notice

Note, no two annual reports are the same; they are all made to suite the company's requirement keeping in perspective the industry they operate in. However, some of the sections in the annual report are common across annual reports.

The first section in ARBL's AR is the **Financial Highlights**. Financial Highlights contains the bird's eye view on how the financials of the company looks for the year gone by. The information in this section can be in the form of a table or a graphical display of data. This section of the annual report generally does a multi-year comparison of the operating and business metrics.

Here is the snapshot of the same:



The details that you see in the Financial Highlights section are basically an extract from the company's financial statement. Along with the extracts, the company can also include a few financial ratios, which are calculated by the company itself. I briefly look through this section to get an overall idea, but I do not like to spend too much time on it. The reason for looking at this section briefly is that, I would anyway calculate these and many other ratios myself and while I do so, I would gain greater clarity on the company and its numbers. Needless to say, over the next few

chapters we will understand how to read and understand the financial statements of the company and also how to calculate the financial ratios.

The next two sections i.e the **'Management Statement'** and **'Management Discussion & Analysis'** are quite important. I spend time going through these sections. Both these sections gives you a sense on what the management of the company has to say about their business and the industry in general. As an investor or as a potential investor in the company, every word mentioned in these sections is important. In fact some of the details related to the 'Qualitative aspects' (as discussed in chapter 2), can be found in these two sections of the AR.

In the 'Management Statement' (sometimes called the Chairman's Message), the investor gets a perspective of how the man sitting right on top is thinking about his business. The content here is usually broad based and gives a sense on how the business is positioned. When I read through this section, I look at how realistic the management is. I am very keen to see if the company's management has its feet on the ground. I also observe if they are transparent on discussing details on what went right and what went wrong for the business.

One example that I explicitly remember was reading through the chairman's message of a well established tea manufacturing company. In his message, the chairman was talking about a revenue growth of nearly 10%, however the historical revenue numbers suggested that the company's revenue was growing at a rate of 4-5%. Clearly in this context, the growth rate of 10% seemed like a celestial move. This also indicated to me that the man on top may not really be in sync with ground reality and hence I decided not to invest in the company. Retrospectively when I look back at my decision not to invest, it was probably the right decision.

Here is the snapshot of Amara Raja Batteries Limited; I have highlighted a small part that I think is interesting. I would encourage you to read through the entire message in the Annual Report.

dear friends,

The Company's product sales are climbing; brands have been a resounding success; factories are buzzing with activity; people are happy and you, the shareholders, are satisfied.

Logic says we should be content. Rationality guides us to make incremental investments. Prudence advises cautious aggression.

At this crucial juncture, we can either be satisfied with the bountiful returns; or undertake the challenge of doing the extraordinary that transforms the perception of the brand and the corporate in the minds of the whole. Here at Amara Raja, we have opted for the latter option. Case in point: we initiated our largest capacity augmentation exercise at a time when most corporates chose to put their capex investments on the backburner.

Because Amara Raja has relentlessly attempted to outperform the prevailing growth averages. And has inevitably made it happen through a combination of superior product quality, distinctive positioning, attractive price-value proposition, enduring OEM customer relationships, deeper distribution network, prudent fiscal management and a proactive ability to invest ahead of the curve.

The efficacy of this approach is reflected in the superior numbers that Amara Raja posted in 2013-14 – 16.15% increase in revenues, 28.16% in profit after tax, growth in return on capital employed by 78 bps - even as the Indian economy reported its second slowest growth of the last 10 years in 2013-14.

Recharged

Recharged – this single word aptly sums up the energy within Amara Raja's team, which provides assurance that our largest capacity augmentation investment will turn out to be an unprecedented success. For it is not

Moving ahead, the next section is the or 'MD&A'. This according to me is perhaps one of the most important sections in the whole of AR. The most standard way for any company to start this section is by talking about the macro trends in the economy. They discuss the overall economic activity of the country and the business sentiment across the corporate world. If the company has high exposure to exports, they even talk about global economic and business sentiment.

ARBL has both exports and domestic business interest; hence they discuss both these angles in their AR. See the snapshot below:

a real

sense

of our performance and plans

Global economy

The global economy remain subdued as global GDP growth decelerated for the third year – 3.9% in 2011 to 3.1% in 2012 and 3% in 2013. Most developed economies addressed the reality through appropriate remedial fiscal policy action. Besides, a number of emerging economies, which had already experienced a debilitating slowdown in the past two years, encountered new domestic and international headwinds during this period.

Prospects: Looking ahead, global growth is projected to strengthen to 3.6% in 2014 and 3.9% in 2015 (Source: IMF April 2014). Global activity is expected to improve during 2014-15, with much of the impetus coming from advanced economies. Many emerging market economies account for more than two-thirds of global growth and their output growth is likely to be lifted by exports to advanced economies.

Challenge: Global recovery is still fragile despite improved prospects with significant downside risks. Among old risks, those related to emerging market economies increased. According to the Global Financial Stability Report, rapid normalisation of the American monetary policy or renewed bouts of high risk aversion on the part of investors could result in further pain *(Source: IMF, April 2014).*

Indian economy

India's economic growth of 4.7% in 2013-14 was marginally higher than the previous year due to an improved performance in the agriculture and allied sectors.

The slowdown was primarily due to an unsupportive external environment, regulatory policy logjam, structural constraints and inflation. Despite these challenges, there were positives which provided a foundation for resurgence:

The current account deficit contracted; the fiscal deficit target was met

India implemented substantive measures to narrow external and fiscal imbalances, tighten monetary policy, move forward on structural reforms and address market volatility to reduce vulnerability

India built upon its foreign exchange reserves

The Indian economy is placed better than what it was in 2013. A dynamic government at the Centre strengthens optimism of robust economic growth, which is projected at 5.6% in 2014, rising to 6.0% in 2015 (Source: RBI).

User sectors

Telecom: India's telecom industry posted a 10.1% revenue growth in 2013-14 from 8.6% in the previous fiscal despite intense competition and call rates declining to an all-time low. The improvement was largely a result of growth in the wireless subscriber base, reduced churn levels and an improvement in revenue realisation.

More importantly, 2013-14 will be regarded as a transformational year for the industry. The uncertainty of the previous years ended with fresh spectrum auctions taking place. The Department of Telecom, Government of India, announced significant initiatives - revision of the 'tower rollout policy' and the 'mergers and acquisitions

Chilling plant cooling towers

New plant at Nunegundapalle village

ARBL's view on the Indian economy:

Following this the companies usually talk about the trends in the industry and what they expect for the year ahead. This is an important section as we can understand what the company perceives as threats and opportunities in the industry. Most importantly I read through this, and also compare it with its peers to understand if the company has any advantage over its peers.

For example, if Amara Raja Batteries limited is a company of interest to me, I would read through this part of the AR and also would read through what Exide Batteries Limited has to say in their AR.

Remember until this point the discussion in the Management Discussion & Analysis is broad based and generic (global economy, domestic economy, and industry trends). However going forward, the company would discuss various aspects related to its business. It talks about how the business had performed across various divisions, how did it fare in comparison to the previous year etc. The company in fact gives out specific numbers in this section.

Here is a snapshot of the same:

Overview	Products	Distribution network	Customers	Niche features
Commenced operations in 2000 with technology from Johnson Controls Inc. USA **Manufacturing** facility is QS-9000, ISO-14001 and TS- 16949 certified	**Passenger cars:** Amaron® Pro, Amaron® Flo, Amaron® Go, Amaron® Black and Amaron® Fresh **Commercial vehicles:** Amaron® Hiway **Tractors:** Amaron® Harvest **Two-wheelers:** Amaron Pro Bike Rider™	**Amaron® network** comprises 294 franchised distributors, including 25,000-plus retailers **PowerZone™ network** comprises 1,100 retail outlets ensuring widespread semi-urban and rural presence	**Major OEM customers:** Ford, Maruti Suzuki, Hyundai, Honda, M&M, Tata, Volvo, Eicher, Daimler Benz, Tafe Tractors, Isuzu Motors among others **Major private label customers:** Bosch, Lucas, Cummins and AC Delco **Leading player** in the aftermarket segment among four-wheelers	**Battery** supplier to the entire 'Comfort Delgro' taxi fleet in Singapore **100%** share of business with Ford India and Daimler Benz **100%** share of business in Maruti A-Star exports and Hyundai EON **First** supplier of batteries to Mahindra and Mahindra for Scorpio micro hybrid vehicles **First** to introduce zero maintenance four-wheeler batteries and VRLA two-wheeler batteries **First** to provide extended warranties to consumers

Some companies even discuss their guidelines and strategies for the year ahead across the various verticals they operate in. Do have a look at the snapshot below:

Rising rural income: The government shifted its focus towards rural sector development. The government's crop price support policy over the last five years has led to higher rural incomes.

Aftermarket

Every vehicle added on Indian roads creates an aftermarket opportunity as batteries need to be changed every few years. So while OE demand extends only to assembly, the aftermarket demand stays upbeat across useful asset life, making the aftermarket a significantly larger opportunity. And while the OE market may experience volatility consequent to economic and business cycles, the aftermarket growth rate remains relatively stable.

Since the battery is a critical component in every automobile (including a two-wheeler), long life and reliability are the most important factors influencing purchase. With the organised sector providing a superior value-proposition, there is an increasing shift towards branded batteries in the aftermarket segment.

Amara Raja's strategy

Aftermarket: The Company's significant presence in the aftermarket segment de-risks it from sectoral cyclicality. Going forward, the Company will continue to strengthen its distribution network by entering areas where its penetration is low, filling gaps in its product range and ensuring supply chain efficiency. Moreover, the Company will continue to invest in brand promotion and ground-level initiatives to develop a stronger bond with customers, retailers and distributors.

OE market: While the aftermarket is the key revenue earner, the Company is also working to forge stronger relationships with leading and reputed OE players in the automotive market, which will increase its brand preference at the time of replacement.

India's automotive sector performance

CAGR for last five years (2007-08 to 2012-13)

Total: 11.6%, Cars: 11.3%, UVs: 10.4%, 3Ws: 10.0%, LCVs: 16.0%, M&HCVs: 1.1%, Tractors: 10.7%

(Source: SIAM)

After discussing these in 'Management Discussion & Analysis' the annual report includes a series of other reports such as – Human Resources report, R&D report, Technology report etc. Each of these reports are important in the context of the industry the company operates in. For example, if I am reading through a manufacturing company annual report I would be particularly interested in the human resources report to understand if the company has any labor issues. If there are serious signs of labor issues then it could potentially lead to the factory being shut down, which is not good for the company's shareholders.

3.3 – The Financial Statements

Finally, the last section of the AR contains the financial statements of the company. As you would agree, the financial statements are perhaps one of the most important aspects of an Annual Report. There are three financial statements that the company will present namely:

1. The Profit and Loss statement
2. The Balance Sheet and
3. The Cash flow statement

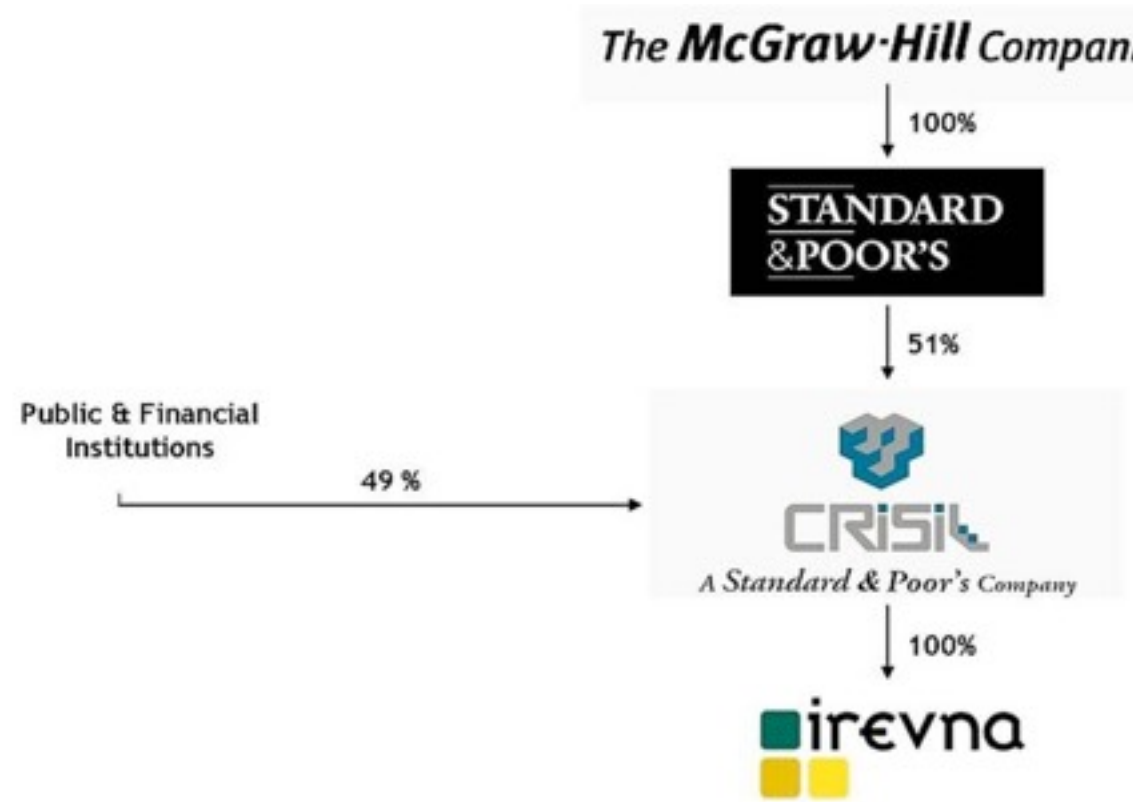
We will understand each of these statements in detail over the next few chapters. However at this stage it is important to understand that the financial statements come in two forms.

1.Standalone financial statement or simply standalone numbers and

2.Consolidated financial statement or simply consolidated numbers

To understand the difference between standalone and consolidated numbers, we need to understand the structure of a company.

Typically, a well established company has many subsidiaries. These companies also act as a holding company for several other well established companies. To help you understand this better, I have taken the example of CRISIL Limited's shareholding structure. You can find the same in CRISIL's annual report. As you may know, CRISIL is an Indian company with a major focus on corporate credit rating services.



As you can see in the above share holding structure:

a. Standard & Poor's (S&P), a US based rating agency holds a 51% stake in CRISIL. Hence S&P is the 'Holding company' or the 'Promoter' of CRISIL

b. The balance 49% of shares of CRISIL is held by Public and other Financial institutions

c. However, S&P itself is 100% subsidiary of another company called 'The McGraw-Hill Companies'

- This means McGraw Hill fully owns S&P, and S&P owns 51% of CRISIL

d. Further, CRISIL itself fully owns (100% shareholding) another company called 'Irevna'.

Keeping the above in perspective, think about this hypothetical situation. Assume, for the financial year 2014, CRISIL makes a loss of Rs.1000 Crs and Irevna, its 100% subsidiary makes a profit of Rs.700 Crs. What do you would be the overall profitability of CRISIL?

Well, this is quite simple – CRISIL on its own made a loss of Rs.1000 Crs, but its subsidiary Irevna made a profit of Rs.700 Crs, hence the overall P&L of CRISIL is (Rs.1000 Crs) + Rs.700 Crs = (Rs.300 Crs).

Thanks to its subsidiary, CRISIL's loss is reduced to Rs.300 Crs as opposed to a massive loss of Rs.1000 Crs. Another way to look at it is, CRISIL on a **standalone** basis made a loss of Rs.1000 Crs, but on a **consolidated** basis made a loss of Rs.300 Crs.

Hence, Standalone Financial statements represent the standalone numbers/ financials of the company itself and do not include the financials of its subsidiaries. However the consolidated numbers includes the companies ((ie., standalone financials) and its subsidiaries financial statements.

I personally prefer to look through the consolidated financial statements as it gives a better representation of the company's financial position.

3.4 – Schedules of Financial Statements

When the company reports its financial statements, they usually report the full statement in the beginning and then follow it up with a detailed explanation.

Have a look at the snapshot of one of ARBL's financial statement (balance sheet):

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

Each particular in the financial statement is referred to as the line item. For example, the first line item in the Balance Sheet (under Equity and Liability) is the share capital (as pointed out by the green arrow). If you notice, there is a note number associated with share capital. These are called the 'Schedules' related to the financial statement. Looking into the above statement, ARBL states that the share capital stands at Rs.17.081 Crs (or Rs.170.81 Million). As an investor I obviously would be interested to know how ARBL arrived at Rs.17.081 Crs as their share capital. To figure this out, one needs to look into the associated schedule (note number 2). Please look at the snap-shot below:

Notes forming part of the Financial Statements

NOTE 2: SHARE CAPITAL

₹ million

Particulars	As at March 31, 2014	As at March 31, 2013
Equity share capital		
Authorised		
200,000,000 Equity shares of ₹1 each	200.00	200.00
Issued	-	-
175,028,500 Equity shares of ₹1 each	175.03	175.03
Subscribed and paid up	-	-
170,812,500 Equity shares of ₹1 each	170.81	170.81
Total	170.81	170.81

Of course, considering you may be new to financial statements, jargons like share capital make not make much sense. However the financial statements are extremely simple to understand, and over the next few chapters you will understand how to read the financial statements and make sense of it. But for now do remember that the main financial statement gives you the sum-mary and the associated schedules give the details pertaining to each line item.

Key takeaways from this chapter

1. The Annual Report (AR) of a company is an official communication from the company to its investors and other stakeholders

2. The AR is the best source to get information about the company; hence AR should be the default choice for the investor to source company related information

3. The AR contains many sections, with each section highlighting certain aspect of the business

4. The AR is also the best source to get information related to the qualitative aspects of the company

5. The management discussion and analysis is one of the most important sections in the AR. It has the management's perspective on the overall economy of the country, their outlook on the industry they operate in for the year gone by (what went right and what went wrong), and what they foresee for the year ahead

6. The AR contains three financial statements – Profit & Loss statement, Balance Sheet, and Cash Flow statements

7. The standalone statement contains the financial numbers of only the company in consideration. However the consolidated numbers contains the company and its subsidiaries financial numbers.

CHAPTER 4

Understanding P&L Statement (Part 1)

4.1 – Overview of the financial statements

You can think about the financial statements from two different angles:

1. From the maker's perspective
2. From the user's perspective

A maker prepares the financial statements. He is typically a person with an accounting background. His job involves preparing ledger entries, matching bills and receipts, tallying the inflows versus the outflows, auditing etc. The final objective of the maker is to prepare transparent financial statements which best represents the true financial position of the company. To prepare such a financial statement certain skills are required, usually these skills are developed through the rigor of a Chartered Accountant's training program.

The user on the other hand just needs to be in a position to understand what the maker has prepared. He is just the user of the financial statements. He need not really know the details of the journal entries or the audit procedure. His main concern is to read what is being stated and use it to make his decisions.

To put this in context, think about Google. Most of us do not understand Google's complex search engine algorithm that runs in the backend, however we all know how to use Google effectively. Such is the distinction between the maker and the user of the financial statements.

A common misconception amongst the market participants is that, they believe the fundamental analyst needs to be thorough with concepts of financial statement preparation. While knowing this certainly helps, it is not really required. To be a fundamental analyst, one just needs to be the user and not the maker of the financial statements.

There are three main financial statements that a company showcases to represent its performance.

1. The Profit and Loss statement

2. The Balance Sheet
3. The Cash flow statement

Over the next few chapters we will understand each of these statements from the user's perspective.

4.2 – The Profit and Loss statement

The Profit and Loss statement is also popularly referred to as the P&L statement, Income Statement, Statement of Operations, and Statement of Earnings. The Profit and Loss statement shows what has transpired during a time period. The P&L statement reports information on:

1. The revenue of the company for the given period (yearly or quarterly)
2. The expenses incurred to generate the revenues
3. Tax and depreciation
4. The earnings per share number

From my experience, the financial statements are best understood by looking at the actual statement and figuring out the information. Hence, here is the P&L statement of Amara Raja Batteries Limited (ARBL). Let us understand each and every line item.

Statement of Profit and Loss for the year ended March 31,2014

₹ million

Particulars	Note No.	Year ended March 31, 2014	Year ended March 31, 2013
REVENUE			
Sale of products		38,041.27	32,949.37
Less: Excise duty		4,005.15	3,512.45
Net sale of products		34,036.12	29,436.92
Sale of services		309.32	137.02
Other operating revenue		21.15	15.21
Net revenue from operations	17	34,366.59	29,589.15
Other income	18	455.14	465.51
Total Revenue		**34,821.73**	**30,054.66**
EXPENSES			
Cost of materials consumed	19	21,011.95	17,603.12
Purchases of stock-in-trade	20	2,113.69	2,632.54
Changes in inventories of finished goods, work-in-process and stock-in-trade	20	(292.10)	(320.89)
Employee benefits expense	21	1,583.16	1,262.30
Finance costs	22	7.18	2.69
Depreciation and amortisation expense [includes impairment loss of ₹Nil (PY ₹75.52 million)]	23	645.71	660.92
Other expenses	24	4,346.60	3,904.24
Total Expenses		**29,416.19**	**25,744.92**
Profit before exceptional items and tax		**5,405.54**	**4,309.74**
Less: Exceptional items (net)	33	38.84	91.57
Profit before tax		**5,366.70**	**4,218.17**
Less: Tax expense			
Current tax		1,580.00	1,377.97
Deferred tax (credit) / expense		106.23	(24.51)
Earlier year's (excess) / short provision		6.11	(2.34)
Profit for the year		**3,674.36**	**2,867.05**
Basic and diluted earnings per equity share of ₹1 each	37	21.51	16.78

4.3 – The Top Line of the company (Revenue)

You may have heard analysts talk about the top line of a company. When they do so, they are referring to the revenue side of the P&L statement. The revenue side is the first set of numbers the company presents in the P&L.

Before we start understanding the revenue side, let us notice a few things mentioned on the header of the P&L statement:

Statement of Profit and Loss for the year ended March 31,2014 ₹ million

Particulars	Note No.	Year ended March 31, 2014	Year ended March 31, 2013

The header clearly states:

1. The statement of P&L for the year **ending** March 31, 2014, hence this is an annual statement and not a quarterly statement. Also, since it is as of March 31st 2014 it is evident that the statement is for the Financial Year 2013 – 2014 or simply it can be referred to as the FY14 numbers

2. All currency is denominated in Rupee Million. Note – 1 Million Rupees is equal to Ten Lakh Rupees. It is upto the company's discretion to decide which unit they would prefer to express their numbers in

3. The particulars show all the main headings of the statement. Any associated note to the particulars is present in the note section (also called the schedule). An associated number is assigned to the note (Note Number)

4. By default when companies report the numbers in the financial statement they present the current year number on the left most column and the previous year number to the right. In this case the numbers are for FY14 (latest) and FY13 (previous)

The first line item on the revenue side is called the **Sale of Products.**

Since we know we are dealing with a batteries company, clearly sale of products means the Rupee value of all the battery sales the company has sold during FY14. The sales stand at Rs.38,041,270,000/- or about Rs.3,804 Crore. The company sold batteries worth Rs.3,294 Cr in the previous financial year i.e FY13.

Please note, I will restate all the numbers in Rupee Crore as I believe this is more intuitive to understand.

The next line item is the excise duty. This is the amount (Rs.400 Crs) the company would pay to the government; hence the revenue has to be adjusted.

The revenue adjusted after the excise duty is the **net sales of the company**. The net sales of ARBL is Rs.3403 Crs for the FY14. The same was Rs.2943 Crs for the FY13.

Apart from the sale of products, the company also draws revenue from services. This could probably be in the form of annual battery maintenance. The revenue from sale of services stands at Rs.30.9 Crs for FY14.

The company also includes “other operating revenues” at Rs.2.1 crs.This could be revenues through the sale of products or services that is incidental to the core operations of the company.

Finally the revenue from Sale of products + Sale of services + Other operating revenues sums up to give the **total operating revenue** of the company. This is reported at Rs.3436 Crs for the FY14 and Rs.2959 Crs for the FY13. Interesting, there is a note; numbered 17 associated with “Net Revenue from Operations” which will help us inspect this aspect further.

Do recall, in the previous chapter we had discussed about notes and schedules of the financial statement.

The following snapshot gives the details of note 17.

Notes forming part of the Financial Statements

NOTE 17: REVENUE FROM OPERATIONS

₹ million

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
a) Sale of products				
Storage batteries (finished goods)	35,237.83		30,363.83	
Storage batteries (stock-in-trade)	2,089.86		1,493.93	
Home UPS (stock-in-trade)	713.58		1,091.61	
Gross revenue from sale of products		38,041.27		32,949.37
Less: Excise duty		4,005.15		3,512.45
Net revenue from sale of products		34,036.12		29,436.92
b) Sale of services				
Installation and commissioning	49.14		17.36	
Annual maintenance	146.91		96.09	
Preventive maintenance	15.41		5.75	
Other services	97.86		17.82	
Net revenue from sale of services		309.32		137.02
c) Other operating revenue				
Sale of process scrap		21.15		15.21
Net revenue from operations		**34,366.59**		**29,589.15**

Clearly, the notes give a more detailed analysis of the split up of **revenues from operations** (does not include other income details). As you can see under the particulars, section 'a' talks about the split up under sales of products.

1. Sale of storage batteries in the form of finished goods for the year FY14 is Rs.3523 Crs versus Rs.3036 Crs for the FY13

2. Sale of Storage batteries (stock in trade) is Rs.208 Crs in FY14 versus 149 Crs in FY13. Stock in trade refers to finished goods of previous financial year being sold in this financial year

3. Sale of home UPS (stock in goods) is at Rs.71 Crs in FY14 versus Rs.109 Crs in FY13

4. Net sales from sales of products adjusted for excise duty amounts to Rs.3403 Crs, which matches with the number reported in the P&L statement

5. Likewise you can notice the split up for revenue from services. The revenue number of Rs.30.9 tallies with number reported in the P&L statement

6. In the note, the company says the "Sale of Process Scrap" generated revenue of Rs.2.1 Cr. Note that the sale of process scrap is incidental to the operations of the company, hence reported as 'Other operating revenue".

7. Adding up all the revenue streams of the company i.e Rs.3403 Crs+ Rs.30.9 Crs +Rs.2.1 Crs gets us the Net revenue from operations = Rs.3436 Crs.

8. You can also find similar split up for the FY13

If you notice the P&L statement, apart from net revenue from operations ARBL also reports 'Other Income' of Rs.45.5 Crs. Note number 18 reproduced below explains what the other income is all about.

NOTE 18: OTHER INCOME

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Interest Income		
On bank and other deposits	131.22	112.29
Against trade receivables	6.72	10.27
Dividend income		
On current investments - mutual funds	142.68	143.96
On long term investments - equity instruments	1.51	1.31
Net gain on foreign currency transactions and translations	89.88	91.71
Insurance claims	32.27	13.48
Scrap Sales (non-process)	14.07	6.94
Cash discount earned on early payments	10.74	43.35
Provisions and credit balances written back	3.90	6.44
Bad debts recovered	15.15	0.25
Profit on sale of tangible fixed assets written off/discarded	4.49	0.04
Provision on doubtful trade receivables/advances written back	0.30	35.06
Royalty income	0.94	-
Sundry income	1.27	0.41
Total	**455.14**	**465.51**

As we can see the other income includes income that is not related to the main business of the company. It includes interest on bank deposits, dividends, insurance claims, royalty income etc. Usually the other income forms a small portion of the total income. A large 'other income' usually draws a red flag and it would demand a further investigation.

So adding up revenue from operations (Rs.3436 Crs) and other income (Rs.45 Crs), we have the total revenue of for FY14 at Rs.3482 Crs.

Key takeaways from this chapter

1. The financial statement provides information and conveys the financial position of the company

2. A complete set of financial statements include the Profit & Loss Account, Balance Sheet and Cash Flow Statement

3. A fundamental Analyst is a user of financial statement, and he just needs to know what the maker of the financial statements states

4. The profit and loss statement gives the profitability of the company for the year under consideration

5. The P&L statement is an estimate, as the company can revise the numbers at a later point. Also by default companies publish data for the current year and the previous year, side by side

6. The revenue side of the P&L is also called the top line of the company

7. Revenue from operations is the main source of revenue for the company

8. Other operating income includes revenue incidental to the business

9. The other income includes revenue from non operating sources

10. The sum of revenue from operations (net of duty), other operating income, and other incomes gives the 'Net Revenue from Operations'

CHAPTER 5

Understanding P&L Statement (Part 2)

5.1 – The Expense details

In the previous chapter we had learnt about the revenues a company generates. Moving further on the P&L statement, in this chapter we will look at the expense side of the Profit and Loss Statement along with the associated notes. Expenses are generally classified according to their function, which is also called the cost of sales method or based on the nature of expense. An analysis of the expenses must be shown in the Profit and Loss statement or in the notes. As you can see in the extract below almost all the line items have a note associated to it.

EXPENSES			
Cost of materials consumed	19	21,011.95	17,603.12
Purchases of stock-in-trade	20	2,113.69	2,632.54
Changes in inventories of finished goods, work-in-process and stock-in-trade	20	(292.10)	(320.89)
Employee benefits expense	21	1,583.16	1,262.30
Finance costs	22	7.18	2.69
Depreciation and amortisation expense [includes impairment loss of ₹Nil (PY ₹75.52 million)]	23	645.71	660.92
Other expenses	24	4,346.60	3,904.24
Total Expenses		**29,416.19**	**25,744.92**

The first line item on the expense side is 'Cost of materials consumed'; this is invariably the cost of raw material that the company requires to manufacture finished goods. As you can see the cost of raw material consumed/raw material is the largest expense incurred by the company. This expense stands at Rs.2101 Crs for the FY14 and Rs.1760 Crs for the FY13. Note number 19 gives the associated details for this expense, let us inspect the same.

NOTE 19: COST OF MATERIALS CONSUMED *(Contd.)*

a) Materials consumed comprise

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Lead	9,882.97	8,221.83
Lead alloys	8,183.44	6,646.43
Separator	895.49	799.95
Others	2,050.05	1,934.91
Total	**21,011.95**	**17,603.12**

As you can see note 19 gives us the details of the material consumed. The company uses lead, lead alloys, separators and other items all of which adds up to Rs.2101 Crs.

The next two line items talks about 'Purchases of Stock in Trade' and 'Change in Inventories of finished goods , work–in-process & stock–in-trade'. Both these line items are associated with the same note (Note 20).

Purchases of stock in trade, refers to all the purchases of finished goods that the company buys towards conducting its business. This stands at Rs.211 Crs. I will give you more clarity on this line item shortly.

Change in inventory of finished goods refers to the costs of manufacturing incurred by the company in the past ,but the goods manufactured in the past were sold in the present/current financial year. This stands at (Rs.29.2) Crs for the FY14.

A negative number indicates that the company produced more batteries in the FY14 than it managed to sell. To give a sense of proportion (in terms of sales and costs of sales) the company deducts the cost incurred in manufacturing the extra goods from the current year costs. The company will add this cost when they manage to sell these extra products sometime in future. This cost, which the company adds back later, will be included in the "Purchases of Stock in Trade" line item.

Here is an extract of Note 20 which details the above two line items:

NOTE 20: PURCHASES OF STOCK IN TRADE AND CHANGES IN INVENTORIES OF FINISHED GOODS, WORK-IN-PROCESS AND STOCK-IN-TRADE

a) PURCHASE OF STOCK-IN-TRADE

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Storage batteries	1,619.44	1,437.71
Home UPS	494.25	1,194.83
Total	2,113.69	2,632.54

b) CHANGES IN INVENTORIES OF FINISHED GOODS, WORK-IN-PROCESS AND STOCK-IN-TRADE

₹ million

Particulars		Year ended March 31, 2014		Year ended March 31, 2013	
Work-in-process					
Opening stock	- Storage batteries	828.95		811.41	
Less: Closing stock	- Storage batteries	1,052.11	(223.16)	828.95	(17.54)
Finished goods					
Opening stock	- Storage batteries	536.44		563.49	
Less: Closing stock	- Storage batteries	941.75		536.44	
		(405.31)		27.05	
Less: Excise Duty on (increase) / decrease of finished goods		(41.95)	(363.36)	6.12	20.93
Stock-in-trade					
Opening stock	- Storage batteries	145.01		21.15	
	- Home UPS	223.97		23.55	
		368.98		44.70	
Less: Closing stock	- Storage batteries	36.73		145.01	
	- Home UPS	37.83		223.97	
		74.56	294.42	368.98	(324.28)
Net increase in inventories			(292.10)		(320.89)

The details mentioned on the above extract are quite straightforward and is easy to understand. At this stage it may not be necessary to dig deeper into this note. It is good to know where the grand total lies. However, when we take up 'Financial Modeling' as a separate module we will delve deeper into this aspect.

The next line item on the expense side is "Employee Benefit Expense". This is quite intuitive as it includes expense incurred in terms of the salaries paid, contribution towards provident funds, and other employee welfare expenses. This stands at Rs.158 Crs for the FY14. Have a look at the extract of note 21 which details the 'Employee Benefit Expense'.

NOTE 21: EMPLOYEE BENEFITS EXPENSE

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Salaries and wages	1,361.32	1,086.99
Contribution to provident and other funds	81.54	69.81
Staff welfare expenses	140.30	105.50
Total	1,583.16	1,262.30

Here is something for you to think about – A company generating Rs.3482 Crs is spending only Rs.158 Crs or just 4.5% of its sales on its employees. In fact this is the pattern across most of companies (at least non IT). Perhaps it is time for you to rethink about that entrepreneurial dream you may have nurtured J

The next line item is the "Finance Cost / Finance Charges/ Borrowing Costs". Finance cost is interest costs and other costs that an entity pays when it borrows funds. The interest is paid to the lenders of the company. The lenders could be banks or private lenders. The company's finance cost stands at Rs.0.7 Crs for the FY14. We will discuss more about debt and related matters when we take up the chapter on the balance sheet later.

Following the finance cost the next line item is "Depreciation and Amortization" costs which stand at Rs.64.5 Crs. To understand depreciation and amortization we need to understand the concept of tangible and intangible assets.

A tangible asset is one which has a physical form and provides an economic value to the company. For example a laptop, a printer, a car, plants, machinery, buildings etc.

An intangible asset is something that does not have a physical form but still provides an economic value to the company such as brand value, trademarks, copyrights, patents, franchises, customer lists etc.

An asset (tangible or intangible) has to be depreciated over its useful life. Useful life is defined as the period during which the asset can provide economic benefit to the company. For example the useful life of a laptop could be 4 years. Let us understand depreciation better with the help of the following example.

Zerodha, a stock broking firm generates Rs.100,000/- from the stock broking business. However Zerodha incurred an expense of Rs.65,000/- towards the purchase of a high performance computer server. The economic life (useful life) of the server is expected to be 5 years. Now if you were to look into the earning capability of Zerodha it appears that on one hand Zerodha earned Rs.100,000/- and on the other hand spent Rs.65,000/- and therefore retained just Rs.35,000/-. This skews the earnings data for the current year and does not really reflect the true earning capability of the company.

Remember the asset even though purchased this year, would continue to provide economic benefits over its useful life. Hence it makes sense to spread the cost of acquiring the asset over its useful life. This is called depreciation. This means instead of showing an upfront lump sum expense

(towards purchase of an asset), the company can show a smaller amount spread across the useful life of an asset.

Thus Rs.65,000/- will be spread across the useful life of the server, which is 5. Hence 65,000/ 5 = Rs.13,000/- would be depreciated every year over the next five years. By depreciating the asset, we are spreading the upfront cost. Hence after the depreciation computation, Zerodha would now show its earrings as Rs.100,000 – Rs.13,000 = Rs.87,000/-.

We can do a similar exercise for non tangible assets. The depreciation equivalent for non tangible assets is called amortization.

Now here is an important idea – Zerodha depreciates the cost of acquiring an asset over its useful life. However, in reality there is an actual outflow of Rs.65,000/- paid towards the asset purchase. But now, it seems like the P&L is not capturing this outflow. As an analyst, how do we get a sense of the cash movement? Well, the cash movement is captured in the cash flow statement, which we will understand in the later chapters.

Here is the snapshot of Note 23, detailing the depreciation cost.

NOTE 23: DEPRECIATION AND AMORTISATION EXPENSE

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Depreciation	634.41	652.72
Amortisation	11.30	8.20
Total	645.71	660.92

Note: Depreciation includes impairment provision on freehold land of ₹NIL (PY ₹75.52 million).

The last line item on the expense side is “other expenses” at Rs.434.6 Crs. This is a huge amount classified under ‘other expenses’, hence it deserves a detailed inspection.

NOTE 24: OTHER EXPENSES

₹ million

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
A. Manufacturing expenses				
a. Stores and spares consumed (including packing material)		449.41		378.41
b. Power and fuel		922.56		978.14
c. Insurance		8.49		7.29
d. Repairs and maintenance to				
i) Machinery	44.46		55.79	
ii) Buildings	18.72	63.18	14.28	70.07
Total (A)		1,443.64		1,433.91
B. Selling expenses				
a. Advertisement and promotion		275.85		154.41
b. Freight outward		595.20		553.25
c. Commission on sales		8.40		10.13
d. Service expenses		219.36		94.16
e. Warehousing and secondary freight		250.50		223.43
f. Other sales expenses		242.15		155.81
g. Royalty on sales		-		0.05
h. Product warranties		383.15		494.62
Total (B)		1,974.61		1,685.86

NOTE 24: OTHER EXPENSES *(Contd.)*

₹ million

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
C. Administrative expenses				
a. Rent		114.10		98.31
b. Commission to Non-Executive Chairman		175.99		140.88
c. Payment to Auditors (Refer Note No. 28)		3.92		2.73
d. Research and development expenses		4.00		2.83
e. Donations		135.42		112.23
f. Travel and conveyance		147.00		116.70
g. Repairs and maintenance to office equipment		18.50		10.27
h. Communication expenses		18.81		16.58
i. Consultancy charges		34.45		39.18
j. Information technology expenses		26.62		18.71
k. Office maintenance expenses		92.79		83.24
l. Loss on sale of current investments		0.20		-
m. Sundry expenses		96.52		77.71
Total (C)		**868.32**		**719.37**
D. Other expenses				
a. Provision for doubtful trade receivables		0.07		-
b. Bad debts and irrecoverable advances written off	32.33		4.84	
Less: Opening provision reversed	30.27	2.06	3.63	1.21
c. Tangible fixed assets written off		24.90		44.27
d. Premium on forward contracts		1.08		-
Total (D)		**28.11**		**45.48**
E. Rates and taxes (excluding Income tax)				
a. Rates, taxes and licenses		5.57		3.63
b. Duties and taxes (indirect taxes)		24.35		14.16
c. Wealth tax		2.00		1.83
Total (E)		**31.92**		**19.62**
Grand Total (A+B+C+D+E)		**4,346.60**		**3,904.24**

From the note it is quite clear that other expenses include manufacturing, selling, administrative and other expenses. The details are mentioned in the note. For example, Amara Raja Batteries Limited (ARBL) spent Rs.27.5 Crs on advertisement and promotional activities.

Adding up all the expenses mentioned in the expense side of P&L, it seems that Amara Raja Batteries has spent Rs.2941.6 Crs.

5.2 – The Profit before tax

It refers to the net operating income after deducting operating expenses but before deducting taxes and interest. Proceeding further on the P&L statement we can see that ARBL has mentioned their profit before tax and exceptional item numbers.

Simply put the profit before tax (PBT) is:

Profit before Tax = Total Revenues – Total Operating Expenses

= Rs.3482 – Rs.2941.6

=Rs.540.5

However there seems to be an exceptional item/ extraordinary item of Rs.3.8 Crs, which needs to be deducted. Exceptional items/ extraordinary items are expenses occurring at one odd time for

the company and the company does not foresee this as a recurring expense. Hence they treat it separately on the P&L statement.

Hence profit before tax and extraordinary items will be:

= 540.5 – 3.88

= **Rs.536.6 Crs**

The snapshot below (extract from P&L) shows the PBT(Profit Before Tax) of ARBL:

Profit before exceptional items and tax		5,405.54	4,309.74
Less: Exceptional items (net)	33	38.84	91.57
Profit before tax		5,366.70	4,218.17

5.3 – Net Profit after tax

The net operating profit after tax is defined as the company's operating profit after deducting its tax liability. We are now looking into the last part of the P&L statement, which is the profit after tax. This is also called the bottom line of the P&L statement.

Profit before tax		5,366.70	4,218.17
Less: Tax expense			
Current tax		1,580.00	1,377.97
Deferred tax (credit) / expense		106.23	(24.51)
Earlier year's (excess) / short provision		6.11	(2.34)
Profit for the year		3,674.36	2,867.05
Basic and diluted earnings per equity share of ₹1 each	37	21.51	16.78

As you can see from the snapshot above, to arrive at the profit after tax (PAT) we need to deduct all the applicable tax expenses from the PBT. Current tax is the corporate tax applicable for the given year. This stands at Rs.158 Crs. Besides this, there are other taxes that the company has paid. All taxes together total upto Rs.169.21 Crs. Deducting the tax amount from the PBT of Rs.536.6 gives us the profit after tax (PAT) at Rs.367.4 Crs.

Hence Net **PAT = PBT – Applicable taxes.**

The last line in the P&L statement talks about basic and diluted earnings per share. The EPS is one of the most frequently used statistics in financial analysis. EPS also serves as a means to assess the stewardship and management role performed by the company directors and managers. The earnings per share (EPS) is a very sacred number which indicates how much the company is

earning per face value of the ordinary share. It appears that ARBL is earning Rs.21.51 per share. The detailed calculation is as shown below:

NOTE 37: EARNINGS PER SHARE

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Numerator - Earnings		
Net profits for the period in ₹ million	3,674 .36	2,867.05
Denominator - Equity shares		
Number of shares at the beginning of the year	17,08,12,500	17,08,12,500
Add: Shares issued during the year	-	-
Less: Shares forfeited / bought back during the year	-	-
Number of shares outstanding at the end of the year	17,08,12,500	17,08,12,500
Weighted average number of shares outstanding at the end of the year (Basic and Diluted)	17,08,12,500	17,08,12,500
Basic and diluted earnings per equity share of ₹1 each	₹21.51	₹16.78

The company indicates that there are 17,08,12,500 shares outstanding in the market. Dividing the total profit after tax number by the outstanding number of shares, we can arrive at the earnings per share number. In this case:

Rs.367.4 Crs divided by 17,08,12,500 yields Rs.21.5 per share.

5.4 – Conclusion

Now that we have gone through all the line items in the P&L statement let us relook at it in its entirety.

Statement of Profit and Loss for the year ended March 31,2014

₹ million

Particulars	Note No.	Year ended March 31, 2014	Year ended March 31, 2013
REVENUE			
Sale of products		38,041.27	32,949.37
Less: Excise duty		4,005.15	3,512.45
Net sale of products		34,036.12	29,436.92
Sale of services		309.32	137.02
Other operating revenue		21.15	15.21
Net revenue from operations	17	34,366.59	29,589.15
Other income	18	455.14	465.51
Total Revenue		**34,821.73**	**30,054.66**
EXPENSES			
Cost of materials consumed	19	21,011.95	17,603.12
Purchases of stock-in-trade	20	2,113.69	2,632.54
Changes in inventories of finished goods, work-in-process and stock-in-trade	20	(292.10)	(320.89)
Employee benefits expense	21	1,583.16	1,262.30
Finance costs	22	7.18	2.69
Depreciation and amortisation expense [includes impairment loss of ₹Nil (PY ₹75.52 million)]	23	645.71	660.92
Other expenses	24	4,346.60	3,904.24
Total Expenses		**29,416.19**	**25,744.92**
Profit before exceptional items and tax		**5,405.54**	**4,309.74**
Less: Exceptional items (net)	33	38.84	91.57
Profit before tax		**5,366.70**	**4,218.17**
Less: Tax expense			
Current tax		1,580.00	1,377.97
Deferred tax (credit) / expense		106.23	(24.51)
Earlier year's (excess) / short provision		6.11	(2.34)
Profit for the year		**3,674.36**	**2,867.05**
Basic and diluted earnings per equity share of ₹1 each	37	21.51	16.78

ZERODHA

Hopefully, the statement above should look more meaningful to you by now. Remember almost all line items in the P&L statement will have an associated note. You can always look into the notes to seek greater clarity. Also at this stage we have just understood how to read the P&L statement, but we still need to analyze what the numbers mean. We will do this when we take up the financial ratios. Also, the P&L statement is very closely connected with the other two financial statements i.e the balance sheet and the cash flow statement. We will explore these connections at a later stage.

Key takeaways from this chapter:

1. The expense part of the P&L statement contains information on all the expenses incurred by the company during the financial year

2. Each expense can be studied with reference to a note which you can explore for further information

3. Depreciation and amortization is way of spreading the cost of an asset over its useful life

4. Finance cost is the cost of interest and other charges paid when the company borrows money for its capital expenditure.

5. PBT = Total Revenue – Total Expense – Exceptional items (if any)

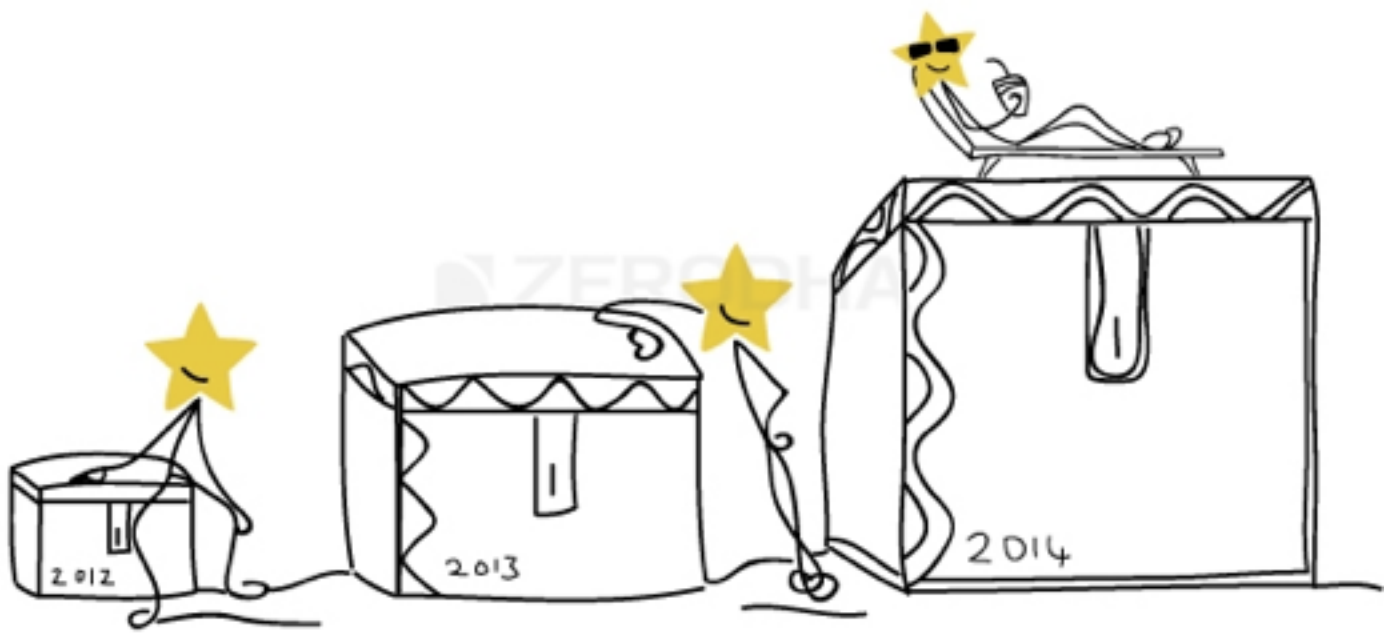
6. Net PAT = PBT – applicable taxes

7. EPS reflects the earning capacity of a company on a per share basis. Earnings are profit after tax and preferred dividends.

8. EPS = PAT / Total number of outstanding ordinary shares

CHAPTER 6

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					
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

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 repre-

sents 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

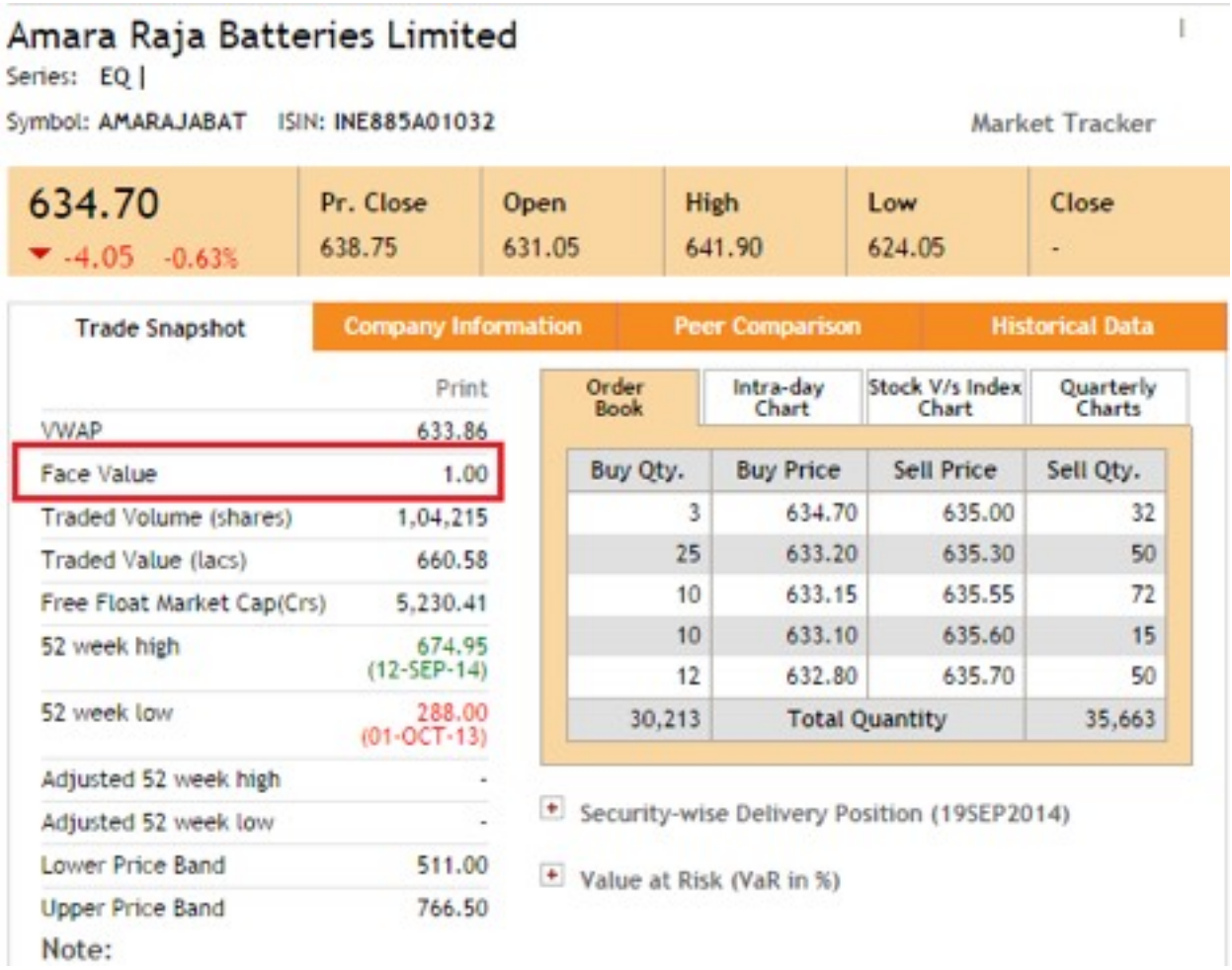
The liabilities side of the balance sheet details out all the liabilities of the company. Within liabilities there are three sub sections – shareholders' fund, non-current liabilities, and current liabilities. The first section is the shareholders' funds.

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:



Amara Raja Batteries Limited

Series: EQ |

Symbol: AMARAJABAT ISIN: INE885A01032 Market Tracker

634.70	Pr. Close	Open	High	Low	Close
▼ -4.05 -0.63%	638.75	631.05	641.90	624.05	-

Trade Snapshot | Company Information | Peer Comparison | Historical Data

	Print
VWAP	633.86
Face Value	1.00
Traded Volume (shares)	1,04,215
Traded Value (lacs)	660.58
Free Float Market Cap(Crs)	5,230.41
52 week high	674.95 (12-SEP-14)
52 week low	288.00 (01-OCT-13)
Adjusted 52 week high	-
Adjusted 52 week low	-
Lower Price Band	511.00
Upper Price Band	766.50

Note:

Order Book | Intra-day Chart | Stock V/s Index Chart | Quarterly Charts

Buy Qty.	Buy Price	Sell Price	Sell Qty.
3	634.70	635.00	32
25	633.20	635.30	50
10	633.15	635.55	72
10	633.10	635.60	15
12	632.80	635.70	50
30,213	Total Quantity		35,663

Security-wise Delivery Position (19SEP2014)

Value at Risk (VaR in %)

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

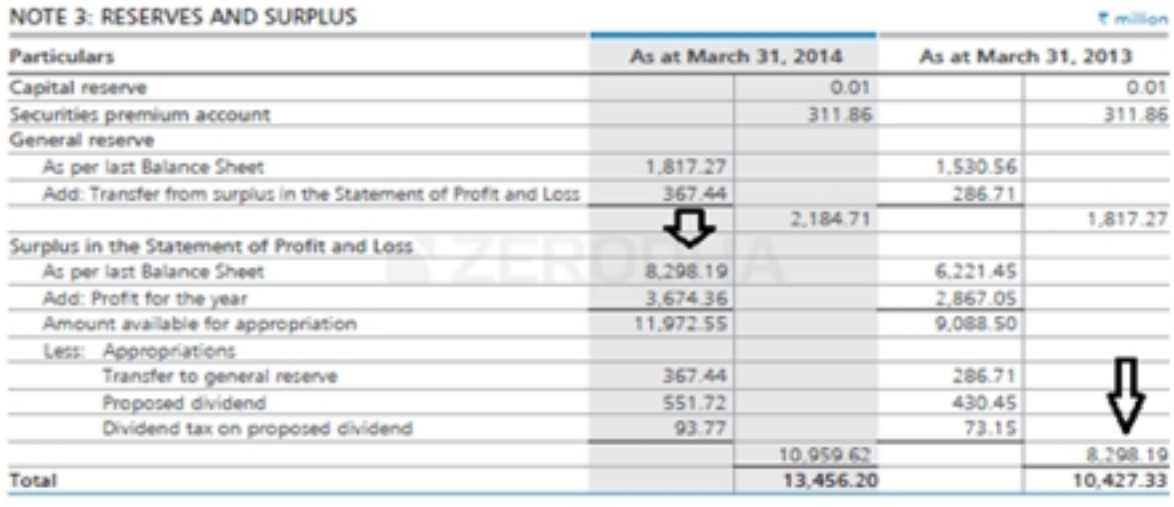
Particulars	As at March 31, 2014		As at March 31, 2013	
Capital reserve		0.01		0.01
Securities premium account		311.86		311.86
General reserve				
As per last Balance Sheet	1,817.27		1,530.56	
Add: Transfer from surplus in the Statement of Profit and Loss	367.44		286.71	
		2,184.71		1,817.27
Surplus 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:



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:

a. 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

b. 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.

a. 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

b. 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 com-

pany 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	
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	

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

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

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

CHAPTER 7

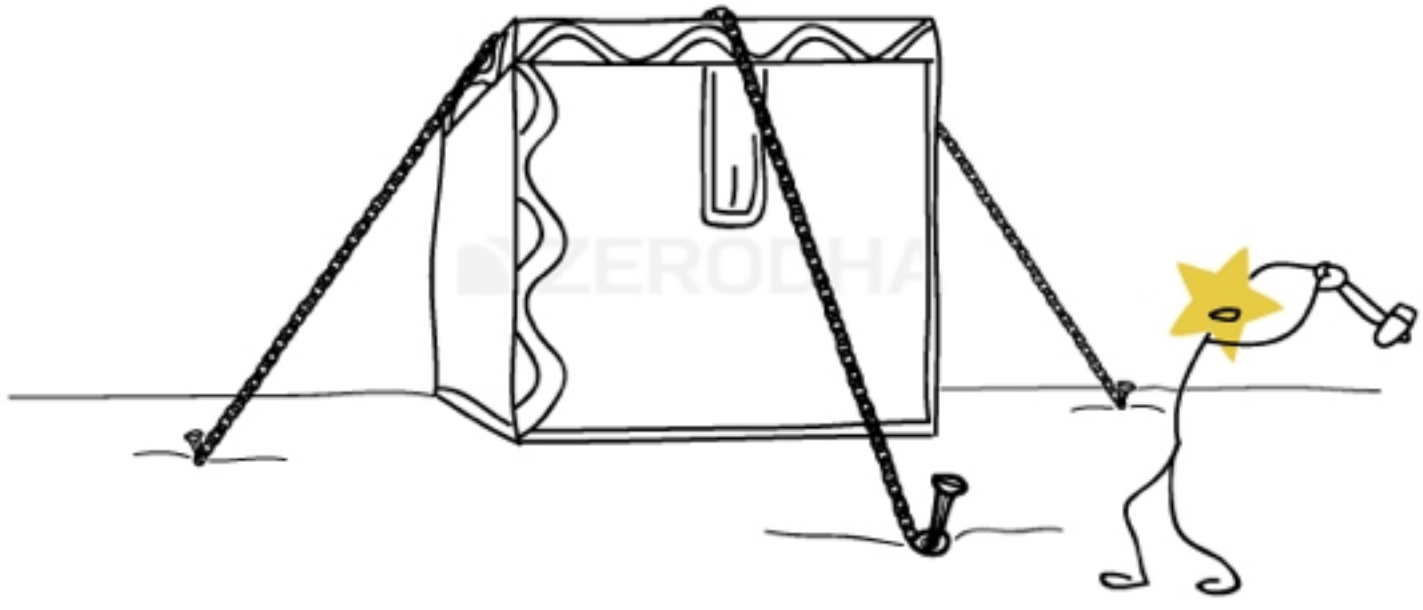
Understanding the Balance Sheet Statement (Part 2)

7.1 – The Assets side of Balance Sheet

In the previous chapter we looked at the liability side of the balance sheet in detail. We will now proceed to understand the 2nd half of the balance sheet i.e the Asset side of the balance sheet. The Asset side shows us all the assets the company owns (in different forms) right from its inception. Assets in simple terms are the resources held by a company, which help in generating the revenues. Here is the snapshot of the Assets side of the balance sheet:

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

As you can see the Asset side has two main sections i.e Non-current assets and Current assets. Both these sections have several line items (with associated notes) included within. We will look into each one of these line items.



7.2 – Non-current assets (Fixed Assets)

Similar to what we learnt in the previous chapter, non-current assets talks about the assets that the company owns, the economic benefit of which is enjoyed over a long period (beyond 365 days). Remember an asset owned by a company is expected to give the company an economic benefit over its useful life.

If you notice within the non-current assets there is a subsection called “Fixed Assets” with many line items under it. Fixed assets are assets (both tangible and intangible) that the company owns which cannot be converted to cash easily or which cannot be liquidated easily. Typical examples of fixed assets are land, plant and machinery, vehicles, building etc. Intangible assets are also considered fixed assets because they benefit companies over a long period of time. If you see, all the line items within fixed assets have a common note, numbered 10, which we will explore in great detail shortly.

Here is the snapshot of fixed assets of Amara Raja Batteries Limited:

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	

The first line item 'Tangible Assets' is valued at Rs.619.8Crs. Tangible assets consists of assets which has a physical form. In other words these assets can be seen or touched. This usually includes plants, machinery, vehicles, buildings, fixtures etc.

Likewise the next line item reports the value of Intangible assets valued at Rs.3.2 Crs. Intangible assets are assets which have an economic value, but do not have a physical nature. This usually includes patents, copyrights, trademarks, designs etc.

Remember when we discussed the P&L statement we discussed depreciation. Depreciation is a way of spreading the cost of acquiring the asset over its useful life. The value of the assets deplete over time, as the assets lose their productive capacity due to obsolescence and physical wear and tear. This value is called the Depreciation expense, which is shown in the Profit and Loss account and the Balance Sheet.

All the assets should be depreciated over its useful life. Keeping this in perspective, when the company acquires an asset it is called the 'Gross Block'. Depreciation should be deducted from the Gross block, after which we can arrive at the 'Net Block'.

Net Block = Gross Block –Accumulated Depreciation

Note, the term 'Accumulated' is used to indicate all the depreciation value since the incorporation of the company.

When we read tangible assets at Rs.619.8 Crs and Intangible assets at Rs.3.2Crs, do remember the company is reporting its Net block, which is Net of Accumulated depreciation. Have a look at the Note 10, which is associated with fixed assets.

NOTE 10: FIXED ASSETS & DEPRECIATION

₹ million

	GROSS BLOCK				DEPRECIATION / AMORTISATION				IMPAIRMENT				NET BLOCK	
Particulars	As at March 31, 2013	Additions during the year	Deductions during the year	As at March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	As at March 31, 2014	As at March 31, 2013
A. Tangible assets														
Land and land development														
- Freehold land	170.17	-	-	170.17	-	-	-	-	75.52	-	-	75.52	94.65	94.65
- Leasehold land*	133.65	267.80	-	401.51	0.84	2.22		3.06	-	-	-	-	398.45	132.81
Buildings	934.48	858.44	6.68	1,786.24	172.70	28.42	3.76	197.36	-	-	-	-	1,588.88	761.78
R&D buildings	9.90	9.02	-	18.93	4.59	0.48	-	5.07	-	-	-	-	13.86	5.31
Plant & machinery	4,549.43	1,950.56	121.13	6,378.86	2,527.37	522.95	105.11	2,945.21	-	-	-	-	3,433.65	2,022.06
R&D plant & machinery	118.84	26.85	9.75	145.94	81.90	12.84	8.95	85.79	-	-	-	-	60.15	36.94
Electrical installations	468.15	58.55	4.52	522.18	153.50	31.08	4.24	180.34	-	-	-	-	341.84	314.65
Furniture	79.25	21.56	0.002	100.81	42.45	4.87	0.002	47.32	-	-	-	-	53.49	36.80
Vehicles	105.50	37.65	12.54	130.61	33.81	9.73	10.07	33.47	-	-	-	-	97.14	71.69
Office equipment	181.06	62.16	6.71	237.51	102.78	24.09	6.19	120.68	-	-	-	-	116.82	78.28
Total	6,750.43	3,303.66	161.33	9,892.76	3,119.94	636.68	138.32	3,618.30	75.52	-	-	75.52	6,198.94	3,554.97
Previous year	6,181.26	724.78	155.61	6,750.43	2,696.46	578.04	114.56	3,119.94	-	75.52	-	75.52	3,554.97	3,524.80
B. Intangible assets														
Brands/trademarks	0.12	-	-	0.12	0.12	-	-	0.12	-	-	-	-	-	-
Computer software	52.08	10.30	-	62.38	18.39	11.04	-	29.43	-	-	-	-	32.96	33.69
Total	52.20	10.30	-	62.50	18.51	11.04	-	29.55	-	-	-	-	32.96	33.69
Previous year	31.23	20.97	-	52.20	10.31	8.20	-	18.51	-	-	-	-	33.69	20.92
Grand Total (A+B)	6,802.63	3,313.96	161.33	9,955.26	3,138.45	647.72	138.32	3,647.85	75.52	-	-	75.52	6,231.90	3,588.66
Previous year	6,212.49	745.75	155.61	6,802.63	2,666.77	586.24	114.56	3,138.45	-	75.52	-	75.52	3,588.66	3,545.72
C. Capital work-in-progress													1,443.60	1,024.97
D. Intangible assets under development													3.14	4.84

*Leasehold land represents one time lease rental paid for 99 years. Amortization of leasehold land rent of ₹2.85 million is capitalised/included in capital work-in-progress as part of pre-operative expenses.

At the top of the note you can see the Gross Block, Depreciation/amortization, and Net block being highlighted. I have also highlighted two net block numbers which tallies with what was mentioned in the balance sheet.

Let us look at a few more interesting aspects on this note. Notice under Tangible assets you can see the list of all the assets the company owns.

NOTE 10: FIXED ASSETS & DEPRECIATION

₹ million

Particulars	GROSS BLOCK				DEPRECIATION / AMORTISATION				IMPAIRMENT				NET BLOCK	
	As at March 31, 2013	Additions during the year	Deductions during the year	As at March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	As at March 31, 2014	As at March 31, 2013
A. Tangible assets														
Land and land development														
- Freehold land	170.17	-	-	170.17	-	-	-	-	75.52	-	-	75.52	94.65	94.65
- Leasehold land*	133.65	267.86	-	401.51	0.84	2.22		3.06	-	-	-	-	398.45	132.81
Buildings	934.48	858.44	6.68	1,786.24	172.70	28.42	3.76	197.36	-	-	-	-	1,588.88	761.78
R&D buildings	9.90	9.03	-	18.93	4.59	0.48	-	5.07	-	-	-	-	13.86	5.31
Plant & machinery	4,549.43	1,950.56	121.13	6,378.86	2,527.37	522.95	105.11	2,945.21	-	-	-	-	3,433.65	2,022.06
R&D plant & machinery	118.84	36.85	9.75	145.94	81.90	12.84	8.95	85.79	-	-	-	-	60.15	36.94
Electrical installations	468.15	58.55	4.52	522.18	153.50	31.08	4.24	180.34	-	-	-	-	341.84	314.65
Furniture	79.25	21.56	0.002	100.81	42.45	4.87	0.002	47.32	-	-	-	-	53.49	36.80
Vehicles	105.50	37.65	12.54	130.61	33.81	9.73	10.07	33.47	-	-	-	-	97.14	71.69
Office equipment	181.06	63.16	6.71	237.51	102.78	24.09	6.19	120.68	-	-	-	-	116.83	78.28
Total	6,750.43	3,303.66	161.33	9,892.76	3,119.94	636.68	138.32	3,618.30	75.52	-	-	75.52	6,198.94	3,554.97
Previous year	6,181.26	724.78	155.61	6,750.43	2,656.46	578.04	114.56	3,119.94	-	75.52	-	75.52	3,554.97	3,524.80
B. Intangible assets														
Brands/trademarks	0.12	-	-	0.12	0.12	-	-	0.12	-	-	-	-	-	-
Computer software	52.08	10.30	-	62.38	18.39	11.04	-	29.43	-	-	-	-	32.96	33.69
Total	52.20	10.30	-	62.50	18.51	11.04	-	29.55	-	-	-	-	32.96	33.69
Previous year	31.23	20.97	-	52.20	10.31	8.20	-	18.51	-	-	-	-	33.69	20.92
Grand Total (A+B)	6,802.63	3,313.96	161.33	9,955.26	3,138.45	647.72	138.32	3,647.85	75.52	-	-	75.52	6,231.90	3,588.66
Previous year	6,212.49	745.75	155.61	6,802.63	2,666.77	586.24	114.56	3,138.45	-	75.52	-	75.52	3,588.66	3,545.72
C. Capital work-in-progress													1,443.60	1,024.97
D. Intangible assets under development													3.14	4.84

*Leasehold land represents one time lease rental paid for 99 years. Amortisation of leasehold land rent of ₹2.85 million is capitalised/included in capital work-in-progress as part of pre-operative expenses.

For example, the company has listed ‘Buildings’ as one of its tangible asset. I have highlighted this part:-

NOTE 10: FIXED ASSETS & DEPRECIATION

₹ million

Particulars	GROSS BLOCK				DEPRECIATION / AMORTISATION				IMPAIRMENT				NET BLOCK	
	As at March 31, 2013	Additions during the year	Deductions during the year	As at March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	As at March 31, 2014	As at March 31, 2013
A. Tangible assets														
Land and land development														
- Freehold land	170.17	-	-	170.17	-	-	-	-	75.52	-	-	75.52	94.65	94.65
- Leasehold land*	133.65	267.86	-	401.51	0.84	2.22		3.06	-	-	-	-	398.45	132.81
Buildings	934.48	858.44	6.68	1,786.24	172.70	28.42	3.76	197.36	-	-	-	-	1,588.88	761.78
R&D buildings	9.90	9.03	-	18.93	4.59	0.48	-	5.07	-	-	-	-	13.86	5.31
Plant & machinery	4,549.43	1,950.56	121.13	6,378.86	2,527.37	522.95	105.11	2,945.21	-	-	-	-	3,433.65	2,022.06
R&D plant & machinery	118.84	36.85	9.75	145.94	81.90	12.84	8.95	85.79	-	-	-	-	60.15	36.94
Electrical installations	468.15	58.55	4.52	522.18	153.50	31.08	4.24	180.34	-	-	-	-	341.84	314.65
Furniture	79.25	21.56	0.002	100.81	42.45	4.87	0.002	47.32	-	-	-	-	53.49	36.80
Vehicles	105.50	37.65	12.54	130.61	33.81	9.73	10.07	33.47	-	-	-	-	97.14	71.69
Office equipment	181.06	63.16	6.71	237.51	102.78	24.09	6.19	120.68	-	-	-	-	116.83	78.28
Total	6,750.43	3,303.66	161.33	9,892.76	3,119.94	636.68	138.32	3,618.30	75.52	-	-	75.52	6,198.94	3,554.97
Previous year	6,181.26	724.78	155.61	6,750.43	2,656.46	578.04	114.56	3,119.94	-	75.52	-	75.52	3,554.97	3,524.80
B. Intangible assets														
Brands/trademarks	0.12	-	-	0.12	0.12	-	-	0.12	-	-	-	-	-	-
Computer software	52.08	10.30	-	62.38	18.39	11.04	-	29.43	-	-	-	-	32.96	33.69
Total	52.20	10.30	-	62.50	18.51	11.04	-	29.55	-	-	-	-	32.96	33.69
Previous year	31.23	20.97	-	52.20	10.31	8.20	-	18.51	-	-	-	-	33.69	20.92
Grand Total (A+B)	6,802.63	3,313.96	161.33	9,955.26	3,138.45	647.72	138.32	3,647.85	75.52	-	-	75.52	6,231.90	3,588.66
Previous year	6,212.49	745.75	155.61	6,802.63	2,666.77	586.24	114.56	3,138.45	-	75.52	-	75.52	3,588.66	3,545.72
C. Capital work-in-progress													1,443.60	1,024.97
D. Intangible assets under development													3.14	4.84

*Leasehold land represents one time lease rental paid for 99 years. Amortisation of leasehold land rent of ₹2.85 million is capitalised/included in capital work-in-progress as part of pre-operative expenses.

As of 31st March 2013 (FY13) ARBL reported the value of the building at Rs.93.4 Crs. During the FY14 the company added Rs.85.8Crs worth of building, this amount is classified as 'additions during the year'. Further they also wound up 0.668 Crs worth of building; this amount is classified as 'deductions during the year'. Hence the current year value of the building would be:

Previous year's value of building + addition during this year – deduction during the year

93.4 + 85.8 – 0.668

= 178.5Crs

You can notice this number being highlighted in blue in the above image. Do remember this is the gross block of the building. From the gross block one needs to deduct the accumulated depreciation to arrive at the 'Net Block'. In the snapshot below, I have highlighted the depreciation section belonging to the 'Building'.

NOTE 10: FIXED ASSETS & DEPRECIATION

₹ million

Particulars	GROSS BLOCK				DEPRECIATION / AMORTISATION				IMPAIRMENT				NET BLOCK	
	As at March 31, 2013	Additions during the year	Deductions during the year	As at March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	As at March 31, 2014	As at March 31, 2013
A. Tangible assets														
Land and land development														
Freehold land	170.17	-	-	170.17	-	-	-	-	75.52	-	-	75.52	94.65	94.65
Leasehold land*	133.65	267.86	-	401.51	0.84	2.22	-	3.06	-	-	-	-	398.45	132.81
Buildings	934.48	858.44	6.68	1,786.24	172.70	28.42	3.78	197.34	-	-	-	-	1,588.88	761.78
R&D buildings	9.90	9.09	-	18.99	4.59	0.48	-	5.07	-	-	-	-	13.86	5.31
Plant & machinery	4,549.43	1,950.56	121.13	6,378.86	2,527.37	522.95	105.11	2,945.21	-	-	-	-	3,433.65	2,022.06
R&D plant & machinery	118.84	36.85	9.75	145.94	81.90	12.84	8.95	85.79	-	-	-	-	60.15	36.94
Electrical installations	468.15	58.55	4.52	522.18	153.50	31.08	4.24	180.34	-	-	-	-	341.84	314.65
Furniture	79.25	21.56	0.002	100.81	42.45	4.87	0.002	47.32	-	-	-	-	53.49	36.80
Vehicles	105.50	37.65	12.54	130.61	33.81	9.73	10.07	33.47	-	-	-	-	97.14	71.69
Office equipment	181.06	63.16	6.71	237.51	102.78	24.09	6.19	120.68	-	-	-	-	116.83	78.28
Total	6,750.43	3,303.66	161.33	9,892.76	3,119.94	636.68	138.32	3,618.30	75.52	-	-	75.52	6,198.94	3,554.97
Previous year	6,181.26	724.79	155.61	6,750.43	2,656.46	578.04	114.56	3,119.94	-	75.52	-	75.52	3,554.97	3,524.80
B. Intangible assets														
Brands/trademarks	0.12	-	-	0.12	0.12	-	-	0.12	-	-	-	-	-	-
Computer software	52.38	10.30	-	62.68	18.29	11.04	-	29.43	-	-	-	-	32.96	33.69
Total	52.50	10.30	-	62.80	18.51	11.04	-	29.55	-	-	-	-	32.96	33.69
Previous year	31.23	20.97	-	52.20	10.31	8.20	-	18.51	-	-	-	-	33.69	20.92
Grand Total (A+B)	6,802.63	3,313.96	161.33	9,955.26	3,138.45	647.72	138.32	3,647.85	75.52	-	-	75.52	6,231.90	3,588.66
Previous year	6,212.49	745.76	155.61	6,802.63	2,666.77	586.24	114.56	3,138.45	-	75.52	-	75.52	3,588.66	3,545.72
C. Capital work-in-progress													1,443.60	1,024.97
D. Intangible assets under development													3.14	4.84

*Leasehold land represents one time lease rental paid for 99 years. Amortisation of leasehold land rent of ₹2.85 million is capitalised/included in capital work in progress as part of pre operative expenses.

As of 31st March 2013 (FY13) ARBL has depreciated Rs.17.2 Crs, to which they need to add Rs.2.8 Crs belonging to the year FY14, adjust 0.376 Crs as the deduction for the year. Thus, the Total Depreciation for the year is:-

Previous year's depreciation value + Current year's depreciation – Deduction for the year

= 17.2 + 2.8 – 0.376

Total Depreciation= Rs.19.73 Crs. This is highlighted in red in the image above.

So, we have building gross block at Rs.178.6 Crs and depreciation at Rs.19.73 Crs which gives us a net block of Rs.158.8 Crs (178.6– 19.73). The same has been highlighted in the image below:

NOTE 10: FIXED ASSETS & DEPRECIATION

₹ million

Particulars	GROSS BLOCK				DEPRECIATION / AMORTISATION				IMPAIRMENT				NET BLOCK	
	As at March 31, 2013	Additions during the year	Deductions during the year	As at March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	Upto March 31, 2013	For the year	On Deductions	Upto March 31, 2014	As at March 31, 2014	As at March 31, 2013
A. Tangible assets														
Land and land development														
- Freehold land	170.17	-	-	170.17	-	-	-	-	75.52	-	-	75.52	94.65	94.65
- Leasehold land*	133.65	267.86	-	401.51	0.84	2.22	-	3.06	-	-	-	-	198.45	132.81
Buildings	934.48	858.44	6.68	1,786.24	172.70	28.42	3.76	197.36	-	-	-	-	1,588.88	761.78
R&D buildings	9.90	9.03	-	18.93	4.59	0.48	-	5.07	-	-	-	-	13.86	5.31
Plant & machinery	4,549.43	1,960.56	121.13	6,378.86	2,527.37	522.95	105.11	2,945.21	-	-	-	-	3,433.65	2,022.06
R&D plant & machinery	118.84	36.85	9.75	145.94	81.90	12.84	8.95	85.79	-	-	-	-	60.15	36.94
Electrical installations	468.15	58.55	4.52	522.18	153.50	31.08	4.24	180.34	-	-	-	-	341.84	314.65
Furniture	79.25	21.56	0.002	100.81	42.45	4.87	0.002	47.32	-	-	-	-	53.49	36.80
Vehicles	105.50	37.65	12.54	130.61	33.81	9.73	10.07	33.47	-	-	-	-	97.14	71.69
Office equipment	181.06	63.16	6.71	237.51	102.78	24.09	6.19	120.68	-	-	-	-	116.83	78.28
Total	6,750.43	3,303.66	161.33	9,892.76	3,119.94	636.68	138.32	3,618.30	75.52	-	-	75.52	6,198.96	3,554.97
Previous year	6,181.26	724.78	155.61	6,750.43	2,696.46	578.04	114.56	3,119.94	-	75.52	-	75.52	3,554.97	3,524.80
B. Intangible assets														
Brands/trademarks	0.12	-	-	0.12	0.12	-	-	0.12	-	-	-	-	-	-
Computer software	52.08	10.30	-	62.38	18.39	11.04	-	29.43	-	-	-	-	32.96	33.69
Total	52.20	10.30	-	62.50	18.51	11.04	-	29.55	-	-	-	-	32.96	33.69
Previous year	31.23	20.97	-	52.20	10.31	8.20	-	18.51	-	-	-	-	33.69	20.92
Grand Total (A+B)	6,802.63	3,313.96	161.33	9,955.26	3,138.45	647.72	138.32	3,647.85	75.52	-	-	75.52	6,231.90	3,588.66
Previous year	6,212.49	745.75	155.61	6,802.63	2,666.77	586.24	114.56	3,138.45	-	75.52	-	75.52	3,588.66	3,545.72
C. Capital work-in-progress													1,443.60	1,024.97
D. Intangible assets under development													3.14	4.84

*Leasehold land represents one time lease rental paid for 99 years. Amortisation of leasehold land rent of ₹2.85 million is capitalised/included in capital work-in-progress as part of pre operative expenses.

The same exercise is carried out for all the other tangible and intangible assets to arrive at the Total Net block number.

The next two line items under the fixed assets are Capital work in progress (CWIP) and Intangible assets under development.

CWIP includes building under construction, machinery under assembly etc at the time of preparing the balance sheet. Hence it is aptly called the “Capital Work in Progress”. This amount is usually mentioned in the Net block section. CWIP is the work that is not yet complete but where a capital expenditure has already been incurred. As we can see, ARBL has Rs.144.3 Crs under CWIP. Once the construction process is done and the asset is put to use, the asset is moved to tangible assets (under fixed assets) from CWIP.

The last line item is ‘Intangible assets under development’. This is similar to CWIP but for intangible assets. The work in process could be patent filing, copyright filing, brand development etc. This is at a miniscule cost of 0.3 Crs for ARBL. All these costs are added to arrive at the total fixed cost of the company.

7.3 – Non-current assets (Other line items)

Besides the fixed assets under the non-current assets, there are other line items as well. Here is a snapshot for the same:

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

Non-current investments are investments made by ARBL with a long term perspective. This stands at Rs.16.07 Crs. The investment could be anything – buying listed equity shares, minority stake in other companies, debentures, mutual funds etc. Here is the partial (as I could not fit the entire image) snapshot of Note 11. This should give you a perspective.

NOTE 11: NON-CURRENT INVESTMENTS

₹ million

Particulars	As at March 31, 2014		As at March 31, 2013	
A. In Equity Instruments				
a. Quoted - Non trade at cost				
i) 125 Fully paid up equity shares of ₹1 each				
in Standard Batteries Limited	0.01		0.01	
Less: Provision for diminution in value	0.01		0.01	
	-		-	
ii) 25 Fully paid up equity shares of ₹2 each				
in Nicco Corporation Limited	0.001		0.001	
iii) 10,000 Fully paid up equity shares of ₹1 each				
in Exide Industries Limited	0.04		0.04	
iv) 5,500 Fully paid up equity shares of ₹1 each				
in HBL Power Systems Limited	0.01		0.01	
v) 160,000 Fully paid up equity shares of ₹2 each				
in IVRCL Limited	0.21		0.21	
vi) 23,749 Fully paid up equity shares of ₹10 each				
in IDBI Bank Limited	1.01		1.01	
vii) 227,900 Fully paid up equity shares of ₹10 each				
in Andhra Bank	2.28	3.55	2.28	3.55
b. Unquoted - Non trade at Cost				
i) 1,128 Fully paid up equity shares of ₹10 each				
in Indian Lead Limited	0.03		0.03	
Less: Provision for diminution in value	0.03	-	0.03	-
c. Unquoted - Trade at Cost				
i) 1,206,000 Fully paid up equity shares of ₹10 each				
in Andhra Pradesh Gas Power Corporation Limited		157.14		157.14
B. In Government Securities - Non trade at Cost				
a) 6 years National Savings Certificates				
(Lodged as security with Government departments.				

The next line item is long term loans and advances which stand at Rs.56.7Crs. These are loans and advances given out by the company to other group companies, employees, suppliers, vendors etc.

The last line item under the Non-current assets is 'Other Non-current assets' which is at Rs. 0.122 Crs. This includes other miscellaneous long term assets.

7.4 – Current assets

Current assets are assets that can be easily converted to cash and the company foresees a situation of consuming these assets within 365 days. Current assets are the assets that a company uses to fund its day to day operations and ongoing expenses.

The most common current assets are cash and cash equivalents, inventories, receivables, short term loans and advances and sundry debtors.

Here is the snapshot of the current assets of ARBL:

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	

The first line item on the Current assets is Inventory which stands at Rs.335.0 Crs. Inventory includes all the finished goods manufactured by the company, raw materials in stock, goods that are manufactured incompletely etc. Inventories are goods at various stages of production and hence have not been sold. When any product is manufactured in a company it goes through various processes from raw material, to work in progress to a finished good. Snapshot of Note 14 associated with inventory of the company is as shown below:As

NOTE 14: INVENTORIES

₹ million

Particulars	As at March 31, 2014		As at March 31, 2013	
(Valued at lower of cost or net realisable value)				
Raw materials	826.36		666.18	
Add: Raw materials in transit	120.73		264.64	
Total Raw materials		947.09		930.82
Work-in-process		1,052.11		828.95
Finished goods		941.75		536.44
Stock-in-trade		74.56		368.98
Stores and spares		323.27		255.22
Loose tools		6.07		4.39
Secondary packing materials and others		5.23		3.78
Total		3,350.08		2,928.58

As you can see, a bulk of the inventory value comes from 'Raw material' and 'Work-in- progress'.

The next line item is 'Trade Receivables' also referred to as 'Accounts Receivables'. This represents the amount of money that the company is expected to receive from its distributors, customers and other related parties. The trade receivable for ARBL stands at Rs.452.7 Crs.

The next line item is the Cash and Cash equivalents, which are considered the most liquid assets found in the Balance sheet of any company. Cash comprises of cash on hand and cash on de-mand. Cash equivalents are short term, highly liquid investments which has a maturity date of less than three months from its acquisition date. This stands at Rs.294.5 Crs. Note 16 associated with Cash and bank balances is as shown below. As you can see the company has cash parked in various types of accounts.

NOTE 16: CASH AND BANK BALANCES

₹ million

Particulars	As at March 31, 2014		As at March 31, 2013	
a) Cash and cash equivalents				
i) Balances with banks				
in current accounts	156.95		238.37	
in deposit accounts	2,445.79		3,652.00	
in exchange earner's foreign currency account	56.65		30.23	
ii) Cheques/drafts on hand	268.15		172.61	
iii) Cash on hand	1.09	2,928.63	1.47	4,094.68
b) Other bank balances in earmarked accounts				
Unclaimed dividends		17.04		13.22
Total		2,945.67		4,107.90

The next line item is short term loans and advances that the company has tendered and which is expected to be repaid back to the company within 365 days. . It includes various items such as advances to suppliers, loans to customers, loans to employees, advance tax payments (income tax, wealth tax) etc. This stands at Rs.211.9 Crs. Following this, is the last line item on the Assets side and infact on the Balance sheet itself. This is the 'Other current assets' which are not considered important, hence termed 'Other'. This stands at Rs.4.3 Crs.

To sum up, the Total Assets of the company would now be:-

Fixed Assets + Current Assets

= Rs.840.831 Crs + Rs.1298.61 Crs

= Rs. 2139.441 Crs, which is exactly equal to the liabilities of the company.

With this we have now run through the entire Assets side of the Balance sheet, and infact the whole of Balance sheet itself. Let us relook at the balance sheet in its entirety:

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 in the above, the balance sheet equation holds true for ARBL's balance sheet,

Asset = Shareholders' Funds + Liabilities

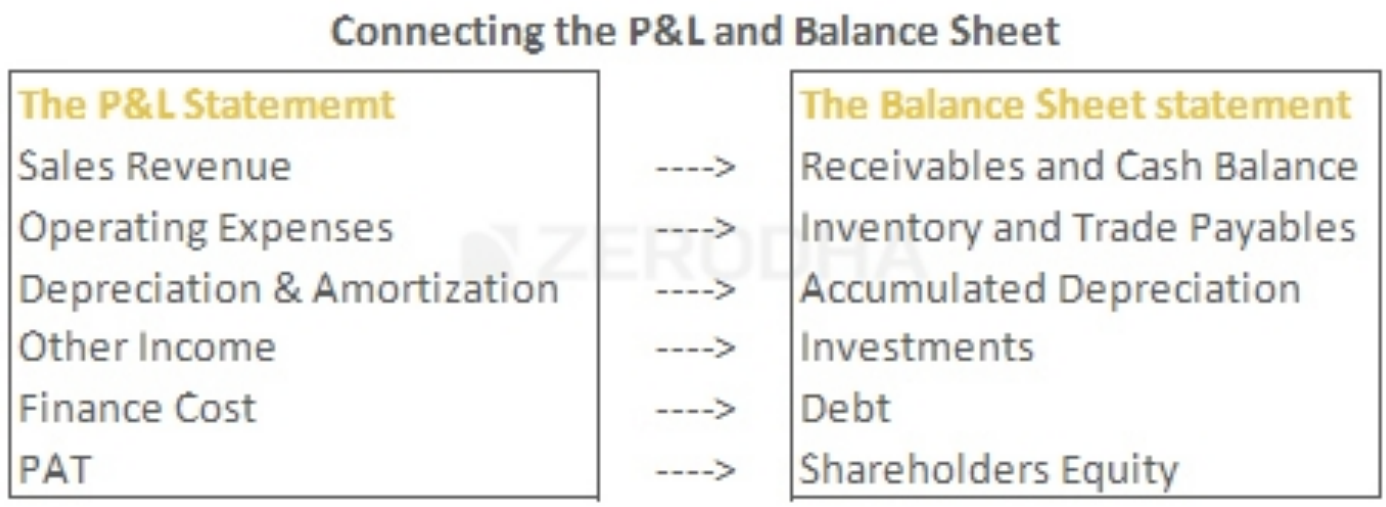
Do remember, over the last few chapters we have only inspected the balance sheet and the P&L statements. However, we have not analyzed the data to infer if the numbers are good or bad. We will do the same when we look into the financial ratio analysis chapter.

In the next chapter, we will look into the last financial statement which is the cash flow statement. However, before we conclude this chapter we must look into the many ways the Balance sheet and the P&L statement are interconnected.

7.5 – Connecting the P&L and Balance Sheet

Let us now focus on the Balance Sheet and the P&L statement and the multiple ways they are connected (or affect) to each other.

Have a look at the following image:



In the image above, on the left hand side we have the line items on a typical standard P&L statement. Corresponding to that on the right hand side we have some of the standard Balance Sheet items. From the previous chapters, you already know what each of these line items mean. However, we will now understand how the line items in the P&L and the Balance Sheet are connected to each other.

To begin with, consider the **Revenue from Sales.** When a company makes a sale it incurs expenses. For example if the company undertakes an advertisement campaign to spread awareness about its products, then naturally the company has to **spend cash** on the campaign. The money spent tends to decrease the cash balance. Also, if the company makes a sale on credit, the **Receivables** (Accounts Receivables) go higher.

Operating expenses includes purchase of raw material, finished goods and other similar expenses. When a company incurs these expenses, to manufacture goods two things happen. One, if the purchase is on credit (which invariably is) then the **Trade payables** (accounts payable) go higher. Two, the **Inventory** level also gets affected. Whether the inventory value is high or low, depends on how much time the company needs to sell its products.

When companies purchase Tangible assets or invest in Brand building exercises (Intangible assets) the company spreads the purchase value of the asset over the economic useful life of the asset. This tends to increase the **depreciation** mentioned in the Balance sheet. Do remember the Balance sheet is prepared on a flow basis, hence the Depreciation in balance sheet is accumulated year on year. Please note, Depreciation in Balance sheet is referred to as the **Accumulated depreciation.**

Other income includes monies received in the form of interest income, sale of subsidiary companies, rental income etc. Hence, when companies undertake **investment** activities, the other incomes tend to get affected.

As and when the company undertakes **Debt** (it could be short term or long term), the company obviously spends money towards financing the debt. The money that goes towards financing the debt is called the **Finance Cost/Borrowing Cost**. Hence, when debt increases the finance cost also increases and vice versa.

Finally, as you may recall the **Profit after tax (PAT**) adds to the surplus of the company which is a part of the **Shareholders equity.**

Key takeaways from this chapter

1. The Assets side of the Balance sheet displays all the assets the company owns
2. Assets are expected to give an economic benefit during its useful life
3. Assets are classified as Non-current and Current asset
4. The useful life of Non-current assets is expected to last beyond 365 days or 12 months
5. Current assets are expected to payoff within 365 days or 12 months
6. Assets inclusive of depreciation are called the 'Gross Block'
7. Net Block = Gross Block – Accumulated Depreciation
8. The sum of all assets should equal the sum of all liabilities. Only then the Balance sheet is said to have balanced.
9. The Balance sheet and P&L statement are inseparable. They are connected to each other in many ways.

CHAPTER 8

The Cash Flow statement

8.1 – Overview

The Cash flow statement is a very important financial statement, as it reveals how much cash the company is actually generating. Is this information not revealed in the P&L statement you may think? Well, the answer is both a yes and a no.

Consider the following scenario.

Assume a simple coffee shop selling coffee and short eats. All the sales the shop does is mostly on cash basis, meaning if a customer wants to have a cup of coffee and a snack, he needs to have enough money to buy what he wants. Going by that on a particular day, assume the shop manages to sell Rs.2,500/- worth of coffee and Rs.3,000/- worth of snacks. It is evident that the shop's income is Rs.5,500/- for that day. Rs.5,500/- is reported as revenues in P&L, and there is no ambiguity with this.

Now think about another business that sells laptops. For sake of simplicity, let us assume that the shop sells only 1 type of laptop at a standard fixed rate of Rs.25,000/- per laptop. Assume on a certain day, the shop manages to sells 20 such laptops. Clearly the revenue for the shop would be Rs.25,000 x 20 = Rs.500,000/-. But what if 5 of the 20 laptops were sold on credit? A credit sale is when the customer takes the product today but pays the cash at a later point in time. In this situation here is how the numbers would look:

Cash sale: 15 * 25000 = Rs.375,000/-

Credit sale: 5 * 25000 = Rs.125,000/-

Total sales: Rs.500,000/-

If this shop was to show its total revenue in its P&L statement, you would just see a revenue of Rs.500,000/- which may seem good on the face of it. However, how much of this Rs.500,000/- is actually present in the company's bank account is not clear. What if this company had a loan of Rs.400,000/- that had to be repaid back urgently? Even though the company has a sale of

Rs.500,000 it has only Rs.375,000/- in its account. This means the company has a cash crunch, as it cannot meet its debt obligations.

The cash flow statement captures this information. A statement of cash flows should be presented as an integral part of an entity's financial statements. Hence in this context evaluation of the cash flow statement is highly critical as it reveals amongst other things, the true cash position of the company.

To sum up, every company's financial performance is not so much dependent on the profits earned during a period, but more realistically on liquidity or cash flows.

8.2 – Activities of a company

Before we go ahead to understand the cash flow statement, it is important to understand 'the activities' of a company. If you think about a company and the various business activities it undertakes, you will realize that the company's activities can be classified under one of the three standard baskets. We will understand this in terms of an example.

Imagine a business, maybe a very well established fitness center (Talwalkars, Gold's Gym etc) with a sound corporate structure. What are the typical business activities you think a fitness center would have? Let me go ahead and list a few business activities:

1. Display advertisements to attract new customers
2. Hire fitness instructors to help clients in their fitness workout
3. Buy new fitness equipments to replace worn out equipments
4. Seek short term loan from bankers
5. Issue a certificate of deposit for raising funds

6. Issue new shares to a few known friends to raise fresh capital for expansion (also called preferential allotment)

7. Invest in a startup company working towards innovative fitness regimes

8. Park excess money (if any) in fixed deposits

9. Invest in a building coming up in the neighborhood, for opening a new fitness center sometime in the future

10. Upgrade the sound system for a better workout experience

As you can see the above listed business activities are quite diverse however they are all related to the business. We can classify these activities as:

1. **Operational activities (OA):** Activities that are directly related to the daily core business operations are called operational activities. Typical operating activities include sales, marketing, manufacturing, technology upgrade, resource hiring etc.

2. **Investing activities (IA)**: Activities pertaining to investments that the company makes with an intention of reaping benefits at a later stage. Examples include parking money in interest bearing instruments, investing in equity shares, investing in land, property, plant and equipment, intangibles and other noncurrent assets etc

3. **Financing activities (FA)**: Activities pertaining to all financial transactions of the company such as distributing dividends, paying interest to service debt, raising fresh debt, issuing corporate bonds etc

All activities a legitimate company performs can be classified under one of the above three mentioned categories.

Keeping the above three activities in perspective, we will now classify each of the above mentioned activities into one of the three categories /baskets.

1. Display advertisements to attract new customers – OA
2. Hire fitness instructors to help customers with their fitness workout – OA
3. Buy new fitness equipment to replace worn out equipments – OA
4. Seek a short term loan from bankers – FA
5. Issue a certificate of deposit (CD) for raising funds – FA
6. Issue new shares to few known friends to raise fresh capital for expansion (also called preferential allotment) – FA
7. Invest in a startup company working towards innovative fitness regimes – IA
8. Park excess money (if any) in fixed deposit – IA

9. Invest in a building coming up in the neighborhood for opening a new fitness center sometime in the future – IA

10. Upgrade the sound system for better workout experience- OA

Now think about the cash moving in and out of the company and its impact on the cash balance. Each activity that the company undertakes has an impact on cash. For example "Upgrade the sound system for a better workout experience" means the company has to pay money towards the purchase of a new sound system, hence the cash balance decreases. Also, it is interesting to note that the new sound system itself will be treated as a company asset.

Keeping this in perspective, we will now understand for the example given above how the various activities listed would impact the cash balance and how would it impact the balance sheet.

Activity No	Activity Type	Rational	Cash Balance	On Balance Sheet
1	OA	Expenditure towards advertisement	Decreases	Treated as an asset as it increases the brand value
2	OA	Expenditure towards new recruits	Decreases	Treated as an asset as it increases the company's intellectual capital
3	OA	Expenditure towards new equipment	Decreases	Treated as asset
4	FA	Loan means cash inflow to business	Increases	Loan is a liability
5	FA	Deposits via CD means cash inflow	Increases	CD is a liability
6	FA	Issue of fresh capital means cash inflow	Increases	Treated as a liability as share capital increases
7	IA	Investment in startup means cash outflow	Decreases	Investment is an asset

Activity No	Activity Type	Rational	Cash Balance	On Balance Sheet
8	IA	Money parked in FD means cash going out of business	Decreases	Equivalent to cash, hence considered an asset
9	IA	Investment in building means cash going out of business	Decreases	Gross block considered an asset
10	OA	Expenditure towards the sound system	Decreases	Treated as an asset

The table above is colour coded:

1. Increase in cash is colour coded in blue
2. Decrease in cash is colour coded in red
3. Assets are colour coded in green and
4. Liabilities are colour coded in purple.

If you look through the table and start correlating the 'Cash Balance' and 'Asset/Liability' you will observe that:

1. Whenever the liabilities of the company increases the cash balance also increases
    a. This means if the liabilities decreases, the cash balance also decreases
2. Whenever the asset of the company increases, the cash balance decreases
    a. This means if the assets decreases, the cash balance increases

The above conclusion is the key concept while constructing a cash flow statement. Also, extending this further you will realize that each activity of the company be it operating activity, financing activity, or investing activity either produces cash (net increase in cash) or reduces (net decrease in cash)the cash for the company.

Hence the total cash flow for the company will be:-

> Cash Flow of the company = Net cash flow from operating activities + Net Cash flow from investing activities + Net cash flow from financing activities

8.3 – The Cash Flow Statement

Having some insight into the cash flow statement, you would now appreciate the fact that you need to look into the cash flow statement to review the company from a cash perspective.

Typically when companies present their cash flow statement they split the statement into three segments to explicitly show how much cash the company has generated across the three business activities. Continuing with our example from the earlier chapters, here is the cash flow statement of Amara Raja Batteries Limited (ARBL):

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
I. CASH FLOW FROM OPERATING ACTIVITIES				
Profit before tax from continuing operations		5,366.70		4,218.17
Add/(Less): Adjustments for				
a. Depreciation	636.69		577.20	
b. Amortization	11.04		8.20	
c. Impairment loss	-		75.52	
d. Net income on sale of tangible fixed assets	(2.26)		(0.04)	
e. Tangible fixed assets written off	24.90		44.27	
f. Donation of tangible fixed asset	0.03		-	
g. Interest paid on working capital facilities	0.03		0.11	
h. Provisions and credit balances written back	(3.90)		(6.44)	
i. Bad debts written off	32.33		4.84	
j. Provision for doubtful trade receivables and advances (net)	(30.50)		(38.69)	
k. Exchange gain on restatement - other than borrowings (net)	(33.81)		(13.18)	
l. Provision for leave encashment	14.83		33.43	
m. Provision for gratuity	6.75		8.74	
n. Provision for warranty	(40.22)		156.14	
o. Dividend received	(144.19)		(145.27)	
p. Interest received on bank and other deposits	(137.94)		(112.29)	
q. Interest on income tax	6.70		2.03	
r. Provision for wealth tax	2.00	342.48	1.83	596.40
Operating profit before working capital changes		5,709.18		4,814.57
Add/(Less): Adjustments for working capital changes				
a. Increase in inventories	(421.50)		(262.41)	
b. Increase in trade receivables	(711.71)		(571.57)	
c. Increase in loans and advances	(445.72)		(421.49)	
d. Increase/(decrease) in trade payables	(77.73)		490.32	
e. Increase in other current liabilities	341.23	(1,315.43)	671.36	(93.79)
Cash generated from operations		4,393.75		4,720.78
Less: a. Income tax	1,604.42		1,365.95	
b. Wealth tax	1.83	1,606.25	0.18	1,366.13
Net cash from operating activities - A		**2,787.50**		**3,354.65**

I will skip going through each line item as most of them are self explanatory, however I want you to notice that ARBL has generated Rs.278.7 Crs from operating activities. Note, a company which has a positive cash flow from operating activities is always a sign of financial well being.

Here is the snapshot of ARBL's cash flow from investing activities:

II. CASH FLOW FROM INVESTING ACTIVITIES		
a. Purchase of tangible fixed assets	(3,303.66)	(724.78)
b. Purchase of intangible fixed assets	(10.30)	(20.97)
c. Increase in capital work-in-progress	(423.26)	(718.50)
d. Decrease/(increase) in intangible assets under development	1.69	(0.25)
e. Sale of tangible fixed assets	4.98	1.80
g. Interest received on bank and other deposits	137.94	112.29
h. Dividend received	144.19	145.27
Net cash from investing activities - B	(3,448.42)	(1,205.14)

As you can see, ARBL has consumed Rs.344.8 Crs in its investing activities. This is quite intuitive as investing activities tend to consume cash. Also remember healthy investing activities foretells the investor that the company is serious about its business expansion. Of course how much is considered healthy and how much is not, is something we will understand as we proceed through this module.

Finally, here is the snapshot of ARBL's cash balance from financing activities:

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
III. CASH FLOW FROM FINANCING ACTIVITIES		
a. Short term borrowings from banks availed / repaid	(13.70)	42.59
b. Interest free sales tax deferment repaid	(13.67)	(16.92)
c. Interest paid on working capital facilities	(0.03)	(0.11)
d. Dividend paid	(430.45)	(322.84)
e. Dividend tax paid	(73.15)	(52.37)
Net cash from financing activities - C	(531.00)	(349.65)

ARBL consumed Rs.53.1Crs through its financing activities. If you notice the bulk of the money went in paying dividends. **Also, if ARBL takes on new debt in future it would lead to an increase in the cash balance** (remember increase in liabilities, increases cash balance). We know from the balance sheet that ARBL did not undertake any new debt.

Let us summarize the cash flow from all the activities:

Cash Flow from	Rupees Crores (2013-14)	Rupees Cores (2012-13)
Operating Activities	278.7	335.4
Investing Activities	-344.8	-120.05
Financing Activities	-53.1	-34.96
Total	**-119.19**	**179.986**

This means the company consumed a total cash of Rs.119.19 Crs for the financial year 2013 -2014. Fair enough, but what about the cash from the previous year? As we can see, the company generated Rs.179.986 Crs through all its activities from the previous year. Here is an extract from ARBL's cash flow statement:

Opening cash and cash equivalents	4,094.68	2,283.19
Add: Net increase/(decrease) in cash and cash equivalents	(1,191.92)	1,799.86
Add: Effect of foreign exchange differences on restatement of cash and cash equivalents	25.87	11.63
Closing cash and cash equivalents	2,928.63	4,094.68

Look at the section highlighted in green (for the year 2013-14). It says the opening balance for the year is Rs.409.46Crs. How did they get this? Well, this happens to be the closing balance for the previous year (refer to the arrow marks). Add to this the current year's cash equivalents which is (Rs.119.19) Crs along with a minor forex exchange difference of Rs.2.58 Crs we get the total cash position of the company which is Rs.292.86 Crs. This means, while the company guzzled cash on a yearly basis, they still have adequate cash, thanks to the carry forward from the previous year.

Note, the closing balance of 2013-14 will now be the opening balance for the FY2014 – 15. You can watch out for this when ARBL provides its cash flow numbers for the year ended 31st March 2015.

At this point, let us run through a few interesting questions and answers:

1. What does Rs.292.86 Crs actually state?

a. This literally shows how much cash ARBL has in its various bank accounts

2. What is cash?

a. Cash comprises cash on hand and demand deposits. Obviously, this is a liquid asset of the company

3. What are liquid assets?

a. Liquid assets are assets that can be easily converted to cash or cash equivalents

4. Are liquid assets similar to 'current items' that we looked at in the Balance sheet?

a. Yes, you can think of it that way

5. If cash is current and cash is an asset, shouldn't it reflect under the current asset on the Balance sheet?

a. Exactly and here it is. Look at the balance sheet extract below.

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

Clearly, we can now infer that the cash flow statement and the balance sheet interact with each other. This is in line with what we had discussed earlier i.e all the three financial statements are interconnected with each other.

8.4 – A brief on the financial statements

Over the last few chapters we have discussed the three important financial statements of the company i.e the P&L statement, the Balance Sheet and the Cash Flow statement of the company. While the Cash flow and P&L statement are prepared on a standalone basis (representing the financial position for the given year), the Balance Sheet is prepared on a flow basis.

The P&L statement discusses how much the company earned as revenues versus how much the company expended in terms of expenses. The retained earnings of the company also called the surplus of the company are carried forward to the balance sheet. The P&L also incorporates the

depreciation number. The depreciation mentioned in the P&L statement is carried forward to the balance sheet.

The Balance Sheet details the company's assets and liabilities. On the liabilities side of the Balance sheet the company represents the shareholders' funds. The assets should always be equal to the liabilities, only then do we say the balance sheet has balanced. One of the key details on the balance sheet is the cash and cash equivalents of the firm. This number tells us, how much money the company has in its bank account. This number comes from the cash flow statement.

The cash flow statement provides information to the users of the financial statements about the entity's ability to generate cash and cash equivalents as well as indicates the cash needs of a company. The statement of cash flows are prepared on a historical basis providing information about the cash and cash equivalents, classifying cash flows in to operating, financing and investing activities. The final number of the cash flow tells us how much money the company has in its bank account.

We have so far looked into how to read the financial statements and what to expect out of each one of them. We have not yet ventured into how to analyze these numbers. One of the ways to analyze the financial numbers is by calculating a few important financial ratios. In fact we will focus on the financial ratios in the next few chapters.

Key takeaways from this chapter

1. The Cash flow statement gives us a picture of the true cash position of the company
2. A legitimate company has three main activities – operating activities, investing activities and the financing activities
3. Each activity either generates or drains money for the company
4. The net cash flow for the company is the sum of operating activities, investing activities and the financing activities
5. Investors should specifically look at the cash flow from operating activities of the company
6. When the liabilities increase, cash level increases and vice versa
7. When the assets increase, cash level decreases and vice versa
8. The net cash flow number for the year is also reflected in the balance sheet
9. The Statement of Cash flow is a useful addition to the financial statements of a company because it indicates the company's performance.