Subject: The regulatory approach for analyzing financial statements may be followed by regulators or other stakeholders while analyzing the financial statement of any company. As regulators, we must examine the broader issues rather than going into the details of calculation and examination. The following steps could be followed/applied while examining the financial statement of any operators/service providers.

(Note: The following steps could also be adopted in the present exercise with respect to a detailed examination of a financial statement as given to us.)

1st Step – Examination of data reliability/correctness and their consistency

Remark on balance sheet: There was an error/mistake in the balance sheet. (e.g., Total of liabilities side is not matching with the total of assets side.)

2nd Step – Analysis of balance sheet

- **Capital structure of the company** – We have to examine the debt-equity ratio of the company to check whether the debt-equity ratio is healthy or not. As we know, debt-equity ratio plays a very crucial and important role in the determination of weighted average cost of capital (WACC) of the company or sector. Therefore, by finding out the debt-equity ratio of the company, we can easily adjust the ratio to find out the optimum WACC of the company or sector. The results help us for formulation of price cap regulation.

- **Additional capitalization of fixed assets** – addition in the fixed assets during the year and their percentage of increase in comparison to last year. (Increase has been registered about 33% during the year.)

- **Liquidity of company** – working capital changes. There is a problem like in our case where working capital is going in the negative. (Current liabilities are more than the current assets or the company is not able to pay its current liabilities through its current assets. In other words, the company does not have sufficient cash or other current assets to meet out the short-term obligations.) If there is a negative working capital, we have to investigate the case to find out whether this is because of regulatory decisions or due to company inefficiency.
• **Turnover ratio** – This ratio denotes the utilization of the company’s resources. This is the turnover of the company’s revenue or sales in comparison to its capital employed of the specific products/services. If the turnover ratio is less than 65%, then we have to examine the reasons. The ratio can be calculated by using this formula:

  - **Capital turnover ratio** = revenue/capital employed
  - Capital employed is the sum of net fixed assets, capital work in progress, and working capital.

• **Free cash flow** – This can be calculated by the following:

  - **Free cash flow** = net cash from operating activities – capital expenditure during the year

3rd Step – Income statement

• **Revenue trends** – Revenue has been increased by 28%, whereas additional investment has increased by about 33%.

• **EBITDA\(^1\) margin trends** – EBITDA margin has declined from 54% to 52%. It means the operating expenditure has been increased by 2% of the company’s revenue.

• **Net margin (profit before tax) trends** – This has also declined from 49% to 45%.

We can observe from the above that the EBITDA margin has registered a change of only 2%, whereas the revenue has increased by 28%. Therefore, there is no need to proceed with a detailed examination of each and every item of operating costs. Definitely, we need a detailed examination of the elements of operating cost if there is a drastic change in the EBITDA margin, say more than 5% and its expected affect on the pricing.

For assessment of operating costs of a company, EBITDA margin plays a very important role.

As far as return of shareholders is concerned, we can directly compare the net profit margin of the company. Therefore, the above-mentioned ratios indicate the position of the company without going into much detailed examination of the balance sheet and income statement.

Note: If the results are not in line with the general accepted benchmarking or ratios, then we should examine the financial statements in much more detail.

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\(^1\) Earnings before interest, tax, depreciation, and amortization (EBITDA) margin measures the extent to which cash operating expenses use up revenue. Interest and tax are excluded because they include the effect of factors other than the profitability of operations. Interest is a result of the company’s financial structure. Depreciation and amortization reflect the accounting treatment of past purchases and are unrelated to future cash flows, and future cash flows are what ultimately matter to investors.