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EXECUTIVE SUMMARY

The aim of the report was to interpret and analyse the asset and cost structure of my organisation.

The subject of the research was the Bank.

The applied approach was the analysis by the numbers of the Bank's balance sheet, P/L account and cost calculation. I have managed to get additional information of the controlling department. The analysis in both part, first introduce the asset or cost types, than analyse the proportion and the progress in time, and link it to the management strategy.

The asset side of the balance sheet was restructured in the last year according to the figures. The importance of the current assets appraised. The main element of this asset style is receivables, which give the significant part of the revenues. An important part of the assets is securities, the primary dealership boosted the amount of this asset, and the increased trading resulted outstanding profit.

The major part of fixed assets is invested financial assets; this row contained all sort of strategic investment of the bank. After clean-out the portion of the invested financial assets dropped. The bad and non-banking style assets were removed from the portfolio.

The different costs of the bank operation can be difficulty grouped into the common cost categories. The result of the management cost reduction effort, operating costs increased by a modest 3% in nominal terms, which is in fact a decrease of 6,7% in real terms. However the cost asset ratio is still higher than the expected 5%. The major source of costs were labour costs by 40%, depreciation by 13%, 25% by non-material services, advertisements, rents, agency fees. Depreciation produced the largest cost increase, 34% due to investments made in the preceding and this year. Non-material expenditures showed the largest cost reduction, including in particular, advertising, PR and marketing costs, rents and usage fees, and other services.

Due to the inherited unfavourable balance sheet structure of the bank, in addition to the costs and unrealised profits of non-earning assets, the Bank's earning capacity is still rather moderate. The management has to continue the asset restructuring, increase the total assets by intense business activity, and to use strict cost control and reduction in the future.

INTRODUCTION

The report has two goals, and divided into two parts. At the first section the aim of the report was to explore asset structure of the company's balance sheet. The analysis the composition of assets and link it to the activity and strategy of the company. In the second part the aim is to interpret a cost analysis, outlining the existing management policy in the field of cost management and give examples of typical cost classes.

The given conditions of the report length and the size of the company don't allow me to review the whole organisation's asset and cost structure. Therefore the subject of the research was to discuss the main elements of the organisation assets and costs.

My organisation is a commercial bank, as this kind of financial institution the assets structure is far different from an ordinary producer or commercial company. I will outline these kinds of differences in my work.

APPROACH

During the report I will rely on my company's audited balance sheet and P\L account. I have got help and additional information from the controlling department and also the auditor of the bank.

In a case of a bank business the common used asset and cost analysing methods are quite different from the studied methods of the given literature, but basically I will rely on the studied methods with some distinction.

First of all in my work I will outline the main assets of my organisation, and point out the main differences of a bank asset structure. I will use a different interpretation of asset structure, which can be useful for the analysis and point out the main points of the progress driven by the management strategy.

In the second part I will interpret the different type of costs of my organisation, I will outline the special costs structure of the banking business. And finally I will analyse the effect of the management decisions in this area.

During the research I will try to point out of the weak points of the structure and processes, and recommend appropriate directions of solution.

I. ASSETS

1. Different types of assets¹

A business unit uses its funds to invest into all sort of assets. Assets are the main ground of its business activity, and determine the profile of a company. In these terms the assets tell lots of things about the kind of business area where the organisation exists.

There are two main groups of assets: Fixed and Current.

Fixed assets serve the company in longer terms, and have more than trivial value. It can be tangible, intangible and investments. The most common fixed assets are land, buildings, machinery, vehicles etc.

Currents assets used for operating activities and change frequently, these can be inventories, receivables, securities, and cash.

In a case of banking operation, the proportion of these asset elements uses to be different from an ordinary producer or commercial company. The equipment of this kind of business is the money itself. The rate of financial based assets (receivables, bonds, shares, etc.) is the highest due to the type of financial business.

2. The asset side of the bank²

The Bank's total asset side amounted to HUF 331 billion by the end of the last financial year. Based on this figure, the Bank had a market share of 4% in the banking sector of Hungary at last year's end.

- **Current assets**

In our case, among this kind of assets we can find those, which acquire the main revenues of the classical retail bank business. This kind of assets forms the majority of the asset side. As a result of corporate and retail lending boom, and the portfolio clean -out, the asset portfolio significantly improved, and the portion of current assets increased dramatically, which helps to improve the profitability too.

The current assets in the Bank's balance sheet are the following:

i) **Liquid assets**

In this row, we counted all sort of cash and cash-equal stock. There is a minimum amount of banknote to operate the branches without any hitch. The management tried to decrease this non-interest bearing assets, but the increased activity on the banknote market and the newly opened branches required more banknote than in the previous year. With the spread of cash saving methods (bankcards, e-banking) and the introduction of Euro banknote, the proportion of this element of assets can be reduced in the future.

¹ Oxford Brookes Univesity, Financial Management, 2001, page 8

² Look Sheet 1.

ii) Securities

These are securities bought for trading purposes. As we can see from the numbers the bonds and other marketable interest bearing securities trading activity dramatically increased and represent the major part of the assets (more than 30%). The purpose of this boom, that the Bank assumed responsibility of the primary dealership license of Postabank Security Ltd. For this year the Bank became the fourth largest dealer in government bonds and T-bills. Another portion of the increase was the result of the portfolio clean up, when Reorg corporate bonds subscribed in amount of HUF 25 billion. The rate of shares and non-interest bearing securities remained low. The security portfolio performance was outstanding in the year 2000.

iii) Receivables

These are all sort of financial credit type assets. This group is the most significant among the assets. These kinds of assets provide the most important part of the bank revenues; these have biggest profit production ability. Within receivables, constituting 44% of total assets, corporate loans were the determining factor. In the Bank strategy, a conservative lending policy and the active presence in the small and medium sized business market, the Bank aimed at vigorously increasing the number and volume of its loans. In regards of the maturity structure of the loan portfolio, the share of loans maturing within and beyond one year was 54% to 46%, which shows healthy progress from the previous year's 39% to 61%.

iv) Inventories

In this group we can find all sort of non-financial assets, which help the everyday operating of banking. These can be all sort of low budget goods, such as stationery. According to the total assets, the amount of these assets is very low.

• Fixed or Invested Assets

It is practical to use invested instead fixed assets in case of banking.

i) Invested financial assets

We can sort here long term strategic investments, bonds, shares, and owned companies. The higher level of management makes the decisions about these investments. In the past the bank acts like an investment bank, and the result was that these fixed assets consist almost the half of the total assets. After the portfolio clean-out the portion of the invested financial assets dropped, mainly by the sell off of HTCC bonds and shares and by the capital reduction of several subsidiaries.

ii) Intangible assets

These are all sort of non-material assets with certain value. We can count here the intellectual products such as software, all kind of property value rights, and the Bank's goodwill itself. The growth in the intangible assets were in connection with the software developments required by the new IT strategy of the management.

iii) **Tangible assets**

These are buildings, land, all sort of equipment, furniture, vehicles. The aim of these assets to serve banking operation and the majority of these assets are not for investment purposes. These assets need bigger investment and serve the company in longer terms.

During the last years, certain non-banking-aimed tangible assets were sold, like buildings, golf club, etc. Despite these facts and the cost reduction strategy of management the numbers show a slight increase in the row of tangible assets. We have to search the reason for that, in the last year intense IT hardware development and the opening of new branches.

3. The asset restructuring strategy of the management

As a result of the management deliberate restructuring the decline in total assets came to halt, and in the second half of the last year, total assets began to grow again.

Important measures were taken during the last year by the new management of the Bank towards establishing a healthy balance sheet structure, especially on the assets' side. As a result of ever-intensifying business activity, corporate and retail lending were definitely boomed. The portfolio clean-out, which started in 1998, has ended. The overall composition of the earning-asset portfolio significantly improved from the point of risk and asset quality.

For the future on the asset side it is of key importance to maintain the dynamism of development and to further increase the Bank's market share. From the point of this, the Bank intends to increase its network sales, as well as involving other market players in its sales activity through international, co-operative agreements. The major objective of corporate business is to maintain its market share, whilst preserving the quality of the portfolio.

II. COSTS

1. Different type of costs

In the literature there are several methods of grouping the costs. The most important and common used the direct/indirect and the fixed/variable grouping method.³

- **Direct vs. Indirect**

A direct cost can be directly linked to the product or service, but indirect can not.

- **Variable vs. Fixed**

Variable cost is changing with the level of the basic activity, which can be a product or a service.

Fixed cost remains the same; there is no effect of business activity. The cost per unit is decreasing with the increase of the produced amount, because the fixed costs are spread over a greater number of units.

³ Oxford Brookes University, Financial Management, 2001, page 51

2. Cost structure in the Bank⁴

In case of a bank business we can not speak about production costs or costs of goods. In this kind of business the typical cost types and the proportion are a bit different. It is very hard to define the direct and indirect, fixed and variable cost of a financial product.

In my corporation the majority of the costs are indirect and fixed. There is a critical mass of assets and customers in the banking business, when profitability of the banking turns into positive territory.⁵ In the Hungarian bank sector the substantial breakeven asset-cost ratio is about 5%. In our case it is a bit more 5.9%.

Let's see what are the main cost factors of the Bank, and what is the management strategy.

i) Labour costs

It represents the biggest stake among the costs, more than 40% of the total cost connected to the workforce. One part of this kind of cost can be direct and variable, according to the financial product, but the major part of this kind of cost is indirect and fixed.

Despite of the staff reduction, the management did not manage to reduce the staff costs last year. The reason for that was the paid bonus for the last two years.

ii) Amortisation

This kind of cost can be linked to non-financial investments. The increased intensity of last year's investments caused this relatively high number. Among the investigations the biggest amortisation has hardware and software investments, the slowing pace of building and vehicle amortisation continued.

iii) Maintenance of buildings

This kind of cost can not be linked to a product or service, these are fixed and indirect costs. The proportion of this cost was unchanged; the majority of the amounts were rental expenditures. In this kind of cost group we can also meet with the heating and lighting charges, and repair works of the buildings.

iv) IT costs

These costs are indirect but it can be fixed and also variable in some terms. The proportion of IT cost remained significant, but we can recognise a slight decrease. The reason for that is the different relation of the types of IT costs. The hardware and the IT outsourcing costs dropped but the software and data communication costs increased.

v) Marketing costs

These kind of cost can be direct or indirect. The management cost reduction strategy drops the proportion of the marketing costs. In the marketing campaigns the cheaper kind of solutions came into front.

⁴ Look sheet 3.

⁵ Economics of scale

vi) Subcontractors cost

One other point where the management could drive through the cost cut effectively. The majority of these contracts has one-off costs, and connected to the clean-out of the portfolio. An other big amount went to the contracted legal representatives.

vii) Other costs

There are several other cost I didn't mention, which are indirect and fixed costs. These are representing a significant proportion all together in the total cost: Telecommunication, vehicles, security, paper materials, fees.

3. The cost reduction strategy of the management

As a result of the management stringent cost control, operating costs increased by a modest 3% in nominal terms, which is in fact a decrease of 6,7% in real terms. An independent firm audited my organisation and cost mechanism, and the changes the management has introduced since have also shown an improvement in the area of cost control. 20% of operating costs were constituted by materials and material type services, 40% by labour costs, 12% by depreciation, 25% by non-material services, advertisements, rents, agency fees and other costs, insurance, duties paid to authorities.

Depreciation produced the largest cost increase, 34% due to investments made in the preceding and this year. Non-material expenditures showed the largest cost reduction, including in particular, advertising, PR and marketing costs, rents and usage fees, and other services. It should be noted that total IT expenditures dropped all in all by 15%, and that significant restructuring occurred within cost boundaries seeing that the preceding year software and data transmission costs had increased. Further rationalisation of the corporate structure and service procedures made a headcount reduction possible, network widening notwithstanding.

III. CONCLUSION AND RECOMMENDATION

At the present situation it must be emphasised that the Bank's capital position is strong, the liquidity is sufficient. Due to the inherited unfavourable balance sheet structure of the bank, in addition to the costs and unrealised profits of non-earning assets, the Bank's earning capacity is still rather moderate.

As a result of the management stringent asset restructuring and cost control, the positive progresses exist in the numbers.

The Bank's management has to identify the improvement of profitability as a central objective. To achieve this, severe cost control will have to be maintained, and a mindful investment policy exercise.

On the asset side the management have to make efforts to increase the proportion of high earning potential assets like receivables and securities, and minimise the non-interest bearing assets like tangible assets. The management has to continue the careful investment policy in long financial investments.

On the cost side, to receive the desired asset-cost ratio, the management has two opportunities. The first to continue the cost cuts, which can drive the Bank to the decrease of quality of services. The second opportunity is to increase the market share by intensive marketing. It can be costly in short terms, but in the middle terms the bigger amount of total assets with the current cost level, can drive to the desired economics of scale.

IV. BIBLIOGRAPHY

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