INTRODUCTORY BANKING

Lecture II, Seminar II – Financial statements

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Financial statements

The balance sheet is a statement of the assets (what the company **owns**) and liabilities (what the company **owes**). The balance sheet shows at a certain point in time:

how the cash is invested in the business

- how the assets are balanced with the liabilities
- how the company is financed

The Profit and loss account (P&L, income statements) records the trading activities of a company for a given period of time. The profit and loss account:

- compares revenues for the year against the cost of goods sold, and other expenses – disclosing the profit or loss made
- measures the current performance of the business, and shows the turnover and expenses
- shows how the profit was earned and how much was taken in taxation

The cash flow statement reports the net changes in the cash balance and helps to explain how the surplus or deficit in cash arose. The cash flow statement has the advantage of being based on hard facts, since its preparation requires no valuation decisions, unlike the income statement. The cash flow statement is:

- a report on the financial effects of all transactions during the accounting period
- a mixture of capital and revenue transactions and is retrospective

Financial statements relationships

Financial statements relationship

Balance sheet

ASSETS

Net fixed assets
Operating assets
Cash

LIABILITIES

Owner's equity
Long-and short-term debt
Operating liabilities

Income statement

Revenues
- Cost of goods sold
- Selling, general and administrative expenses
- Depreciation

Operating profit
-/+ Interest income/expense

Income before tax
Income taxes

Net profit (Net income)

Attention !!!

- Interest payment x principal repayment (recongnition on balance sheet and P/L)
- Costs x cash outflow
- Debt financiang and alternative forms of financing – e.g. Leasing

Example 1

As of 1.1. 2021 we have a simple bank with the asset comprising of cash deposited with the central bank in the amount of 78, fixed investment in the building (where the bank has its headquarters) of 58 net value and 3 mortgages.

- Mortgage A in the nominal amount of 100, just granted, 20 years maturity, 4 % p.a. interest, instalments paid semi-annualy,
- Mortgage B in the nominal amount of 120, granted on 1.1.2019, 15 years maturity, 3 % p.a. interest, instalments paid annualy,
- Mortgage C in the amount of 150, granted on 1.1. 2018, 10 years maturity, 2,5 % p.a. interest, instalments paid monthly,

The liability of the bank are retail deposits collected from general public in the amount of 380, current payables of 10 and bonds issued in the amount of 40.

What is the amount of capital ?

What is the interest income of the bank in 2020 ?

Example 1

Opening information

Assets		***Liabilities and Equity***	
Cash	78	Retail deposits	380
Mortgage A	?	Current payables	10
Mortgage B	?	Bonds issued	40
Mortgage C	?		
Fixed investment	58	Equity	?
TOTAL			

… and now,

….. what is the amount of mortgages to be recorded on the balance sheet ?

….how do we arrive at the interest income amount ?

see solution in excel

Example II

J&J decided to start their own business by baking fresh bread. They found out that they have CZK 65,000 in their current account at the Village Bank and CZK 50,000 in a special savings account at the same bank. After a detailed analysis they realised they would need another CZK 90,000 to start the business. A subsequent meeting in the Village Bank showed that the bank is prepared to finance the project by granting a 10-year loan. So the deal was done: the interest rate was set at 7% p.a. of the remaining principal and also the repayment schedule was agreed, 10% of the initial principal at the end of each period.

After having cleared the financing, J&J purchased all they needed: an oven for CZK 150,000, flour for CZK 20,000, eggs for CZK 10,000 and baking powder for CZK 5,000.

1. Construct an initial balance sheet of J&J's situation after they have paid for the oven and all the ingredients. Assume that they used the money from the loan first.
2. Construct an initial sub-balance sheet of the bank at the same point in time only for balances related to J&J.

The business ran well, and after one year after using all the ingredients and paying CZK 10,000 for electricity and water, they sold CZK 120,000 worth of bread.

3. Construct the income statement of the situation. Assume that the depreciation rate of the oven was 25% and the applicable income tax rate was 28% and was paid on the 31.12.(simplifying assumption). Ignore any potential interest earned on the savings and current account.
4. Construct the end of period balance sheet of the situation of J&J.
5. Construct the cash flow statement of J&J's situation.
6. Construct the end of period sub-balance sheet of the Village Bank.

see solution in excel

Example III

Where do these items belong? Indicate their effect on the balance sheet, income statement and cash flow statement of a change in each of the items listed below. Assume a CZK 100 increase in each case.

- Salaries paid
  - Income statement (expenses), lowers income before tax (EBT) by CZK 100
  - Balance sheet – it lower cash by CZK 100 and liabilities to employees (if booked like this before), also by CZK 100
  - it lowers the cash flow by CZK 100

- Profit from the current period
- Loan granted
- Interest received from a granted loan
- Bonds issued
- Loan promise
- Equity increase
- Purchase of a new building
- Deposit accepted
- Guarantee issued
- Deposit at the Czech National Bank