



# Accounting Principles



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Maryland Banking School  
Accounting Principles

- I. Introduction - Definition of Accounting
- II. Accounting & It's Use in Business Decisions
- III. The Flow of Accounting Information
- IV. Preparation of Financial Statements
- V. Financial Performance Analysis

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- I. Introduction - Definition of Accounting

- A. The Language of Business

Accounting is ... "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information."

- B. Financial vs. Managerial Accounting

Financial - information intended primarily for external use by the following groups:

- 1. Owners & perspective owners
- 2. Creditors and lenders
- 3. Employees and their unions
- 4. Customers
- 5. Governmental units
- 6. General public

Managerial - information intended primarily for internal use by the managers of the company and should support the following types of internal management decisions:

- 1. Financial decisions
- 2. Resource allocation decisions
- 3. Production decisions
- 4. Marketing decisions

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I. Introduction - Definition of Accounting (con't)

C. Development of Accounting Standards

Seven organizations most influence the establishment of  
Generally Accepted Accounting Principles (GAAP):

1. American Institute of CPA's (AICPA)
2. Financial Accounting Standards Board (FASB)
3. Securities & Exchange Commission (SEC)
4. International Accounting Standards Board (IASB)
5. Public Company Accounting Oversight Board (PCAOB)
6. Governmental Accounting Standards Board (GASB)
7. American Accounting Association (AAA)

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II. Accounting & It's Use in Business Decisions

A. Forms of Ownership

1. Sole Proprietorship
2. Partnership
3. Corporation

B. Types of Businesses

1. Service
2. Merchandising
3. Manufacturing

C. Financial Statements

1. Income Statement
2. Statement of Owner's/Stockholders' Equity
3. Balance Sheet
4. Statement of Cash Flows

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II. Accounting & It's Use in Business Decisions (con't)

D. The Financial Accounting Process

1. The Accounting Equation

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

2. Analysis of Transactions

When analyzing business transactions, accountants rely on the following five accounting assumptions or concepts:

- a. Business entity concept
- b. Money measurement concept
- c. Exchange price (or cost) concept
- d. Going - concern (continuity) concept
- e. Periodicity (time periods) concept

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III. The Flow of Accounting Information

A. Recording Business Transactions

1. The Account

Debits/Credits  
Double entry procedure

2. Ledger

Balance sheet accounts  
Income statement accounts (nominal accounts)

3. Journal

Journalizing  
Posting  
Cross-Indexing (referencing)

4. Trial Balance

B. Adjusting the Accounts

1. The Matching Principle
2. Cash vs. Accrual Basis of Accounting
3. Deferrals
4. Accruals

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IV. Preparing the Financial Statements

A. The Income Statement

The primary objective of the income statement is to provide a measure of profit for **a stated period of time**, so that users can predict the amount, timing and uncertainty of future cash flows.

Major sections of the statement:

Revenues  
Cost of Goods Sold (Merchandising only)  
Gross Margin (Merchandising only)  
Expenses  
Net Income

In Banking

Interest Income  
Interest Expense  
Net Interest Income  
Provision for Loan Losses  
Net Interest Income after provision

Non-Interest Income  
Non-Interest Expense  
Net Income Before Taxes  
Income taxes  
Net Income

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ABC Banking Company  
INCOME STATEMENT  
For the Year Ended December 31, 2021

Interest Income on Loans	\$XX
Interest Income on Investments	<u>XX</u>
Total Interest Income	XX
Interest Expense on Deposits	\$XX
Interest Expense on Borrowings	<u>XX</u>
Total Interest Expense	XX
Net Interest Income	\$XX
Provision for Loan/Lease Losses	<u>XX</u>
Net Interest Income after Provision	XX
Non-Interest Income	\$XX
Non-Interest Expense	<u>XX</u>
Income before taxes	XX
Income taxes (state & federal)	<u>XX</u>
Net income	<u>\$XX</u>
Earnings per share	
Basic	\$XX
Diluted	\$XX

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IV. Preparing the Financial Statements (con't)

B. The Statement of Change in Stockholders' Equity

The primary purpose of the statement of change in stockholders' equity is to connect the income statement and the balance sheet. It shows the changes that occurred in the capital account balances between balance sheet dates. Like the income statement, it is presented for **a stated period of time**.

ABC Banking Company  
STATEMENT OF CHANGE IN STOCKHOLDERS' EQUITY  
For the Year Ended December 31, 2021

Balance at December 31, 2020	\$ xxxxx
Add: Net Income for 2021	xxxx
Deduct: Dividends paid to stockholders	<u>(xxxx)</u>
Add: Stock Issued	xxxx
Deduct: Stock repurchased	<u>(xxxx)</u>
Balance at December 31, 2021	<u>\$ xxxxx</u>

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IV. Preparing the Financial Statements (con't)

C. The Balance Sheet

The primary purpose of the balance sheet is to reflect a company's solvency. Solvency is the ability to pay debts as they come due. It displays a company's financial condition **as of a specific moment in time**.

Major sections of the statement:

- Assets
- Liabilities
- Stockholders' Equity

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Maryland Banking School Accounting Principles ABC Banking Company STATEMENT OF CONDITION December 31, 2021		
<u>Assets:</u>		
Cash & Due from Banks	\$	xxxx
Short Term Investments		xxxx
Investments		xxxx
Loans & Leases	\$	xxxx
Less: Reserve for Loan/Lease Loss		(xxxx)
Net Loans & Leases		xxxx
Fixed Assets	\$	xxxx
Accrued Interest		xxxx
Other Assets		xxxx
Total Assets	\$	xxxxx
<u>Liabilities &amp; Stockholders' Equity:</u>		
Non-Interest Bearing Deposits	\$	xxxx
Interest Bearing Deposits		xxxx
Total Deposits		xxxx
Short Term Borrowings	\$	xxxx
Long Term Borrowings		xxxx
Total Borrowings		xxxx
Other Liabilities		xxxx
Total Liabilities	\$	xxxxx
Preferred Stock		xxxx
Common Stock		xxxx
Paid-in Surplus		xxxx
Retained Earnings		xxxx
Total Stockholders' Equity	\$	xxxxx
Total Liabilities & Stockholders' Equity	\$	xxxxx

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IV. Preparing the Financial Statements (con't)	
D. The Statement of Cash Flows	
<p>The purpose of this statement is to provide present and potential investors and creditors with information concerning future cash flows. Like the income statement, it is presented for a <b>stated period of time</b>.</p> <p>The three major sections of the Statement of Cash Flows are:</p>	
1. Operating Activities	
<p>Net Income</p> <p>+ Non-cash expenses</p> <p>+ Increases in current liabilities</p> <p>+ Decreases in current assets</p> <p>- Decreases in current liabilities</p> <p>- Increases in current assets</p> <p>= Net cash flows from Operating Activities</p>	
2. Investing Activities	
3. Financing Activities	

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V. Financial Performance Analysis

A. Measurement Perspectives

1. Historical (trend)
2. Judgmental (standards)
3. External (peer)

B. Risk & Return Criteria in Banking

**Risk**

1. Asset Quality
2. Liquidity
3. Interest Rate Sensitivity

**Return**

1. Profitability
2. Growth

**Capital Adequacy**

Loan Loss Reserve to Loans

**Year 1**

$$\frac{\text{Loan Loss Reserve}}{\text{Total Loans}} = \frac{\$ 125}{\$ 10,000} = 1.25\%$$

**Year 2**

Beg Balance + Provision - Net Charge-offs = End Balance

$$125 + 10 - 5 = 130$$

$$\frac{\text{Loan Loss Reserve}}{\text{Total Loans}} = \frac{\$ 130}{\$ 10,000} = 1.30\%$$

**Year 3**

Beg Balance + Provision - Net Charge-offs = End Balance

$$130 + 10 - 25 = 115$$

$$\frac{\text{Loan Loss Reserve}}{\text{Total Loans}} = \frac{\$ 115}{\$ 10,000} = 1.15\%$$

Net Charge-offs is loans charged off net of loans recovered

### Net Interest Margin/Spread Comparison

#### Example #1

	<u>\$ Amount</u>		<u>Interest Rate</u>	<u>Interest</u>
Loans	\$ 1,000	@	6.00%	\$ 60.00
Deposits	\$ 1,000	@	2.00%	\$ 20.00
<b>Spread</b> (difference between rates)			<b>4.00%</b>	

$$\text{Net Interest Margin} = \frac{\text{Net Interest Income}}{\text{Earning Assets}} = \frac{\$ 40.00}{\$ 1,000} = 4.00\%$$

**Spread and Net Interest Margin are EQUAL**

### Net Interest Margin/Spread Comparison

#### Example #2

	<u>\$ Amount</u>		<u>Interest Rate</u>	<u>Interest</u>
Loans	\$ 1,000	@	6.00%	\$ 60.00
Non-Int Deposits	\$ 200	@	0.00%	\$ -
Int Deposits	\$ 800	@	2.00%	\$ 16.00
Total Deposits	\$ 1,000		2.00%	\$ 16.00
<b>Spread</b> (difference between rates)			<b>4.00%</b>	

$$\text{Net Interest Margin} = \frac{\text{Net Interest Income}}{\text{Earning Assets}} = \frac{\$ 44.00}{\$ 1,000} = 4.40\%$$

**Spread and Net Interest Margin are NOT EQUAL**

**WHY?**

**Answer: The effect of funding \$200 of earning assets with non-int bearing deposits**

### Efficiency Ratio Calculation

#### Example #1

Total Expenses \$ 500

Net Interest Income	\$ 750
+ Non-Interest Income	\$ 250
Total Revenue	\$ 1,000

$$\text{Efficiency \%} = \frac{\text{Total Expenses}}{\text{Total Revenue}} = \frac{\$ 500}{\$ 1,000} = 50.00\%$$

### Efficiency Ratio Calculation

#### Example #2

Total Expenses \$ 700

Net Interest Income	\$ 750
+ Non-Interest Income	\$ 250
Total Revenue	\$ 1,000

$$\text{Efficiency \%} = \frac{\text{Total Expenses}}{\text{Total Revenue}} = \frac{\$ 700}{\$ 1,000} = 70.00\%$$

### Efficiency Ratio Calculation

#### Example #3

Total Expenses	\$ 700
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Net Interest Income	\$ 1,000
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+ Non-Interest Income	\$ 450
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Total Revenue	\$ 1,450
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$$\text{Efficiency \%} = \frac{\text{Total Expenses}}{\text{Total Revenue}} = \frac{\$ 700}{\$ 1,450} = 48.28\%$$