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

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

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)

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

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

D. The Financial Accounting Process

1. The Accounting Equation

Assets = Liabilities + 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

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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Rules of Debits & Credits

Dr.	Cr.
Assets =	Liabilities + Capital

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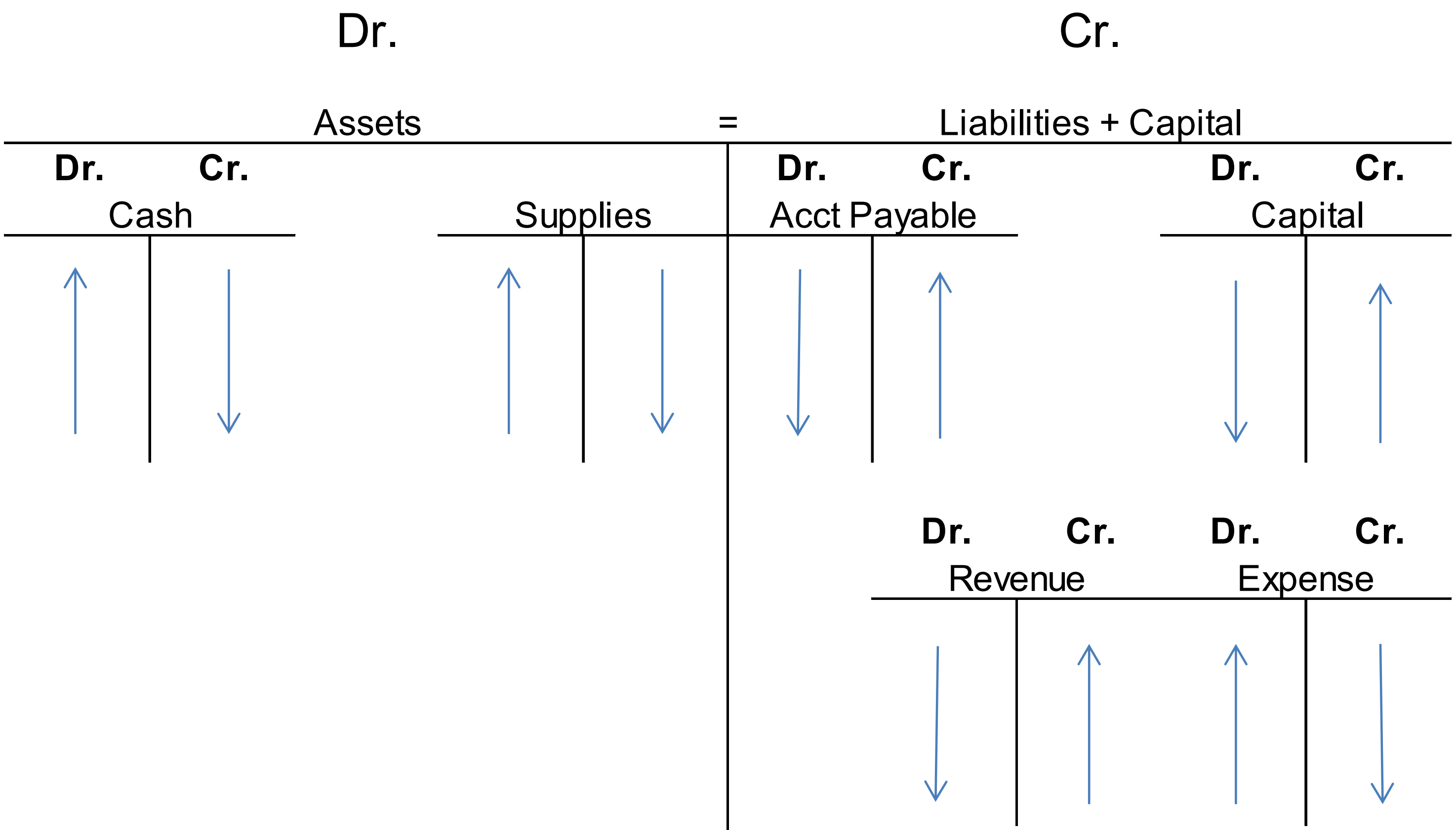
Rules of Debits & Credits



Debits increase asset accounts
Credits decrease asset accounts

Debits decrease liability & capital accounts
Credits increase liability & capital accounts

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Rules of Debits & Credits

Dr. Cr.

Assets = Liabilities + Capital

Dr. **Cr.**
Cash
1000

Supplies

Dr. **Cr.**
Acct Payable

Dr. **Cr.**
Capital
1000

Dr. **Cr.**
Revenue

Dr. **Cr.**
Expense

Debits increase asset accounts
Credits decrease asset accounts

Debits decrease liability & capital accounts
Credits increase liability & capital accounts

Assets = Liabilities + Capital

1000 = 0 + 1000

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Rules of Debits & Credits

Dr. | **Cr.**

Assets = Liabilities + Capital

Cash

	Dr.	Cr.	
(1)	1000		
(3)	75		
		50	(4)
Bal	1025		

Supplies

	Dr.	Cr.
(2)	250	

Acct Payable

Dr.	Cr.	
	250	(2)

Capital

Dr.	Cr.	
	1000	(1)

Revenue

	Dr.	Cr.
(3)		75

Expense

Dr.	Cr.	
50		(4)

Debits increase asset accounts
Credits decrease asset accounts

Debits decrease liability & capital accounts
Credits increase liability & capital accounts

Assets	=	Liabilities	+	Capital
1275	=	250	+	1025

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

<u>In Banking</u>

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

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

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

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	(xxxx)
Add:	Stock Issued	xxxx
Deduct:	Stock repurchased	(xxxx)
Balance at December 31, 2021		$ xxxxx

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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ABC Banking Company
STATEMENT OF CONDITION
December 31, 2021

Assets:	
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
Liabilities & Stockholders' Equity:	
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	
Common Stock	xxxx
Paid-in Surplus	xxxx
Retained Earnings	xxxx
Total Stockholders' Equity	$ xxxxx
Total Liabilities & Stockholders' Equity	$ xxxxx

IV. Preparing the Financial Statements (con't)

D. The Statement of Cash Flows

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 stated period of time**.

The three major sections of the Statement of Cash Flows are:

1. Operating Activities

   Net Income

   + Non-cash expenses

   + Increases in current liabilities
   + Decreases in current assets

   - Decreases in current liabilities
   - Increases in current assets

   = Net cash flows form Operating Activities

2. Investing Activities

3. Financing Activities

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

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

Year 2

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

125 + 10 - 5 = 130

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

Year 3

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

130 + 10 - 25 = 115

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

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

Net Interest Margin/Spread Comparison

Example #1

	$ Amount		Interest Rate	Interest
Loans	$ 1,000	@	6.00%	$ 60.00
Deposits	$ 1,000	@	2.00%	$ 20.00
Spread (difference between rates)			**4.00%**	

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

Spread and Net Interest Margin are EQUAL

Net Interest Margin/Spread Comparison

Example #2

	$ Amount		Interest Rate	Interest
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
Spread (difference between rates)			**4.00%**	

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

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	

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

Efficiency Ratio Calculation

Example #2

Total Expenses		**$ 700**
Net Interest Income	$ 750	
+ Non-Interest Income	$ 250	
Total Revenue	$ 1,000	

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

Efficiency Ratio Calculation

Example #3

Total Expenses		**$ 700**
Net Interest Income	**$ 1,000**	
+ Non-Interest Income	**$ 450**	
Total Revenue	**$ 1,450**	

$$\textbf{Efficiency \%} = \frac{\text{Total Expenses}}{\text{Total Revenue}} = \frac{\$\ 700}{\$\ 1{,}450} = \textbf{48.28\%}$$