

HOW BANKS WORK

[Select Page](#)

Accounting In Banks

by Robert Tripp | Feb 24, 2005 | Articles | 1 comment



Summary

This article sets out to give its reader an idea of how accounting is used within the banking environment. It will look at the users of Bank accounting and the reports produced on a yearly basis. It does not assume any accounting knowledge on the part of the reader, indeed accountants will find it a bit “noddy”.

Introduction

Every year banks must produce statutory accounts that expose everything the company has. The main purpose of financial accounting is to prepare financial reports that provide information about the bank’s performance to external parties such as investors, creditors, tax authorities and more (see fig 1.1). Managerial accounting contrasts with Financial accounting in that managerial accounting is for internal decision making and does not have to follow any rules issued by standard-setting bodies. Financial accounting, on the

other hand, is performed according to Generally Accepted Accounting Principles (GAAP) guidelines.

More on Financial, Customer and Managerial accounting

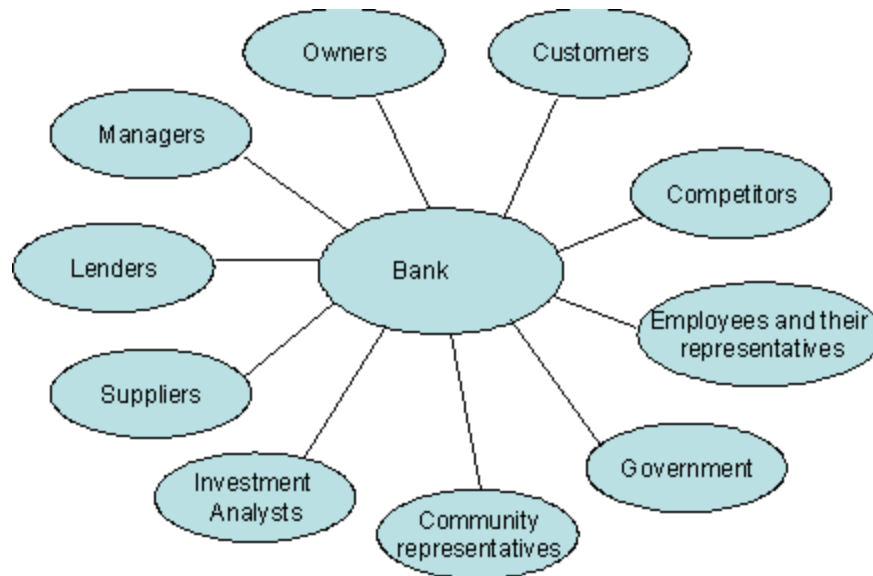


fig.1.1

Several of the above user groups are outside the bank but nevertheless have a stake in the business. This is not meant to be an exhaustive list of potential users but to be the main and most important ones.

No one would claim that accounting information fully meets the needs of the various user groups identified. Accounting is a developing subject and there is still much to learn about user needs and the ways in which these needs should be met. Nevertheless, the information contained within accounting reports should reduce uncertainty in the minds of the users over the financial position and performance of the business. It should help answer questions concerning the availability of cash to pay owners a return for their investment or to repay loans, etc. Often there is no close substitute for the information contained within accounting reports and so the reports are usually regarded as more useful than other sources of information which are available regarding the financial health of a business.

More on accounting as a service function

The Report: The major financial statement

The major financial statements are designed to provide a picture of the overall financial position and performance of the bank. To provide this overall picture, the Financial

accounting system will normally produce three major financial statements on a regular basis. The three statements are concerned with answering the following:

- How much profit was generated by the business over a particular period?
- What is the accumulated wealth of the business at the end of a particular period?
- What cash movements took place over a particular period?

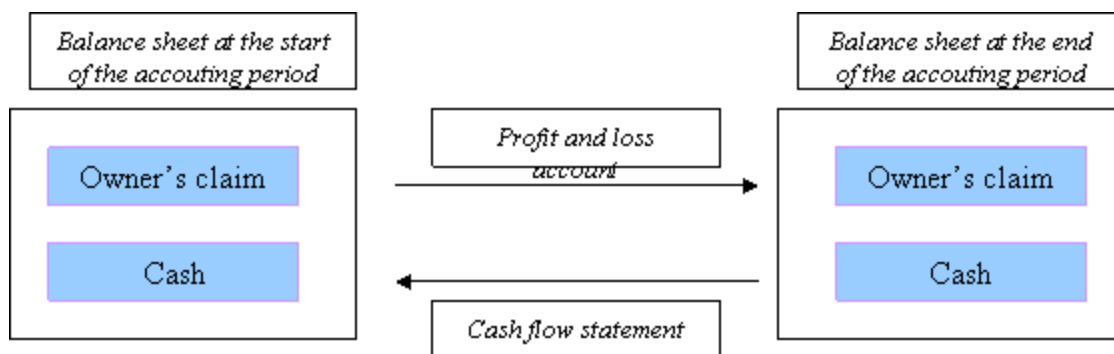
These questions are addressed by the three financial statements, each addressing one of the questions. The produced statements are:

1) The profit and loss account

2) The balance sheet

3) The cash flow statement

The three statements are interrelated; the balance sheet reflects the combination of assets (including cash) and claims (including the owner's capital) of the business at a particular point in time. Both the cash flow statement and the profit and loss account explain the changes over a period of two of the items in the balance sheet, namely cash and owner's claim, respectively.



1) The profit and loss account

The purpose of the profit and loss account (P&L) is to measure and report how much profit the business has generated over a period. Below is an example of an interim P&L Bank account.

	First half 2004 £m	First half 2003 £m	Full year 2003 £m
Net interest income	4,378	4,025	8,301
Non-interest income (excluding general insurance)	4,146	3,876	7,805
General insurance net premium income	2,416	1,177	3,123
Non-interest income	6,562	5,055	10,928
Total income	10,940	9,080	19,229
Operating expenses	4,615	4,051	8,389
Profit before other operating charges	6,325	5,029	10,840
General insurance net claims	1,723	836	2,195
Operating profit before provisions	4,602	4,193	8,645
Provisions	751	742	1,494
Profit before tax, goodwill amortisation and integration costs	3,851	3,451	7,151
Goodwill amortisation	413	373	763
Integration costs	57	182	229
Profit before tax	3,381	2,896	6,159
Tax	1,048	927	1,910
Profit after tax	2,333	1,969	4,249
Minority interests (including non-equity)	111	87	210
Preference dividends	116	137	261
	2,106	1,745	3,778
Additional Value Shares dividend	-	-	1,463
Profit attributable to ordinary shareholders	2,106	1,745	2,315
Ordinary dividends	529	431	1,490
Retained profit	1,577	1,314	825
Basic earnings per ordinary share (Note 4)	69.9p	60.0p	79.0p
Adjusted earnings per ordinary share (Note 4)	84.4p	76.5p	159.3p

The measurement of profit requires that the total revenues of the business, generated during a particular period, be calculated. Revenue or Total Income as stated in the above P&L, is simply a measure of the inflow of assets, which arise as a result of trading operations e.g. sales of loans to customers, fees for services.

The key feature of a bank's P&L statement (as opposed to a company's P&L) is that the income is not very intuitive. The income of normal manufacturing or trading company is essentially sales. Another common term in manufacturing companies' P&L statements is gross margin which is sales less cost of goods sold. With a bank the income is broken down into

- Non interest income – this is fairly intuitive in that it usually refers to fees and charges (loan arrangement fees, annual credit card fee, charges for using cheques when account is overdrawn etc. etc.).
- Net interest income – this is less intuitive; it is the total amount of interest earned (e.g. from loans) less interest paid out (e.g. depositors). This is only loosely related to the concept of sales which in a banking context would be akin to size of loans or deposits. It is closer to the idea of gross margin because it represents a difference between an incoming and an outgoing expense.

The total expenses relating to the period must also be calculated. An expense represents the outflow of assets which is incurred as a result of generating revenues e.g. salaries and wages, rent and rates. As shown above, operating profit in the P&L account in the example above deducts further costs, which are described in further detail:

- **provisions** is an amount set aside out of profits to provide for anticipated losses arising from debts which may prove irrecoverable. The other important distinguishing feature of a bank's P&L is the line for provisions which is always large relative to the similar line for a company and quite variable because it is money that the bank sets aside for bad loans. Because banks are cyclical businesses following economic cycles, in a recession, this line can dwarf the profit for the year, hence giving the bank a loss.
- **tax**
- **goodwill** (i.e. the amount by which the total paid for a business taken over exceeds the total value of the assets acquired. This additional amount represents a payment for 'goodwill' which arises from such factors as the skill of the workforce and brand)
- **Integration** (This is specific to the above example and will not be found in all P&L summaries. In this particular case the bank is going through an integration process and is baring its costs)

The Cost: Income ratio gives users of the financial information a "bank size independent" view of cost to income generated during the period. This is a key indicator in the banking industry, the smaller the number the more efficient the bank.

The dividends per ordinary share figure represents the transfer of assets made by a company to its shareholders.

The P&L account for a period, simply shows the total revenue generated during a particular period and deducts from this the total expenses incurred in generating that revenue. The difference between the total revenue and the total expenses will represent either profit or loss.

2) The balance sheet

The balance sheet sets out the financial position of a business at a particular moment in time. The balance sheet reveals the forms in which the wealth of the business is held, and how much wealth is held in each form.

We can be more specific about the nature of the balance sheet by saying that it sets out the assets of the business, on the one hand, and the claims against the business on the other.

Below is an example of a bank balance sheet:

AVERAGE BALANCE SHEET

First half 2004

First half 2003

	Average balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %
Assets						
Treasury and other eligible bills						
UK	620	11	3.55	1,956	27	3.26
Overseas	63	1	3.17	-	-	-
Loans and advances to banks						
UK	13,870	255	3.68	13,212	230	3.48
Overseas	9,617	107	2.23	9,406	107	2.28
Loans and advances to customers						
UK	181,086	5,187	5.73	166,743	4,671	5.80
Overseas	56,105	1,332	4.75	40,023	1,020	5.10
Debt securities						
UK	21,152	373	3.53	22,683	382	3.37
Overseas	17,352	362	4.17	18,160	413	4.55
Interest-earning assets						
- banking business						
UK	216,728	5,826	5.38	204,294	5,310	5.20
Overseas	83,137	1,802	4.34	67,589	1,540	4.56
- trading business						
	299,865	7,628	5.09	271,883	6,650	5.04
	116,805			91,946		
Total interest-earning assets	416,470			363,829		
Non-interest-earning assets	68,672			67,300		
Total assets	485,142			431,129		
Percentage of assets applicable to Overseas operations	31.9%			32.0%		
Liabilities						
Deposits by banks						
UK	33,253	455	2.74	26,515	338	2.55
Overseas	13,628	146	2.14	9,819	110	2.24
Customer accounts						
UK	139,253	1,726	2.48	130,902	1,513	2.31
Overseas	45,604	360	1.58	40,953	366	1.79
Debt securities in issue						
UK	34,054	519	3.05	29,034	495	3.41
Overseas	11,474	88	1.53	9,674	64	1.32
Loan capital						
UK	16,834	302	3.59	14,435	228	3.16
Overseas	164	5	6.10	156	8	10.26
Internal funding of trading business	(30,993)	(351)	2.27	(22,218)	(297)	2.67
Interest-bearing liabilities						
- banking business						
UK	193,325	2,661	2.75	180,767	2,292	2.54
Overseas	69,956	589	1.68	58,503	533	1.82
- trading business						
	263,281	3,250	2.47	239,270	2,629	2.36
	114,402			88,778		
Total interest-bearing liabilities	377,683			328,045		
Non-interest-bearing liabilities						
- demand deposits	26,080			24,130		
- other liabilities	51,660			51,326		
Shareholders' funds	29,739			27,625		
Total liabilities	485,142			431,129		
Percentage of liabilities applicable to Overseas operations	30.3%			31.1%		

Asset

Claims

The analysis between UK and Overseas has been compiled on the basis of location of office. Interest receivable and interest payable on trading assets and liabilities are included in dealing profits.

The analysis between UK and Overseas has been compiled on the basis of location of office. Interest receivable and interest payable on trading assets and liabilities are included in dealing profits.

Asset

Claims

An asset, in accounting terms, is used to describe a resource held by the bank that has certain characteristics:

- The bank has a probable future benefit from the asset
- The business has an exclusive right to control the benefit
- The benefit must arise from some past transaction or event
- The asset must be capable of measurement in monetary terms

One key feature of the assets a bank's balance sheet (as opposed to a company's balance sheet) are the loans which are recorded as assets. Unfortunately, valuing an asset is not an exact science. This is a particular problem for banks who attempt to value financial products, such as derivatives, where no money actually exchanges hands and where the value of the derivative could change over time.

Another important feature of a bank's balance sheet is whether a contract is an asset in the banking book or whether it is in the trading book. For example suppose a car

manufacturer issues €1,100M in the form of 5-year bonds and the bank pays the car manufacturer at the outset of the bonds' life for €20M with a view to holding on to them for the life of the bond. That would be considered to be part of the banking book. However, a different part of the bank may be buying and selling the same bonds in the secondary market with a view to make profits from buying at a low price and selling at a high price later. These would form part of the assets in the trading book. This classification is important because accountants value the bonds differently depending on the book it is in (see Report 2.2: What is IAS 39?).

A claim is an obligation on the part of the bank to provide cash, or some other form of benefit, to an outside party. A claim will normally arise as a result of the outside party providing funds in the form of assets for use by the bank.

There are essentially two types of claim against an organisation. These are:

- **Capital**
 - This represents the claim of owners against the business.
 - This is sometimes referred to as the owners 'equity or shareholders' funds, as in the above example.
- **Liabilities**
 - These represent the claims of individuals and organisations, apart from the owner, which have arisen from past transactions or events such as supplying goods or lending money to the business.
 - In the above example, Customer Accounts is recorded as a liability, as this is money owned to the customer.

What distinguishes a bank's (as opposed to a company's) liabilities is the amount of money it owes to its depositors. The proportion of assets that are "owned" by the bank is, relative to most large companies, very small. In financial jargon this is called being highly leveraged and banks are extremely highly leveraged. One of the consequences of this is that when things go well all the profits from the huge asset base goes to a, relatively, small amount of shareholder equity. Conversely when there is a recession and lots of the assets (loans) are turning bad, all the losses are concentrated in a, relatively, small amount of shareholder equity. This makes banks a volatile investment over an economic cycle. In the extreme, if a bank does not have enough shareholder funds to cope with a series of bad loans it will go bust. For this reason regulations require a certain minimum amount of shareholder funds be used to make loans. (See the report 2.1 What is Basel II).

The balance sheet equation, shown below, will always hold true:

Assets = Capital + Liabilities

This is because the equation is based on the fact that, if a business wishes to acquire assets, it must raise funds equal to the cost of those assets. These funds must be provided by the owners (capital) or other outside parties (liabilities), or both.

Shareholder funds often fluctuate. This is because there is a direct relationship between assets, liabilities and capital. If the assets or liabilities change, this has a direct influence on Capital.

This is particularly true within Banks, especially when we consider the Trading book. The Trading book is inherently riskier as it is made up of deals where no money may have changed hands and could be essentially a promise to deliver some assets in the future. A good illustration of this type of deals would be a FRA (Forward Rate Agreement). As the name implies, it is an agreement to fix a future rate today. For instance, let's imagine that a bank decides to buy £5,000,000 at \$1.55 from an individual in two years time. There are three possible outcomes to this deal:

1. The exchange rate between the GBP and the dollar does not change (highly unlikely)
2. The value of the dollar decreases compared to the GBP, eg: £1 valued at \$2
3. The value of the dollar increases compared to the GBP, e.g: £1 valued at \$1

Thus the value of the contract varies over time as the dollar/sterling exchange rate changes.

3) The cash flow statement

The cash flow statement is, in essence, a summary of the cash receipts and payments over the period concerned. All payments of a particular type are added together to give just one figure which appears in the statement. The net total of the statement is the net increase or decrease of the cash in the bank over the period. Below is an example of a bank's cash flow statement:

**STATEMENT OF CONSOLIDATED TOTAL RECOGNISED GAINS AND LOSSES
FOR THE HALF YEAR ENDED 30 JUNE 2004 (unaudited)**

	First half 2004	First half 2003	Full year 2003 (Audited)
	£m	£m	£m
Profit attributable to ordinary shareholders	2,106	1,745	2,315
Currency translation adjustments and other movements	(30)	47	43
Revaluation of premises	-	-	(69)
Total recognised gains in the period	2,076	1,792	2,289

**RECONCILIATION OF MOVEMENTS IN CONSOLIDATED SHAREHOLDERS' FUNDS
FOR THE HALF YEAR ENDED 30 JUNE 2004 (unaudited)**

	First half 2004	First half 2003	Full year 2003 (Audited)
	£m	£m	£m
Profit attributable to ordinary shareholders	2,106	1,745	2,315
Ordinary dividends	(529)	(431)	(1,490)
Retained profit for the period	1,577	1,314	825
Issue of ordinary shares	2,829	555	775
Redemption of preference shares	-	(364)	(364)
Own shares held in relation to employee share schemes	(7)	-	-
Goodwill previously written off to reserves	-	40	40
Other recognised gains and losses	(30)	47	(26)
Currency translation adjustment on share premium account	(60)	(30)	(203)
Net increase in shareholders' funds	4,309	1,562	1,047
Opening shareholders' funds	28,099	27,052	27,052
Closing shareholders' funds	32,408	28,614	28,099

1 Comment

1.

phone myint on July 15, 2016 at 3:46 am

I like these question and explain.

Trackbacks/Pingbacks

1. Kế toán ngân hàng là gì? Công việc của một kế toán ngân hàng – Đào tạo bồi dưỡng ngân
hạn - [...] Nguồn tham khảo: <https://howbankswork.com/accounting-in-banks/> [...]

Search

	Search
--	--------

Recent Posts

Future of Payments review – Cui Bono?

Digital Pound – (still) don't do it!

CBDCs and Digital IDs – like love and marriage

Retail CBDC – Don't do it!

Managing Change in Financial Services Risk and Compliance Communities – why is it more difficult?

Social Links



Latest News

- FT
- Error
- Euromoney
- Error

Increasing defence budget will require tough trade-offs
'Fish disco' row risks fresh delays to Hinkley Point nuclear plant
Reeves' private share trading plan criticised by executives
The good, the bad and the ugly of earnings statements
Tell 'price walkers' to take a hike

TRIPPLE CONSULTING

Tripple Consulting are the creative force behind Howbankswork.com. Read more about us or visit our website at www.trippleconsulting.co.uk

Privacy Policy & Disclaimer

Howbankswork.com takes your privacy seriously.

Read our [Privacy Policy and Disclaimer](#)

[Banking Framework](#)

[Articles](#)

[Blog](#)

[Links](#)

[Privacy & Disclaimer](#)

[Contact](#)