

# Management I: An Introduction to **Financial Accounting**

Compulsory Module Bachelor Level  
Winter Term 2015/16

Prof. Dr. Barbara Schöndube-Pirchegger  
Lehrstuhl für Unternehmensrechnung und Controlling

- **Class Schedule**

- Lecture Hours: Monday, 11:15 – 12:45
- Tutorial: Tuesday, 13:15 – 14:45
- Grading: Final Exam 60 (60 min)
- Assignments ?
- Total 60+?

- **Lecturer contact**

- Office: Vilfredo Pareto Gebäude (G 22), Room E 209
- Office Hours: Thursday 11-12 a.m. or by appointment
- E-mail: [barbara.schoendube@ww.uni-magdeburg.de](mailto:barbara.schoendube@ww.uni-magdeburg.de)
- Phone: 67 58728

- **Website:** <http://www.bwl1.ovgu.de/>

- Particular link to class website:

# Textbook



## Basic Text:

- Michael Jones (2014). “[Financial Accounting](#)“ 2<sup>nd</sup> ed., Wiley.

## Also of interest:

- Tim Sutton (2004). “[Corporate Financial Accounting and Reporting](#)“ 2<sup>nd</sup> ed., Prentice Hall.
- Joel Demski, (2008), “*Managerial Uses of Accounting Information*“, Second Edition, Springer
  - Available online via SpringerLink  
<http://link.springer.com>

# Chapter 1: Introduction

## Purpose and Object of Financial Accounting



- **What is Accounting?**
- Accounting is the language of business
  - Accounting provides information to managers and owners so they can make business decisions
  - It is about recording, preparing and interpreting business transactions
  - Business transactions are reflected in monetary terms
- The accounting system can be regarded as a library
  - It stores financial data of a firm
  - It is organized in some fashion
  - The manager uses the library to gather information
  - The manager's choices are reflected in the library

# Why do we need Accounting?

- Take an economist's view for the moment
  - A firm uses inputs to produce outputs
  - This process is described by a production function

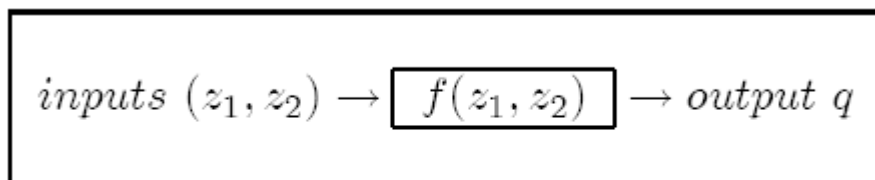


EXHIBIT 2.1

- Factor inputs, e.g. capital and labor,  $z_1, z_2$  are used to produce output  $q$
- Real live situation:
  - Do we know what the production function of a firm looks like?
  - Do we know the cost or profit function of a firm?

# How does the accounting system work?



- Accounting involves two functions:
  - Recording of transactions
    - Transactions are business activities such as buying or selling goods, paying salaries
    - Are to be measured in monetary terms
    - Recording is also referred to as **bookkeeping**
  - Preparation of financial statements and reports
    - Regular interval reports
    - Set up based on the recorded transactions
    - Reports map financial consequences of business activities in an aggregated form

# Stocks and flows in the library



- Stock variables
  - relate to the situation of the company at a specific point in time
  - Examples: stocks of goods, assets, liabilities
- Flow variables
  - relate to the change of situation over a specific period of time
  - Examples: expenses, income; change in value of a fixed asset, e.g. due to exchange rate changes
- Stocks are essentially reflected in the balance sheet
  - Shows assets and liabilities present in a firm at the end of a financial year (point in time)
- Flows are added up to generate the income statement
  - all revenues and expenses recorded within the period of a financial year are added up

# Financial versus Management Accounting



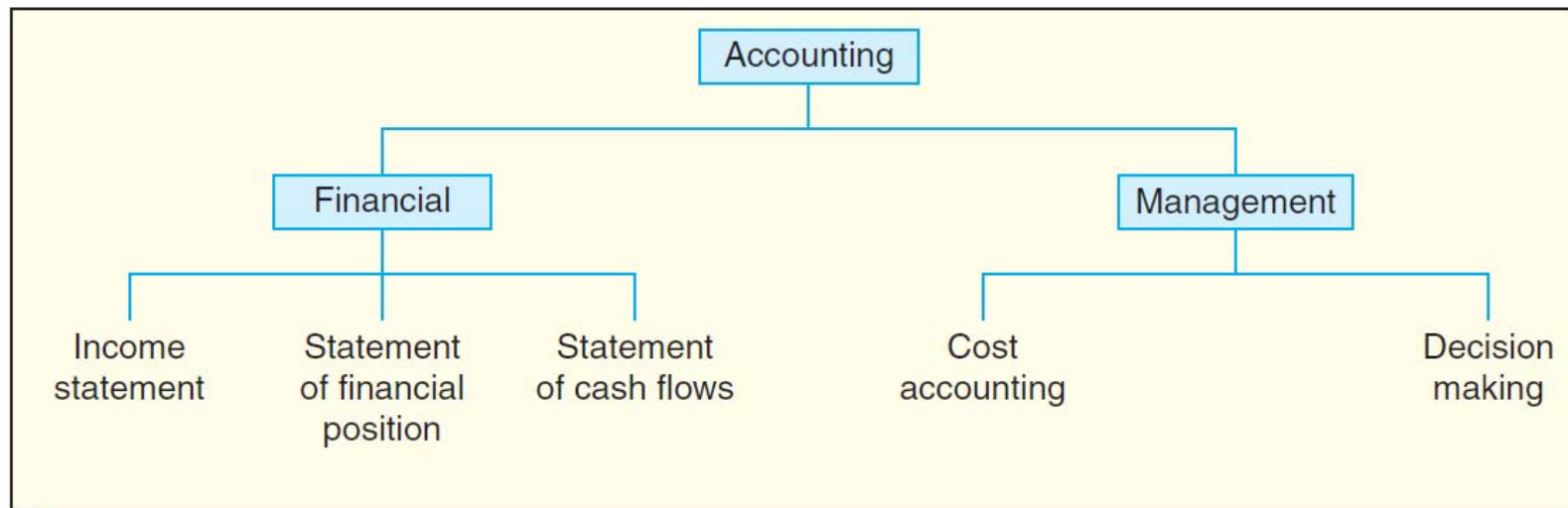
- Financial Accounting: external focus
  - Primary objectives
    - Stewardship, reports on past performance
    - Instrument to facilitate decisions for investors in the capital market
- Management Accounting: internal focus
  - Primary objectives:
    - Decision facilitating for the management
      - Financial planning Instruments
      - Cost accounting for decision making
    - Control of management behaviour
      - Budgeting: goal setting and control of achievement
      - Incentive system based on performance measures to be delivered by accounting

# Financial and Management Accounting



- Overview of financial and management accounting

**Figure 1.1** Overview of Financial and Management Accounting



# Contents of Financial Statements



- Main contents
  - Balance Sheet (Statement of financial position)
    - Helps assess the company's financial strength
  - Income Statement
    - Helps measure the firm's financial performance
  - Cash flow statement
    - Helps to assess the firm's ability to survive
  
- Further Contents
  - Notes to the Accounts
  - Statement of changes in equity, Comprehensive Income
  - Segment report
  - Environmental report

# Financial Accounting: who is addressed?



- **Investor orientation**
  - owners and potential acquirers of residual claims
    - Shareholders
- **Stakeholder orientation**
  - All parties that consider to or have committed resources to a relation with the reporting entity in exchange for future compensation
    - Shareholders, creditors, suppliers, customers, government, public
- **Tax authority orientation**
  - other interest groups could use the information to the detriment of investors
    - Regulators, trade unions, competitors

# Emphasize: Investor Orientation



What would be objective of financial accounting?

- Providing information that investors find helpful in making economic decisions (Decision usefulness)
- What is useful information?
  - Forward looking information
  - Backward looking information
- Information that is
  - *Relevant*,
  - *Reliable*
  - *Comparable*
- *Alternatively: monitoring and disciplining role of accounting?*

# Desirable characteristics of accounting



- Relevance
  - timely
  - material
- Reliability
  - unbiased, neutral, comprehensive, objective
- Comparable
  - between entities
  - over time (consistency principle)
- Transaction cost-efficient
  - cost of information should not exceed its value
  - influence on cost of capital
    - unreliable and scarce information may lead to market failure (accounting scandals)

## **Accounting Conventions**

1. Entity.
2. Monetary Measurement.
3. Historical Cost.
4. Periodicity.

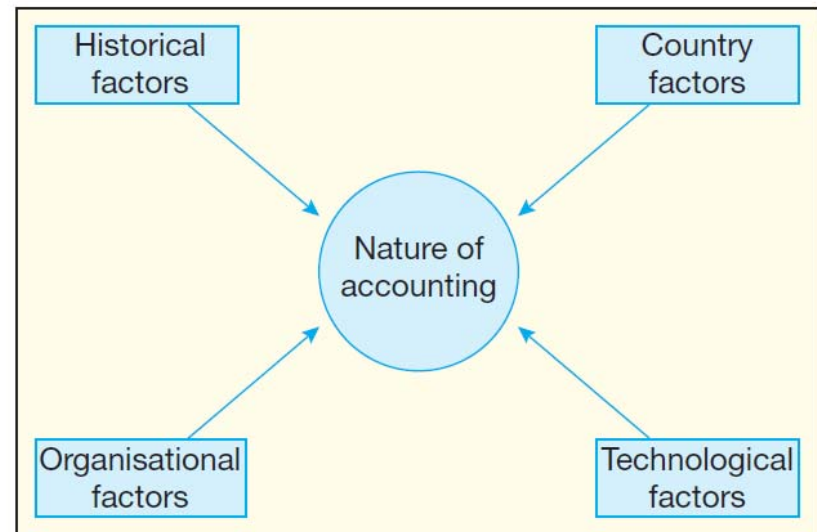
## **Accounting Concepts**

1. Going Concern.
2. Matching (accruals).
3. Consistency.
4. Prudence.

# Accounting Context

- Accounting standards differ from country to country
- They are affected historical factors, country specifics, tradition
- Standards are sometimes customized for specific types of businesses (sole trader, partnership, corporation; manufacturing or service industry)
- Technological change (computerization) affects accounting practice

**Figure 1.4** Importance of Accounting Context



# Who is required to *prepare* financial statements?



- An Accounting Entity
  - In this class we typically think of an accounting entity as either
    - Sole traders, Partnerships
    - A company
    - A group of companies under common control
  - Also possible:
    - non for profit organizations (e.g. Charities, government agencies)
- Requirement to set up financial statements does not necessarily imply an requirement to publish them
  - Accounting entities may be required to set up financial statements in order to ensure a decent information basis for business decisions

# Who is required to *publish* Financial Accounting Information?



- General idea: accounting entities should be required to publish financial accounting information whenever there is a sufficient need for such information from outside the firm
  - Investors
  - Stakeholders
- Financial accounting information is more valuable the more information asymmetry with respect to relevant information is present
  - Investors: Separation of ownership and control
  - Stakeholders: creditors, suppliers, and customers may need some information, too
- Requirements to publish accounts differ in different countries
  - Sole traders are in some countries not required to publish accounts
  - Specific accounting rules for non for profit organizations

# Accounting Entity versus Legal Entity



- A group consists of at least two individual companies each being a legal entity
- If the companies are under common control the group is an accounting entity
- Each individual company is an accounting entity, too
  - In most countries companies belonging to a group are required to publish financial statements
    - For each single company belonging to the group
    - For the group as a whole
- Problematic aspect with regard to groups:
  - What does common control mean?

- Germany
  - Regulation in codified law: Handelsgesetzbuch (HGB)  
= commercial code
  - German Accounting Standards Committee (Deutsches Rechnungslegungs Standards Committee (DRSC)), 1998
  - DSR (Deutscher Standardisierungsrat)
- The United States
  - US-GAAP (generally accepted accounting principles); numerous detailed regulations
  - FASB (Financial Accounting Standards Board) established in 1973; private-sector body
  - SEC (Securities and Exchange Commission) established in 1934; federal agency

- IASC (International Accounting Standards Committee)
  - Was founded in 1973; privately-funded accounting standard setter (based in London)
- Since 2001 **IASB** (International Accounting Standards Board)
  - Sets International Accounting Standards (IAS), now IFRS (International Financial Reporting Standards)
  - <http://www.iasb.org.uk/>
- European Union authorities influence regulations of member states by rulings that have to be translated into the law of the individual member states.
  - Since 2005 companies listed in member states are required to publish group accounts following International Financial Reporting Standards as far as endorsed by the European Union

# Structure of this lecture

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- Part 1: Foundations
  - Balance Sheet
  - Income Statement
  - Double Entry Bookkeeping
  - Financial Statement Preparation
- Part 2: Accounting treatment of specific items