Financial accounting

more than just bookkeeping

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The previous chapters and our practice examples can already be used without doubt to derive a host of measures to improve the control of subsidiaries abroad. Nonetheless we would like to complete the picture and briefly address our attention to financial accounting in Mittelstand companies. In particular, from the point of view of Mittelstand companies, the area of financial accounting is viewed as unspectacular. However, the area has a potential which is not to be underestimated in respect of improving the control of subsidiaries abroad.

First of all, we can take stock of the situation and outline the typical characteristics of financial accounting of the German Mittelstand companies:

- Traditionally, differentiation is made between the internal and external financial accounting. The internal financial accounting primarily includes cost and performance accounting, the income statement and frequently also the company planning. The external financial accounting is oriented towards financial accounting and the annual financial statement. Accordingly, here one finds the financial accounting and necessary auxiliary ledgers such as asset accounting, accounts payable/receivable and payroll accounting. In addition, there is frequently a marked materials management. Due to the interlacing of commercial and tax matters in financial accounting which was prevalent before the German Act on the Modernisation of Accounting Law (authoritative principle) the (external) financial accounting practice today is still strongly tax oriented.

- The internal and external financial accounting processes differ considerably in their structure and complexity. In the external financial accounting entries are booked according to entire operating costs, in internal financial accounting the so-called imputed costs dominate with a pronounced internal production cost allocation. The method of imputed additional costs is designed to improve the significance of the operative accounting. The imputed cost variables are frequently so complex that a transition of the result of the internal financial accounting to the result of the external financial accounting is only possible with a great deal of effort. Added to this there is a differentiated cost centre structure with complicated regulations for the coding of overheads.

- The result is a lack of a pronounced liquidity planning, whereby the monitoring of bank accounts and liquidity is more or less an isolated function and a systematic linking of liquidity planning between the external or internal financial accounting does not take place.

- The company planning exists in isolation next to the internal and external financial accounting and there is no integrated financial planning with regard to the balance sheet and income statement.

- Different programs are frequently used by the external and internal financial accounting and also for the maintenance of auxiliary ledgers, whereby a consistent, uniform ERP system is usually the exception.

- Financial accounting is largely carried out manually, based on paper. The degree of automation and digitalisation is low.

- In international operations, depending on the country different financial and auxiliary accounting methods are applied. There are no automated reporting interfaces for the financial accounting of the parent company.

- The reporting is mostly accomplished using Excel. The reports of the foreign subsidiaries are sent by email to the parent company.

- The consolidation, i.e. the preparation of consolidated group accounts is made manually using Excel or an own independent (consolidation) software.

- There is no binding group manual to achieve uniform group reporting standards.

- The focus of financial accounting is (even three years after the German Act on the Modernisation of Accounting Law) on the tax balance sheet.

- The financial accounting processes are not integrated in the central workflow of the other company processes, but are frequently isolated. The result in practice is a substantial deficit of information in the accounting department.

- In addition to internal and external financial accounting, over the years further commercial functions have developed organically such as controlling, treasury, planning, taxes etc.
  It is often not clear which set of data the respective departments are working with. The situation is aggravated by the fact that departments were historically created at different times without a binding definition of the content and scope of their tasks, whereby these are often influenced by the respective department head. The result is double structures and partly unclear assignment of responsibility leading to "organised irresponsibility". Overall the commercial field seems in need of continuous discussion.

- Monthly reports are not made available to the management before the middle of the month.

- The annual financial statement is often delayed far into the next financial year.

In total, the German financial accounting practice is obsessed with details, whereby the time factor is often not considered to be relevant for quality. The financial accounting is mostly managed with own personnel and outsourcing or partial outsourcing is not made or is partly only an option abroad.

› The main functions of a systematic risk management such as continuous monitoring measures in the form of systematic data analysis are not integrated in the financial accounting.

Overall, external financial accounting is rather seen as an annoying duty instead of an important element of the company control. One is often given the impression that the financial accounting has remained at the same technical level as 20 years ago. This picture is surprising especially in view of the commonly used modern production control systems and the high degree of automation in the production process. This is also true regarding the characteristic of lean production. While in the area of production and purchasing there is constant price pressure and the processes are maintained as lean as possible, the commercial department in total seems not to be subject to these requirements. That does not mean that the commercial department is overstaffed. In this respect there is a healthy awareness of cost. The criticism is more to do with the quality of the commercial processes.

In practice, the German Mittelstand financial accounting therefore differs considerably to the Anglo-Saxon financial accounting practice or the financial accounting in listed companies. Here the focus is not on financial accounting, but on the selective provision of the decision makers with relevant management information. Relevance refers to the usefulness of the information, i.e. all the information necessary for decisions has to be available at the right time. The factor of time is a decisive quality factor for the winning and processing of information. The following further features of modern financial accounting can be defined:

› There is just one financial accounting department. Differentiation is not made between internal and external financial accounting. A differentiation is made between management reporting and tax reporting. Management reporting is oriented to the recognised financial reporting standards such as HGB or IFRS, whereby tax reporting serves to comply with the tax obligations.

› Entire operating costs are always posted. There are no imputed costs. The cost and performance accounting is made on the basis of direct costing (calculation of profit contribution).

› The financial accounting is systematically integrated in the main workflow of the company. That begins with the ordering and production logistics and ends with sales or invoicing of the company's services. Naturally, all formation processes relevant for management regarding personnel and financial matters are integrated in the financial accounting.

- Financial accounting integrates financial planning and preparation of the balance sheet and result.
- Financial accounting is as far as possible automated and digitalised.
- The financial accounting systems are integrated throughout the group, often on the basis of a uniform ERP solution. All commercial analysis whether for the balance sheet, planning or profit and loss account use the same data.
- Monthly or quarterly reports are listed in the same quality as the annual financial statement, i.e. there are the corresponding time limits and continuous monitoring of devaluations, revaluations or additions to provisions for risk management.
- For the annual financial statement the possibilities of fast close can be exploited with the aim having the audited annual financial statement and consolidated financial statement available at the latest by the end of May.
- The co-operation with the auditor of the annual financial is systematic and continuous. Complex facts are discussed through the year. The audit is carried out with a strong business-process oriented focus.
- Risk management measures are systematically integrated in the financial accounting, i.e. for the inspection and monitoring of the correctness of the business processes. This includes, for example, automated data analysis (e.g. checking for unusual posting times, the synchronisation of creditor/debitor accounts with employee data, the automated plausibility check for travel expense accounting and much more). In the course of this data analysis the data protection regulations must of course be observed.
- There is a group accounting manual which defines binding rules for uniform group reporting standards for all subsidiary companies worldwide.

At this point, we would briefly like to address the subject of the group accounting manual in more detail. True to the motto of SMALL EFFORT – BIG EFFECT the use of the group accounting manual can result in numerous improvements in the control of foreign subsidiaries. Using a group accounting manual you create a regular and comparable pool of information which prevents a gradual loss of control. There is a clear action corridor for the accounting practices in connection with all business transactions and this therefore improves the objective view of the economic situation of the subsidiary company, whereby this counteracts the subconscious or conscious manipulation of figures or also concealment of the actual economic situation of the subsidiary. In addition, the group accounting manual supports the consolidation process in the preparation of the consolidated financial statement. The group accounting manual clearly and openly documents all decisions to be made with regard to the schedule, assignment of responsibility and expertise, uniform group reporting standards and the processes of the intra-group exchange of information.

The group accounting manual is also not an attack on the culture of trust, but rather establishes clear rules for the management at the subsidiary. Alone for this reason each newly founded (foreign) company should be equipped from the start with a group accounting manual.

A group accounting manual should include the following points:

› A clear description of the tasks and responsibilities of the local financial accounting of the subsidiary with regard to content, scope and deadlines of the continuous financial accounting, the continuous reporting and further facts relevant for reporting

› Definition of the relevant group reporting standards (HGB, international standards (IAS/IFRS, US-GAAP))

› Description of tasks, content, deadlines and responsibilities for the preparation of the local annual financial statement and group reporting packages (HB II) for the consolidated financial statement

› Definition of the system and chart of accounts

› Description of all balance sheet and income statement items and the associated balance sheet and accounting policy (with the objective of standardising the approaches, disclosure and valuation options worldwide)

› Principles and methods for currency conversion

› Provision of all forms for the group reporting system (reporting packages)

The above descriptions demonstrate that in the area of financial accounting there are numerous effective levers to improve the control and monitoring of the business activities overall and in particular of foreign companies. German Mittelstand companies are well placed to systematically exploit this potential for improvement.