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M03 – Fundamentals of Financial Accounting

The Role of Financial Accounting in Business Decision-Making

Detailed Project Report – Assignment Option 1

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Abstract

This report examines how financial accounting supports decision-making by managers, investors, creditors and other stakeholders. It combines a review of the accounting literature and standards with a ratio analysis of two years of financial statements for a fictional hospitality company, Havelland Hospitality GmbH, and with documented real-world cases (TUI, Thomas Cook and Wirecard). The literature shows that the purpose of financial accounting, as defined by the IASB Conceptual Framework, is to provide information that is useful to providers of capital, and that this information is valued because it reduces information asymmetry and supports the monitoring of management. The case analysis shows how the income statement, balance sheet and cash flow statement together measure profitability, liquidity and financial position. In the sample company, revenue grew 11%, but the net margin fell from 5.8% to 3.8%, the current ratio dropped from 0.94 to 0.62 and interest cover fell from 4.8× to 2.9× after a debt-financed renovation. Each stakeholder group would draw different decisions from the same statements. The real-world cases confirm that decisions are only as good as the reliability of the underlying figures. The report concludes with recommendations for using financial statements more effectively in planning and decision-making.

1. Introduction

Every business must decide how to use scarce resources: which products to sell, how much to invest, whether to borrow, and how much profit to distribute. Outside the business, investors decide whether to buy or sell shares, banks decide whether to lend, and suppliers decide whether to offer credit. All of these decisions depend on information about the firm’s performance and financial position. Financial accounting is the system that produces this information in a standardised, regular and audited form.

Despite its importance, financial accounting is often seen only as a legal duty: something prepared for the tax office or the commercial register at year-end. This view overlooks its role as a decision tool. A bank that refuses a loan, an investor who sells shares or a manager who postpones an investment is usually reacting to figures in the financial statements.

The aim of this report is to analyse how financial accounting supports business decision-making. It has four objectives, which follow the assignment brief:

1. to explain the meaning, objectives and importance of financial accounting;

2. to discuss how accounting information helps managers, investors, creditors and other stakeholders;
3. to analyse the role of financial statements in measuring profitability, liquidity and financial position; and
4. to provide real-world examples of businesses using accounting information for planning and decision-making.

Section 2 reviews the relevant literature and standards. Section 3 explains the methodology. Section 4 presents the findings from the sample-company analysis and the real-world cases. Section 5 discusses the implications and limitations, and Section 6 concludes with recommendations.

2. Literature Review

2.1 Meaning of financial accounting

Financial accounting is the process of recording, classifying and summarising a business's transactions and presenting them in general-purpose financial statements for users outside the business (Weetman, 2019). It differs from management accounting, which produces detailed internal information for planning and control, in three ways: it is aimed mainly at external users, it follows a regulatory framework (in Germany the Commercial Code, HGB, and for listed groups International Financial Reporting Standards, IFRS), and it reports on the past rather than forecasting the future. Its main outputs are the statement of financial position (balance sheet), the statement of profit or loss (income statement), the statement of cash flows, the statement of changes in equity and the accompanying notes.

2.2 Objectives of financial accounting

The IASB Conceptual Framework (2018) states that the objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Such decisions include buying, selling or holding equity and debt instruments, providing or settling loans, and exercising rights such as voting on management's actions. To make these decisions, users need to assess the amount, timing and uncertainty of the entity's future net cash inflows and how efficiently management has used the entity's resources.

Two traditional objectives can be distinguished. The **stewardship** objective holds that accounts show owners how managers have looked after the resources entrusted to them. The **decision-usefulness** objective holds that accounts should help users predict future cash flows. Modern standards combine both, while national traditions differ in emphasis: German HGB accounting has historically stressed prudence and creditor protection, whereas IFRS focuses more on information for investors (Elliott & Elliott, 2019).

2.3 Importance of financial accounting

The importance of financial accounting can be seen at three levels. At the level of the **firm**, it provides a complete and systematic record of all transactions, which is the basis for internal control, the calculation of taxable profit and the planning of future activities. At the level of **capital markets**, standardised and audited statements allow investors and lenders to compare firms and to price risk, which channels savings towards the most productive uses. At the level of **society**, financial reports support accountability: they show employees, regulators and the public how a company performs and whether it can meet its obligations. Without trustworthy accounting, lenders would demand higher interest rates and investors would demand higher returns to compensate for uncertainty, raising the cost of capital for all businesses.

2.4 Users of financial accounting information

Stakeholder theory argues that a firm is accountable not only to its shareholders but to all groups that can affect or are affected by its activities (Freeman, 1984). Financial statements are one of the main channels through which this accountability is exercised. Each user group reads them with a different question in mind. **Investors** want to know whether the firm will generate future returns and how much risk they carry. **Lenders** want to know whether interest and principal will be repaid. **Suppliers** assess whether they will be paid on time, and **customers**, particularly in tourism where they often pay in advance, have an interest in the firm's continued existence. **Employees** look for job security and the basis for wage negotiations, **governments** use the accounts for taxation and statistics, and **managers** use them to evaluate their own performance and plan ahead. Because general-purpose statements cannot meet every need in full, the Conceptual Framework identifies investors and creditors as the primary users, on the assumption that information useful to them will also be broadly useful to others (IASB, 2018).

2.5 Qualitative characteristics of useful information

For accounting information to support decisions, the Conceptual Framework requires two fundamental qualities. **Relevance** means the information is capable of making a difference to a

decision because it has predictive or confirmatory value and is material. **Faithful representation** means the information is complete, neutral and free from error. Four enhancing characteristics (comparability, verifiability, timeliness and understandability) make relevant and faithful information more useful. The framework also recognises a cost constraint: reporting should not cost more than the benefit it brings to users (IASB, 2018).

2.6 Theoretical explanations of the value of accounting information

Several economic theories explain why financial accounting matters. **Information asymmetry** theory shows that when sellers know more than buyers, markets can break down because buyers cannot distinguish good products from bad ones (Akerlof, 1970). In capital markets, managers know more about the firm than investors and lenders do; audited financial statements reduce this gap and therefore lower the cost of capital. **Agency theory** describes the relationship between owners (principals) and managers (agents) whose interests may differ (Jensen & Meckling, 1976). Financial statements and audits are monitoring mechanisms that allow owners to check managers' performance, and contracts such as bonus plans and loan covenants are often written in accounting numbers.

Empirical research supports these views. Ball and Brown (1968) showed that share prices move in the same direction as unexpected changes in reported earnings, demonstrating that accounting income contains information that investors use. Research on financial distress shows that ratios calculated from published statements can predict business failure years in advance: Beaver (1966) found that the ratio of cash flow to total debt was a strong predictor, and Altman (1968) combined several ratios into the Z-score model of bankruptcy prediction. These studies confirm that financial statements are not just historical records but contain signals about the future.

2.7 Financial statements as measures of profitability, liquidity and position

The literature commonly organises financial statement analysis into four groups of ratios (Weetman, 2019; Elliott & Elliott, 2019):

- **Profitability** ratios, such as gross margin, operating margin, net margin, return on assets (ROA) and return on equity (ROE), are mainly drawn from the income statement and show how effectively the business turns sales and capital into profit.
- **Liquidity** ratios, such as the current ratio, quick ratio and cash ratio, are drawn from the balance sheet and show whether the business can meet short-term obligations.

- **Solvency or gearing** ratios, such as debt-to-equity, the equity ratio and interest cover, show the long-term financial position and the risk borne by lenders.
- **Efficiency** ratios, such as receivable and payable days, show how well working capital is managed.

The cash flow statement complements these ratios by showing whether profit is being converted into cash, which accrual-based profit figures cannot show on their own.

2.8 Limitations identified in the literature

Financial accounting information also has well-known limitations. It is largely historical and may be out of date by the time it is published. Many assets are measured at historical cost, so balance sheets may not show current values, and important resources such as staff skills, brand reputation and customer relationships are often not recognised at all. Accounting choices and estimates (depreciation methods, provisions, revenue recognition) leave room for judgement and, in extreme cases, manipulation. Users therefore need to read the statements critically, together with the notes, the audit report and non-financial information.

3. Methodology

This report uses a **qualitative, desk-based research design** combined with a **quantitative case analysis**. Three sources of evidence were used.

5. **Literature and standards.** Academic textbooks, peer-reviewed articles and the IASB Conceptual Framework were reviewed to define financial accounting, its objectives and the theories that explain its value (Section 2).
6. **Illustrative company case.** A set of financial statements for two years (FY2024 and FY2025) was constructed for Havelland Hospitality GmbH, a fictional mid-sized hotel and travel company. Using an illustrative case allows the full statements to be shown and analysed without confidentiality issues. Profitability, liquidity, solvency and efficiency ratios were calculated in a spreadsheet using standard formulas (Appendix B), and a cash flow statement was derived from the two balance sheets and the income statement (Appendix A).
7. **Real-world cases.** Three documented cases from the European travel and financial-services sectors (TUI, Thomas Cook and Wirecard) were selected because each shows a different aspect of how accounting information influences decisions: capital planning,

financial distress and reliability. Information was taken from company announcements and reputable news sources.

The method has limitations. The company figures are invented, so the findings illustrate the analytical process rather than describing a real firm. The real-world cases are based on secondary sources and cannot capture internal decision processes. Ratio analysis also depends on the comparability of the figures; benchmarks used for interpretation are general rules of thumb rather than industry-specific norms.

4. Findings

4.1 The sample company's financial statements

Havelland Hospitality GmbH operates two hotels and a small tour-operating business. In FY2025 it renovated one hotel at a cost of about €2,120 thousand, financed by a new bank loan and by its own cash reserves. Table 1 summarises its income statement and balance sheet (all figures in € thousand).

Table 1. Summary financial statements, Havelland Hospitality GmbH (fictional, € thousand)

Item	FY2024	FY2025
Revenue	8,200	9,100
Cost of sales	3,690	4,277
Gross profit	4,510	4,823
Operating expenses	3,200	3,550
Depreciation	450	520
Operating profit (EBIT)	860	753
Interest expense	180	260
Tax (30%)	204	148
Net profit	476	345
Non-current assets	7,800	9,400
Current assets	1,510	1,070
of which cash	980	310
Total assets	9,310	10,470
Equity	4,100	4,245
Long-term loans	3,600	4,500
Current liabilities	1,610	1,725

4.2 Profitability

Revenue rose by 11.0%, which at first sight suggests a successful year. The income statement, however, shows that profit did not follow. The gross margin fell from 55.0% to 53.0% because

food, energy and partner-hotel costs grew faster than prices. The operating margin fell from 10.5% to 8.3% as depreciation on the renovated hotel increased, and the net margin from 5.8% to 3.8% as higher interest was paid on the new loan. Return on equity dropped from 11.6% to 8.1%. For managers this indicates a pricing and cost-control problem; for owners it means a lower return on their capital, at least until the renovated hotel earns higher room rates.

4.3 Liquidity

The balance sheet reveals the most serious change. The current ratio fell from 0.94 to 0.62 and the cash ratio from 0.61 to 0.18. Cash fell from €980 thousand to €310 thousand because part of the renovation was paid from the company's own reserves. At the same time, receivable days rose from 18 to 25, meaning that corporate customers and travel agents were paying more slowly. A current ratio well below 1 is a warning sign: the company now depends on continuous customer prepayments and its bank's goodwill to meet short-term obligations.

4.4 Financial position and cash flows

Debt-to-equity rose from 0.98 to 1.18, and the equity ratio fell from 44.0% to 40.5%. Interest cover, the number of times operating profit covers interest, fell from 4.8× to 2.9×. The cash flow statement (Appendix A) explains the movement: operating activities generated €650 thousand, investing activities used €2,120 thousand and financing activities provided €800 thousand (new loans less a €200 thousand dividend). Cash therefore fell by €670 thousand. The company remained profitable, but it financed a long-term investment partly with short-term resources, a classic cause of liquidity strain.

Table 2. Key ratios

Ratio	FY2024	FY2025	Trend
Gross margin	55.0%	53.0%	Worse
Net margin	5.8%	3.8%	Worse
Return on equity	11.6%	8.1%	Worse
Current ratio	0.94	0.62	Worse
Quick ratio	0.86	0.54	Worse
Debt / equity	0.98	1.18	Higher risk
Interest cover	4.8×	2.9×	Worse
Receivable days	18	25	Slower

A vertical analysis, expressing each item as a percentage of revenue, confirms where the pressure arises: cost of sales rose from 45.0% to 47.0% of revenue and interest from 2.2% to 2.9%, while operating expenses stayed broadly stable at about 39.0%. A horizontal analysis,

comparing the change in each item, shows that receivables grew by 51.2% while revenue grew by only 11.0%, which explains part of the cash shortfall. These two simple techniques allow a non-specialist reader to locate problems quickly before calculating more detailed ratios.

4.5 How different stakeholders would use the information

The same set of statements leads each stakeholder group to different decisions:

- **Managers** would use the analysis to plan corrective action: review room and package prices, renegotiate supplier contracts to restore the gross margin, tighten credit control to bring receivable days back below 20, and arrange a working-capital credit line before the low season.
- **Owners and investors** would weigh the lower ROE against the expected return from the renovation. They might accept a lower or no dividend for FY2026 to rebuild cash, as paying €200 thousand while cash fell sharply weakened the company further.
- **Banks and other creditors** would focus on interest cover (2.9×) and the current ratio (0.62). A lender might still grant further credit, but only with covenants such as a minimum interest cover or a ban on dividends, or with additional security.
- **Suppliers** would note that payable days stayed stable at about 75 days, showing that the company still pays on time, but might shorten credit terms if liquidity worsens further.
- **Customers**, particularly tour-operator customers who pay deposits months before travel, depend on the company's continued solvency. The fall in liquidity matters to them, which is one reason why package-travel law requires insolvency protection for customer prepayments.
- **Employees and tax authorities** would see a profitable firm that is investing, which supports job security, while the lower profit reduces income tax due.

4.6 Real-world example 1: TUI – planning a capital increase

TUI, Europe's largest leisure travel group, received three state stabilisation packages worth around €4.3 billion from the German government during the pandemic. In April 2023 it raised about €1.8 billion through a capital increase and used the proceeds to repay the remaining aid from the Economic Stabilisation Fund in full; the group had paid around €381 million in interest and related compensation for the support (TUI Group, 2023). The decision was based on balance-sheet analysis: management explained that repaying the aid would reduce net debt and interest costs and restore a sound balance-sheet structure. This shows financial accounting

information being used for long-term financial planning, and also how investors used TUI's published statements to decide whether to subscribe to the new shares.

4.7 Real-world example 2: Thomas Cook – warning signs in the statements

Thomas Cook, the world's oldest travel company, ceased trading in September 2019. Its published accounts had shown the warning signs for some time: a debt burden of around £1.6–1.7 billion, a very large reported loss in its 2019 half-year results and heavy fixed costs from hundreds of high-street shops (Financier Worldwide, 2019). Lenders and investors who read these statements could see deteriorating profitability, solvency and liquidity ratios, the same pattern that Beaver (1966) and Altman (1968) identified as predictors of failure. When the company failed to raise a final £200 million of funding, it collapsed. The case shows how creditors use financial statements to decide whether to continue lending.

4.8 Real-world example 3: Wirecard – when information is unreliable

Wirecard, a German payments company listed in the DAX, collapsed in June 2020. Its auditor, EY, refused to sign off the 2019 accounts because it could not confirm the existence of €1.9 billion in cash supposedly held in trust accounts, roughly a quarter of the balance sheet. Wirecard then admitted the money probably did not exist, and on 25 June 2020 filed for insolvency, owing creditors almost USD 4 billion. Investors and banks had made decisions based on financial statements that did not faithfully represent the company's position. The case demonstrates that the decision-usefulness of accounting depends on faithful representation and effective audit, and it led to reforms of German auditing and financial supervision.

5. Discussion

5.1 Financial accounting as a decision tool

The findings support the view in the literature that financial accounting is primarily a decision tool. In the sample company, no single figure told the full story: revenue growth looked positive, while profitability, liquidity and solvency ratios showed a business under strain. Only by reading the three main statements together could users understand that a profitable, growing firm had created a liquidity problem by financing a long-term investment partly with its own short-term resources. This confirms the importance of the cash flow statement alongside accrual-based profit, as Beaver's (1966) emphasis on cash flow suggests.

The stakeholder analysis also illustrates agency theory in practice (Jensen & Meckling, 1976). The dividend paid in FY2025 benefited owners in the short term but transferred risk to lenders. Banks protect themselves against such behaviour by writing covenants based on accounting ratios, which shows how contracts and monitoring depend on financial statements.

5.2 Planning and control

Although financial accounting looks backwards, it is the starting point for planning. Budgets for the next year start from the latest income statement, investment plans are tested against the balance sheet's capacity for further borrowing, and cash budgets build on the cash flow statement. The TUI case shows the same logic at large scale: the decision to raise equity was justified by its effect on net debt and interest costs, which are accounting measures. For a small or medium-sized company, this suggests that managers should not treat annual accounts as a compliance exercise but should analyse them systematically, ideally supported by more frequent internal reports.

5.3 Reliability, ethics and the limits of accounting information

The Wirecard case highlights the dependence of every decision on reliable figures. Investors, banks and even regulators acted on financial statements that misrepresented the company's cash position. Information asymmetry, which accounting is supposed to reduce, was instead exploited (Akerlof, 1970). This points to the role of auditors, audit committees and regulators, and to the ethical responsibility of accountants and managers. Users can protect themselves partly by cross-checking accounting numbers: for example, by comparing reported profit with operating cash flow, which in Wirecard's case had long attracted critical questions from analysts and journalists.

More generally, financial accounting has limitations as a decision basis. Historical cost values may understate the worth of property such as hotels, intangible strengths are often not recorded, and the information arrives months after year-end. In tourism, where demand is seasonal and can change abruptly, annual statements need to be combined with monthly management accounts, booking data and non-financial indicators such as occupancy and customer satisfaction.

5.4 Using ratios responsibly

Ratio analysis is powerful but easily misread. A current ratio below 1 is alarming for a manufacturer that holds large stocks, but less so for a hotel or tour operator that collects cash

from customers before it pays suppliers; the sample company's prepayments partly explain why it could operate with a low ratio. Ratios also need context over time and against peers: a single year's figure says little, while a three-year trend or an industry comparison shows whether a change is unusual. Finally, ratios can be affected by accounting choices, such as the depreciation method or the timing of a dividend, and by one-off events such as a renovation. Good practice is therefore to combine ratios with the notes to the accounts, the management report and an understanding of the business model. In the sample company, for example, the fall in profitability is partly temporary, because the renovated hotel was closed for part of the year and only began earning higher room rates afterwards, while the fall in liquidity is structural and needs immediate action.

5.5 National and international reporting frameworks

The usefulness of financial statements also depends on the framework under which they are prepared. Most German small and medium-sized companies, like the sample company, report under the HGB, which emphasises prudence: assets are generally valued at no more than cost, and losses are recognised as soon as they are foreseeable, while gains are recognised only when realised. This protects creditors and supports a cautious dividend policy, but it can hide reserves and make firms look less profitable than they are. IFRS, required for the consolidated accounts of listed groups such as TUI, places more weight on current values and on information for investors. Users who compare companies across frameworks must therefore adjust for these differences, for example in the valuation of property, leases and provisions.

5.6 Changing scope of financial reporting

Financial reporting is also expanding beyond purely financial figures. Through the Corporate Sustainability Reporting Directive (Directive (EU) 2022/2464), the EU has extended corporate reporting to include standardised information on environmental, social and governance matters, to be presented in the management report and subject to assurance. For tourism businesses, whose long-term prospects depend on climate, energy costs and destination quality, such information can be as decision-relevant as the balance sheet. At the same time, digital bookkeeping and cloud-based accounting systems allow statements to be produced faster and more often, reducing the timeliness problem identified in the literature. These developments strengthen the decision-making role of financial accounting, provided that the new information is as reliable as traditional financial data.

5.7 Implications for small and medium-sized businesses

For businesses like the sample company, the practical lessons are clear. Financial statements should be analysed every year using a consistent set of ratios, and trends should be compared with industry benchmarks. Major investments should be planned with a projected balance sheet and cash flow statement to check their effect on liquidity before the decision is made. Finally, open and accurate reporting to banks builds trust and improves access to finance, while any attempt to present an overly positive picture risks the kind of loss of confidence seen in the real-world cases.

6. Conclusion

Financial accounting is the systematic recording and reporting of a business's transactions in financial statements prepared under recognised standards. Its main objective is to provide information that is useful to investors, lenders and other creditors when they decide whether to provide resources to the business, and it also allows owners to monitor management. Theory and empirical evidence show that this information reduces information asymmetry, is reflected in share prices and can predict financial distress.

The analysis of the sample company demonstrated how the income statement, balance sheet and cash flow statement together measure profitability, liquidity and financial position, and how the same figures lead managers, owners, creditors and suppliers to different decisions. The real-world cases of TUI, Thomas Cook and Wirecard illustrated, respectively, the use of accounting information for capital planning, the warning signs of financial distress, and the damage caused when figures are unreliable.

Overall, the evidence shows that the value of financial accounting lies less in any individual figure than in the connections between the statements. Profit without cash, growth without margin, or investment without matching long-term finance are all patterns that become visible only when the statements are read together and over time. For decision-makers, the skill that matters most is therefore not preparing the statements but interpreting them critically and acting on what they reveal.

The following recommendations are made for businesses using financial accounting in decision-making:

8. Analyse the annual financial statements with a fixed set of profitability, liquidity, solvency and efficiency ratios, and track trends over at least three years.

9. Always read profit together with operating cash flow, and investigate any persistent gap between the two.
10. Before major investments, prepare projected financial statements to test the effect on liquidity and gearing; finance long-term assets with long-term funds.
11. Link dividend decisions to liquidity and gearing targets, not only to profit.
12. Supplement annual accounts with monthly management reports and key non-financial indicators.
13. Maintain strong internal controls and an independent audit, and communicate openly with banks and investors to preserve trust.

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Appendices

Appendix A – Cash flow statement FY2025 (indirect method, € thousand, fictional)

Item	FY2025
Net profit	345
Add: depreciation	520
Increase in inventory	(20)
Increase in receivables	(210)
Increase in trade payables	120
Decrease in customer prepayments	(105)
Cash from operating activities	650
Purchase of non-current assets (renovation)	(2,120)
Cash used in investing activities	(2,120)
New long-term loans	900
Increase in short-term borrowing	100
Dividend paid	(200)
Cash from financing activities	800
Net change in cash	(670)
Cash at start of year	980
Cash at end of year	310

Appendix B – Detailed balance sheet and ratio formulas

Working-capital item (€ thousand)	FY2024	FY2025
Inventory	120	140
Trade receivables	410	620
Cash	980	310
Trade payables	760	880
Short-term borrowing	400	500
Customer prepayments	450	345

Ratio	Formula
Gross margin	Gross profit ÷ revenue
Operating margin	EBIT ÷ revenue
Net margin	Net profit ÷ revenue
Return on equity	Net profit ÷ closing equity
Return on assets	EBIT ÷ total assets
Current ratio	Current assets ÷ current liabilities
Quick ratio	(Current assets − inventory) ÷ current liabilities
Cash ratio	Cash ÷ current liabilities
Debt / equity	(Long-term loans + short-term borrowing) ÷ equity
Equity ratio	Equity ÷ total assets

Ratio	**Formula**
Interest cover	EBIT ÷ interest expense
Receivable days	Trade receivables ÷ revenue × 365
Payable days	Trade payables ÷ cost of sales × 365