An analysis of the business importance of accounting

By Filbert Tsai

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Filbert Tsai is a Filipino financial accounting advisory services executive in the UK with specialization in transaction accounting in the power and utilities sector. He had provided accounting advice to a significant number of government and financial institutions investing or providing financing structures in the renewables sector in Europe and in developing countries.

Accounting is usually viewed as the back office department that merely adds cost for compliance purpose without adding any real value. It is difficult to articulate the value of accounting to management and more so finance people used to doing highly complex calculations and forecasting business performance. So indeed, what value is accounting adding to a business or to an organisation?

Traditional textbooks define accounting as the language of business which allow investors to interpret the financial performance or position of a company. Indeed, accounting information provides a great deal of information about a company's performance and position through the financial statements and savvy analysts tend to be able to predict the upcoming performance of the company. But for most companies, these analysis tend to be not really relevant, albeit reliable, as financial statements are merely prepared for the purpose of filing for regulatory compliance.

Working with investment bankers and transaction advisors most of the time made me realise why accounting is actually relevant. Investment bankers and transaction advisors are interested in achieving a high level of free cash flow used to compute for the corporate value using the discounted cash flow approach. Being non-accountants, financial models built by investment bankers and transaction advisors usually rely heavily on cash basis accounting which results to large differences in actual free cash flow after consideration of accrual basis accounting.

After careful analysis of what's really important to businesses, the mismatch between accounting and finance boils down to two key points:

· Distributable reserves

· Cash tax payments

The importance of accounting for businesses is down to its cash implications. Regardless of the size of the business, owners (businessman or shareholders) are interested in what a company actually pays out either through dividend (or drawings for small businesses) or through capital growth (through improved corporate valuation).

Distributable reserves is the key driver in appreciating the importance of accounting. Distributable reserves is the amount actually distributable from the company's retained earnings determined in accordance with accounting standards. The problem is that in complying with accounting standards, accrual of expenses and non-cash adjustments can prove detrimental to a company's distributable reserves.

Meanwhile, small business or entrepreneurs usually see cash balance in their business as the actual earnings, ignoring distributable reserves as the true net worth of a business results to potential bankruptcy concerns. In fact, most small businesses and entrepreneurs ignore the importance of accounting resulting to difficulty in settling obligations as they fall due because of the lack of transparency in liquidity.

Large businesses or conglomerates understands the importance of distributable reserves as finance departments keeps on pushing the limits of free cash flow. The problem with most large businesses is the mismatch of understanding of free cash flow concept in the finance department versus the distributable reserves concept in the accounting department. Free cash flow is a finance concept adopted from the cash flow statement in accounting and is usually computed by investment bankers to project corporate value. In essence, free cash flow information is the key input to compute for the value of a business which, under ceteris paribus, would equal the distributable reserves. But the world of accounting complicates the amount of distributable reserves through accruals which results to significant cash being strapped-out for dividends as they are tied-against liabilities. While the overall distributable reserves over the life of a business will generally equal the free cash flow, timing differences for the release of these cash assets could result to significant valuation differences due to the time value of money.

Cash tax payment is an easy discussion. Every business, regardless of its size is concerned by the net amount of cash tax payment. While in Asia, income tax inclines towards cash accounting, tax accounting under International Accounting Standards 12 (IAS on Income Taxes) would still result to tax expenses being recognised at the amount of accounting profit determined based on accrual accounting. In developed countries, the determination of cash tax payment using accrual basis accounting will generally result to increased importance of accounting as a determinant of the amount of cash tax to be paid. In developing countries, the tax gap between cash and accrual accounting will impact distributable reserves instead of cash taxes.

Understanding the importance of accounting can simply be highlighted through its cash impact. The role of the accounting department in a business can play between a mere transaction processor to a valued business adviser which depends of the readiness of the business to change the role of their accountants.

Accounting for large business and conglomerates are handled by accounting departments which are fully with capable and qualified personnel, what is important then is to ensure that proper linkage between finance department and accounting department is enabled to maximise corporate value.

Changing the business perspective of the accounting department from a financial processor role to a valuable business adviser role is critical in the long term growth of the business.

For small businesses and entrepreneurs, accounting does not necessarily need to be complex and costly. A few training sessions to enable non-accountants to do the basic role of recording financial transaction as they happen would provide small businesses and entrepreneurs ease of mind to have a ready glimpse of their financial position and performance.

So how is accounting important to the profession itself? The Economist estimates a 94% probability for accountants to be replaced by technology within the next two decades in their article dated 18 January 2014]. With the continuous improvements in accounting systems, most of the accounting work can be done automatically by accounting systems which ultimately reduces significantly the need to have accountants working of the transaction processing.

Understanding the importance of accounting highlights as well the expectations from an accountant. For accountants to be responsive to today's business requirement, an accountant would need to know more than number crunching and transaction processing. Accountants would now need a more holistic understanding of business, economics and finance to be able to form valuable inputs and make appropriate judgment calls.

Machines cannot replace the ability of humans for judgments. But do you have the knowledge to make the right judgment?