Sh. 30/=

30

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES- GAAP

What Does *Generally Accepted Accounting Principles - GAAP* Mean?

GAAP *refers to the* common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP explained

GAAP are imposed on companies so that investors have a minimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such things as revenue recognition, balance sheet item classification and outstanding share measurements. Companies are expected to follow GAAP rules when reporting their financial data via financial statements. That said, keep in mind that GAAP is only a set of standards. There is plenty of room within GAAP for unscrupulous accountants to distort figures. So, even when a company uses GAAP, you still need to scrutinize its financial statements.

INTERNATIONAL ACCOUNTING STANDARDS – IAS

What Does *International Accounting Standards - IAS* Mean?

IAS is an older set of standards stating how particular types of transactions and other events should be reflected in financial statements. In the past, international accounting standards (IAS) were issued by the Board of the International Accounting Standards Committee (IASC).

Since 2001, the new set of standards has been known as the **international financial reporting standards (IFRS)** and has been issued by **the International Accounting Standards Board (IASB).**

IASC has no authority to require compliance with its accounting standards. However, many countries require the financial statements of publicly-traded companies to be prepared in accordance with IAS.

What is the difference between IAS and GAAP?

To answer this question, we must first define what IAS and GAAP are, in order to get a

better grasp of the function they serve in the world of accounting.
The acronym "IAS" stands for International Accounting Standards. This is a set of accounting standards set by the International Accounting Standards Committee (IASC), located in London, England. The IASC has a number of different bodies, the main one being the International Accounting Standards Board (IASB), which is the standard-setting body of the IASC. The acronym "GAAP" stands for Generally Accepted Accounting Principles.
The IASC does not set GAAP, nor does it have any legal authority over GAAP. The IASC can be thought of as merely a very influential group of people who love making up accounting rules. However, a lot of people actually do listen to what the IASC and IASB have to say on matters of accounting.

When the IASB sets a brand new accounting standard, a number of countries tend to adopt the standard, or at least interpret it, and fit it into their individual country's accounting standards. These standards, as set by each particular country's accounting standards board, will in turn influence what becomes GAAP for each particular country. For example, in the United States, the Financial Accounting Standards Board (FASB) makes up the rules and regulations which become GAAP.

The best way to think of GAAP is as a set of rules that accountants follow. Each country has its own GAAP, but on the whole, there aren't many differences between countries - interpretations might vary from country to country, but everyone tends to agree that a company can't simply make up billions of dollars worth of revenue and put it on its books. Every country, in turn, influences the other countries that follow GAAP.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

What Does International Financial Reporting Standards - IFRS *Mean?*

IFRS is a set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements. IFRS are issued by the International Accounting Standards Board (IASB)
IFRS are sometimes confused with International Accounting Standards (IAS), which are the older standards that IFRS replaced. Many of the standards forming part of IFRS are

known by the older name of **International Accounting Standards** (IAS). IAS were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC). On 1 April 2001, the new IASB took over from the IASC the responsibility for setting International Accounting Standards. During its first meeting the new Board adopted existing IAS and SICs. The IASB has continued to develop standards calling the new standards IFRS.

IFRS *explained*

The goal of IFRS is to make international comparisons as easy as possible. This is difficult because, to a large extent, each country has its own set of rules. For example, U.S. GAAP are different from Canadian GAAP. Synchronizing accounting standards across the globe is an ongoing process in the international accounting community.

What are some of the key differences between IFRS and U.S. GAAP?

The International Financial Reporting Standards (IFRS) - the accounting standard used in more than 110 countries - has some key differences from the U.S. Generally Accepted Accounting Principles (GAAP). At the conceptually level, IFRS is considered more of a "principles based" accounting standard in contrast to U.S. GAAP which is considered more "rules based." By being more "principles based", IFRS, arguably, represents and captures the economics of a transaction better than U.S. GAAP. Some of differences between the two accounting frameworks are highlighted below:

Intangibles

The treatment of acquired intangible assets helps illustrate why IFRS is considered more "principles based." Acquired intangible assets under U.S. GAAP are recognized at fair value, while under IFRS, it is only recognized if the asset will have a future economic benefit and has measured reliability. Intangible assets are things like R&D and advertising costs.

Inventory Costs

Under IFRS, the last-in, first-out (LIFO) method for accounting for inventory costs is not allowed. Under U.S. GAAP, either LIFO or first-in, first-out (FIFO) inventory estimates can be used. The move to a single method of inventory costing could lead to enhanced comparability between countries, and remove the need for analysts to adjust LIFO inventories in their comparison analysis.

Write Downs

Under IFRS, if inventory is written down, the write down can be reversed in future periods if specific criteria are met. Under U.S. GAAP, once inventory has been written down, any reversal is prohibited.

STRUCTURE OF *IFRS*

IFRS are considered a "principles based" set of standards in that they establish broad rules as well as dictating specific treatments.

International Financial Reporting Standards comprise:

- *International Financial Reporting Standards (IFRS)*—standards issued after 2001
- *International Accounting Standards (IAS)*—standards issued before 2001
- *Interpretations originated from the International Financial Reporting Interpretations Committee (IFRIC)*—issued after 2001
- *Standing Interpretations Committee (SIC)*—issued before 2001
- *Framework for the Preparation and Presentation of Financial Statements (1989)*

IAS 8 Par. 11

"In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and

*(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the **Framework**."*

FRAMEWORK

The Framework for the Preparation and Presentation of Financial Statements states basic principles for IFRS.

The IASB and FASB Frameworks are in the process of being updated and converged. The Joint Conceptual Framework project aims to update and refine the existing concepts to reflect the changes in markets, business practices and the economic environment that have occurred in the two or more decades since the concepts were first developed.

Its overall objective is to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged. Therefore the IASB and the US FASB (the boards) are undertaking the project jointly.

Role of Framework

According to Deloitte; *In the absence of a Standard or an Interpretation that specifically applies to a transaction, management must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, IAS 8.11 requires management to consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the Framework. This elevation of the importance of the Framework was added in the 2003 revisions to IAS 8.*

Objective of financial statements

A financial statement should reflect true and fair view of the business affairs of the organization. As these statements are used by various constituents of the society / regulators, they need to reflect true view of the financial position of the organization. and it is very helpful to check the financial position of the business for a specific period.

Underlying assumptions

IFRS authorize two basic accounting models:

I. Financial capital maintenance in nominal monetary units, i.e., Historical cost accounting during low inflation and deflation

II. Financial capital maintenance in units of constant purchasing power, i.e., Constant Item Purchasing Power Accounting - CIPPA - during low inflation and deflation and Constant Purchasing Power Accounting (see IAS 29) - CPPA - during hyperinflation. Financial capital maintenance in units of constant purchasing power is not authorized under US GAAP.

The following are the four underlying assumptions in IFRS:

- 1. **Accrual basis**: the effect of transactions and other events are recognized when they occur, not as cash is gained or paid.
- 2. **Going concern**: an entity will continue for the foreseeable future.
- 3. **Stable measuring unit assumption**: financial capital maintenance in nominal monetary units or traditional Historical cost accounting; i.e., accountants consider changes in the purchasing power of the functional currency up to but excluding 26% per annum for three years in a row (which would be 100% cumulative inflation over three years or hyperinflation as defined in IFRS) as immaterial or not sufficiently important for them to choose financial capital maintenance in units of constant purchasing power during low inflation and deflation as authorized in IFRS in the Framework

Accountants implementing the stable measuring unit assumption (traditional Historical Cost Accounting) during annual inflation of 25% for 3 years in a row would destroy 100% of the real value of all constant real value non-monetary items not maintained under the Historical Cost paradigm.

- 4. **Units of constant purchasing power**: financial capital maintenance in units of constant purchasing power during low inflation and deflation; i.e. the rejection of the stable measuring unit assumption. Measurement in units of constant purchasing power (inflation-adjustment) under Constant Item Purchasing Power Accounting of only constant real value non-monetary items (not variable items) remedies the destruction caused by Historical Cost Accounting of the real values of constant real value non-monetary items never maintained constant as a result of the implementation of the stable measuring unit assumption during low inflation. It is not inflation doing the destroying. It is the implementation of the stable measuring unit assumption, i.e., HCA. Only constant real value non-monetary items are inflation-adjusted during low inflation and deflation. All non-monetary items (both variable real value non-monetary items and constant real value non-monetary items) are inflation-adjusted during hyperinflation as required in IAS 29 Financial Reporting in Hyperinflationary Economies, i.e. under Constant Purchasing Power Accounting.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

Qualitative characteristics of financial statements include:

- Understandability
- Reliability
- Comparability
- Relevance
- True and Fair View/Fair Presentation

Elements of financial statements

The financial position of an enterprise is primarily provided in the Statement of Financial Position. The elements include:

1. **Asset**: An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.
2. **Liability**: A liability is a present obligation of the enterprise arising from the past events, the settlement of which is expected to result in an outflow from the enterprise' resources, i.e., assets.
3. **Equity**: Equity is the residual interest in the assets of the enterprise after deducting all the liabilities under the Historical Cost Accounting model. Equity is also known as owner's equity. Under the units of constant purchasing power model equity is the constant real value of shareholders´ equity.

The financial performance of an enterprise is primarily provided in an income statement or profit and loss account. The elements of an income statement or the elements that measure the financial performance are as follows:

1. **Revenues**: increases in economic benefit during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in

increases in equity. However, it does not include the contributions made by the equity participants, i.e., proprietor, partners and shareholders.

2. **Expenses**: decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrences of liabilities that result in decreases in equity.

Revenues and expenses are measured in nominal monetary units under the Historical Cost Accounting model and in units of constant purchasing power (inflation-adjusted) under the Units of Constant Purchasing Power model.

Recognition of elements of financial statements

An item is recognized in the financial statements when:

- it is probable future economic benefit will flow to or from an entity.
- the resource can be reliably measured - otherwise the stable measuring unit assumption is applied under the Historical Cost Accounting model: i.e. it is assumed that the monetary unit of account (the functional currency) is perfectly stable (zero inflation or deflation); it is simply assumed that there is no inflation or deflation ever, and items are stated at their original nominal Historical Cost from any prior date: 1 month, 1 year, 10 or 100 or 200 or more years before; i.e. the stable measuring unit assumption is applied to items such as issued share capital, retained earnings, capital reserves, all other items in shareholders' equity, all items in the Statement of Comprehensive Income (except salaries, wages, rentals, etc., which are inflation-adjusted annually), etc.

Under the Units of Constant Purchasing Power model, all constant real value non-monetary items are inflation-adjusted during low inflation and deflation; i.e. all items in the Statement of Comprehensive Income, all items in shareholders' equity, Accounts Receivables, Accounts Payables, all non-monetary payables, all non-monetary receivables, provisions, etc.

MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

Concepts of Capital

Par. 102. A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

Par. 103. The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

Par. 104. The concepts of capital in paragraph 102 give rise to the following concepts of capital maintenance:

(a) **Financial capital maintenance**. Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) **Physical capital maintenance**. Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the entity is seeking to maintain.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas; management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.

Requirements of IFRS

IFRS financial statements consist of (IAS 1.8)

- **a Statement of Financial Position**
- **a Statement of Comprehensive Income** or two separate statements comprising an Income Statement and separately a Statement of Comprehensive Income, which reconciles Profit or Loss on the Income statement to total comprehensive income
- a **Statement of Changes in Equity** (SOCE)
- a **Cash Flow Statement or Statement of Cash Flows**
- **notes**, including a summary of the significant accounting policies

Comparative information is required for the prior reporting period (IAS 1.36). An entity preparing IFRS accounts for the first time must apply IFRS in full for the current and comparative period although there are transitional exemptions (IFRS1.7).

On 6 September 2007, the IASB issued a revised IAS 1 Presentation of Financial Statements. The main changes from the previous version are to require that an entity must:

- Present all non-owner changes in equity (that is, 'comprehensive income') *either* in one Statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income).

Components of comprehensive income may *not* be presented in the Statement of changes in equity.

- Present a statement of financial position (balance sheet) as at the beginning of the earliest comparative period in a complete set of financial statements when the entity applies the new standard.
- Present a statement of cash flow.
- Make necessary disclosure by the way of a note.

The revised IAS 1 is effective for annual periods beginning on or after 1 January 2009.

Adoption of IFRS

IFRS are used in many parts of the world, including the European Union, Hong Kong, Australia, Malaysia, Pakistan, GCC countries, Russia, South Africa, Singapore and Turkey. As of 27 August 2008, more than 113 countries around the world, including all of Europe, currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic, listed companies. In addition, the US is also gearing towards IFRS. The SEC in the US is slowly but progressively shifting from requiring only US GAAP to accepting IFRS and will most likely accept IFRS standards in the long-term.

It is generally expected that IFRS adoption worldwide will be beneficial to investors and other users of financial statements, by reducing the costs of comparing alternative investments and increasing the quality of information. Companies are also expected to benefit, as investors will be more willing to provide financing.

KENYA

International Financial Reporting Standards

IFRS was set to be the accounting standard in Kenya in 1998 by the council of ICPAK. Kenya adopted **International Accounting Standards (IASs)**, later renamed **International Financial Reporting Standards (IFRSs)** in 1998, thereby "closing the gap" between national and international accounting standards. International standards are adopted as drafted without any modifications, and the text of laws and regulations simply refers to IFRSs. As of 2006, all IFRSs in effect were adopted. The 2006 United

Nations Conference on Trade and Development (UNCTAD) report states that IFRSs are to be applied by all public interest entities and Small and Medium-size Enterprises. Although in practice companies use the standards adopted by the ICPAK, it is not legally authorized to issue accounting and auditing standards. As far as enforcement of legal requirements is concerned, the UNCTAD pointed out that in practice the levels of non-compliance with IFRSs are quite high. In addition, UNCTAD reported that some industry specific regulation in Kenya and IFRS-based requirements are not compatible and thus universal adherence to IFRSs has not been achieved. In response, the ICPAK stated in a 2008 Action Plan prepared for the IFAC that it is in the process of reviewing the financial reporting environment to identify existing and potential hindrances to the adoption and implementation of IFRSs.

According to a 2006 Institute of Certified Public Accountants of Kenya (ICPAK) self-assessment prepared for the International Federation of Accountants (IFAC), "IFRSs are adopted as drafted without amendments except to rename the IFRS as a national standard and / or to translate it into another language". However, some standards are not applicable in Kenya and therefore have not been adopted. Since the 2001World Bank assessment, the International Accounting Standards Board (IASB) revised IASs and issued new IFRSs for areas where no guidance previously existed. Although the ICPAK in its 2006 self-assessment states that all international standards in effect as of the date of the assessment are adopted, no further information as to the adoption of all the latest versions of IFRSs is publicly available.

The legal framework for accounting requirements in Kenya is largely based on the Companies Act which, according to the 2006 United Nations Conference on Trade and Development (UNCTAD) report, prescribes the format of financial reports and requires all limited liability companies to keep books of account. Some of the requirements of the Companies Act, the report notes, do contradict IFRSs. The 2005 ICPAK self-assessment reported that the Accountants Act supplements the Companies Act and specifies rules for private sector accounting standards. The World Bank observed that neither act accounted for a legal obligation to comply with the accounting standards in use and recommended the amendment of the two acts to strengthen the financial reporting regime in Kenya. According to the same assessment, the Accountants Act was amended in 2002. It is unclear, however, if the World Bank's recommendations have been incorporated into the revised Accountants Act.

According to the description of the Kenyan regulatory framework as detailed in the 2005 ICPAK self-assessment, banks are regulated by the Central Bank of Kenya (CBK). The CBK does not set any additional accounting or auditing requirements. Compliance with accounting standards is enforced by the ICPAK. The Banking Act and the Central Bank Act specify the minimum disclosure requirements. The securities market is regulated by the Capital Markets Authority (CMA), which monitors compliance with IASs for listed companies. Noncompliance could lead to imposition of fines or suspension from the Nairobi Stock Exchange. The CMA does not play a role in the setting of accounting standards. The 2001 World Bank assessment noted that enforcement of accounting standards was not as rigorous and that the stock exchange did not have any mechanism for improvement in quality of financial reporting by listed companies. The subsequent 2006 UNCTAD report highlighted that both the CMA and the CBK require application of IFRSs.

All financial statements covering periods beginning January 1, 1999, must be prepared in accordance with IASs. IASs are required for enterprises of all types and sizes, both listed and non-listed

The ICPAK is a member of IFAC. ICPAK is the accounting and auditing standard-setting body in Kenya. It was established under the Accountants Act, Chapter 531 along with the establishment of the Registration of Accountants Board (RAB) and the Kenya Accountants and Secretaries National Examinations Board (KASNEB). The KASNEB conducts examinations for prospective accountancy professionals, while the RAB is responsible for registration of successful candidates. These candidates can then be registered as ICPAK members. The World Bank noted that the process involving three different bodies leads to coordination problems.

In June 2001 n CMA made IASs mandatory for accounting and financial reporting by all listed companies. The Banking Supervision Department of the Central Bank of Kenya used its legal authority to require individual banks to disclose information in compliance with IASs. The requirement for adopting IFRS has been legalized for both listed and non-listed companies in the Companies Act