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**KENYA SCHOOL OF LAW  
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**LEGAL PRACTICE MANAGEMENT (ACCOUNTING)**

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**THEORETICAL FRAMEWORK OF ACCOUNTING**

Accounting – Process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information.

**CONCEPTUAL FRAMEWORK**

It is a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, functions and limits of financial accounting and financial statements.

Also, conceptual framework can be defined as a statement of **Generally Accepted Accounting Principles**, which form the frame of reference for financial reporting.

From the above definition, we can deduce that:

- i. Conceptual framework forms a basis for development of new accounting standards and the evaluation of those standards that are already in existence.
- ii. It forms the theoretical basis for determining which events should be accounted for and how they should be communicated to the users.

**ADVANTAGES OF CONCEPTUAL FRAMEWORK**

- i. A conceptual framework provides a written constitution for the professional standard committee to set standards in a coherent manner.
- ii. Provides a framework of reference for those who prepare financial statements.
- iii. The preparation of financial statements requires knowledge of specific accounting techniques and the exercise of judgment. A conceptual framework may be useful in distinguishing between areas of judgments and areas where rules should be followed.
- iv. The existence of a conceptual framework might win the confidence of the users of financial statements by increasing their understanding on how and why they have been produced.
- v. Without a conceptual framework some standards could concentrate too much into income statement or too much into balance sheet.

**DISADVANTAGES OF CONCEPTUAL FRAMEWORK**

- i. It is uncertain whether a single conceptual framework can be devised to meet the needs of all the users of accounting information.

- ii. Accounting conventions that underlie financial some areas in reporting cannot be proved to be correct; they depend on consensus. Without consensus there cannot be an agreed conceptual framework and it may not be possible to achieve consensus on wide issues.
- iii. Whilst it may be argued that it would be desirable for the PSC to develop the standards in accordance with an agreed conceptual framework, in reality it may not happen. The development of accounting standards may be influenced by factors other than the conceptual framework e.g. existing practice and political pressures.

#### **STEPS IN THE DEVELOPMENT OF THE STRUCTURE OF THE TYPICAL CONCEPTUALFRAMEWORK**

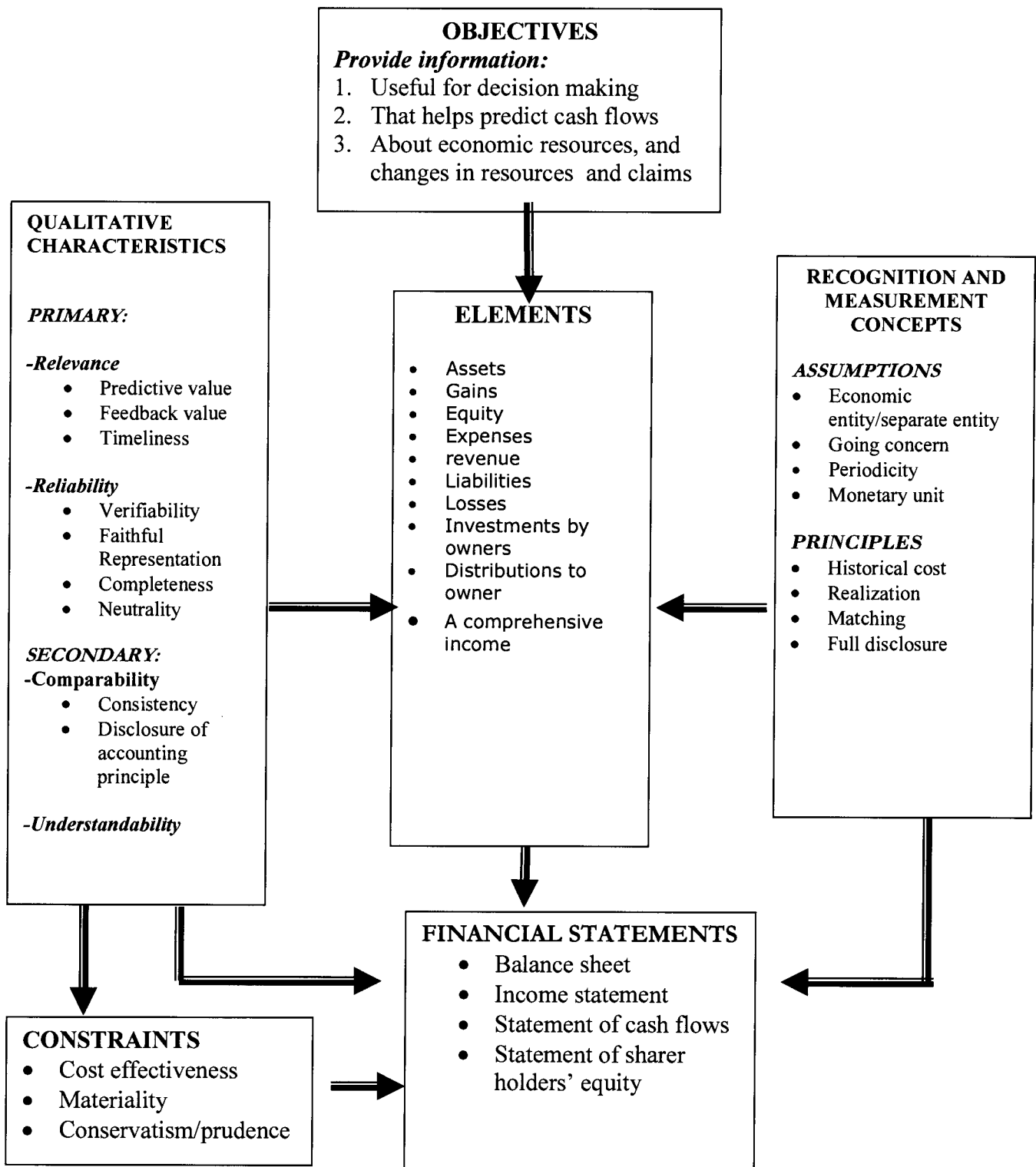
- i. **Identify user groups** and discuss their needs; determine primary users for whom financial statements are prepared.
- ii. **List desirable qualitative characteristics** of information provided in the financial statements.
- iii. **Define elements** (i.e. assets, gains, equity, expenses, revenue, liabilities, loses, investments by owners, distributions to owner, and comprehensive income) to be included in the financial statements.
- iv. **Specify recognition** criteria to determine when elements should be recognized in the financial statements.
- v. **Specify measurements basis** for elements recognized in the financial statements.

#### **ISSUES DEALT WITH BY FRAMEWORK**

The conceptual framework of accounting deals with a number of issues which includes:

- i. **Objectives** of financial statements.
- ii. The **qualitative characteristics** that determine usefulness of information in financial statements.
- iii. **Definition, recognition and measurements of the elements** from which the financial statements are constructed.
- iv. **Concept** of capital and capital maintenance.
- v. **Users** of the financial information.

## THE CONCEPTUAL FRAME WORK OF ACCOUNTING



### ***Objectives of financial statements***

Financial reporting is not an end itself but it is intended to provide information that is useful in making business and economic decisions. It follows that it is necessary to determine who the users are and to explore the sort of decision, which they have to take.

Therefore, the objective of financial reporting is to provide information about economic resources of an enterprise, the claims to those resources (obligation to transfer resources to other entities and owners' equity) and the effects of transactions, events and circumstances that change resources and claims to those resources.

Also financial reporting can be defined as the process of communicating, identifying economic information and economic report of resources and performance of the reporting entity useful to those having right to such information.

Such financial information will meet needs of most of the users but it has shortcomings in that:

- i. It is based on past events.
- ii. Financial statements sometimes contain non-financial information.

### **USERS OF ACCOUNTING INFORMATION**

- i. Share holders – These are people who have contributed capital to the business and are interested in the performance of the business or reporting entity.
- ii. Investors – Are those people who are willing to invest e.g. by way of buying shares in the reporting companies and are interested with the performance and financial position of the companies.

Others include:

- |                |                            |
|----------------|----------------------------|
| i. Employees   | v. Income department e.g.  |
| ii. Lenders    | Kenya Revenue Authority in |
| iii. Creditors | Kenya.                     |
| iv. Government | vi. General society        |
|                | vii. Customers.            |

### **QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS (*What makes accounting information useful*)**

Appropriateness of accounting policies should be judged against the following objective

- i. **Understandability** – Users should be made to understand financial statements. The assumption made is that they have enough knowledge to understand well-presented accounts. This does not mean that complex issues should be left out in accounts.
- ii. **Relevance** – Information is relevant if it would influence economic decisions and it would be able to do that if it has ***predictive value*** or ***confirmatory value***.
  - **Predictive value** – Information with predictive value will help users to assess what is likely to happen in future. I.e. predicting the future
  - **Confirmatory value/feedback value** – Information with confirmatory value would help user to confirm or correct previous predictions, which they have made.

**NB:** In many, if not most, cases information will have both confirmatory and predictive value.

- **Timeliness** -information is timely when it is available to users early enough to allow its use in decision process.

**iii. Reliability** – Reliability is the extent to which information is *verifiable*, *representationally faithful*, and *neutral*.

Information is said to be reliable when it is **free from material error** and can be depended upon by users of accounts to represent faithfully that which it either purports to represent or could reasonably be expected to represent. In order for information to be reliable it must possess certain subsidiary characteristics. They include:

- **Faithful representation:** Exists when there is agreement between a measure or description and the phenomenon it purports to represent. E.g. assume that the term *inventory* in a balance sheet of a retail firm is understood by external users to represent items intended for sale in the ordinary course of the business. If inventory in this case includes machines used to produce inventory then it lacks representational faithfulness. Thus it must faithfully represent what it purports to represent so that, for example, the substance of a transaction must be portrayed when this differs from its legal form.
- **Verifiability:** implies consensus among different measurers i.e. being objective
- **Neutral:** means unbiased; this means that accounting information should not be subject to deliberate or systematic bias.
- **Complete:** this means including all the information necessary for faithful representation

**iv. Comparability** – is the ability to help users see similarities and differences between events and conditions. Closely related to *Comparability* is the notion that *consistency* of accounting practices over time permits valid comparisons between different periods. Users must be able to compare an enterprise financial statements in the following ways:

- a. Overtime trend analysis (past performance)
- b. Other enterprises (firms in the industry within which the reporting entity operates)
- c. Reporting entity budgeted or projected performance with the actual performance.

## **FINANCIAL POSITION, FINANCIAL PERFORMANCE AND CHANGES IN FINANCIAL POSITION**

### **1. Financial Position (Balance Sheets)**

It is affected by the following information

1. Economic resources controlled – help to predict the ability to generate cash.
2. Financial structure – To predict the borrowing need, dividend policies and likely success in saving new finance.
3. Liquidity and solvency – Predict whether financial commitment will be met as they fall due.

### **2. Financial performance – Income statement**

Users want to know about profitability or the performance of the reporting entity.

Performance – Profit is the measure of performance or it can be used as a basis for other measures e.g. earning per share. This depends on measurement of income and other expenses, which in turn depend on the concept of capital and capital maintenance adapted.

### **3. Changes in the financial position - Cash flow used to assess the enterprises investing, financing and operating activities.**

This will show the enterprises ability to provide cash and how that cash is used.

### **Measurement of the elements of financial statements**

According to the I.A.S.C framework, measurement is the process of determining the monetary amount at which the elements of the financial statements are to be recognized and carried in the balance sheet and in the income statement. It involves selection of a particular basis of measurements. This includes:

1. **Historical costs** – assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them.
2. **Current costs** – This is the amount of cash equivalent that will have to be paid if the same or an equivalent was acquired currently.
3. **Realizable value** – The amount of cash or cash equivalent that could be currently obtained by selling an asset.
4. **Present value** – The discounted future cash flow from an asset.

## **CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE**

### **Concepts of capital**

- a) **Financial concept** – Money invested or the purchasing power can be seen as net assets.
- b) **Physical concept (operating capability concept)** – Productive or operating capacity of an enterprise based on units of output produced i.e. volume of goods and services capable of being produced.

## CONCEPTS OF CAPITAL MAINTENANCE

- a) **Financial capital maintenance concept** – Profit is earned if net assets at the end of a period exceed net assets at the beginning of a period excluding any distributed capital and contribution from owners during the period.
- b) **Physical concept** – Profit is earned only if the physical productive capacity of the enterprise at the end of the period exceeds the physical productive capacity of the enterprise at the beginning of the period if you exclude distribution to and contribution from owners during the period.

## FUNDAMENTAL ACCOUNTING CONCEPTS, ACCOUNTING BASES AND ACCOUNTING POLICIES

In accounting usage of terms such as accounting principles, practices conventions or procedures have often been treated as interchangeable. However, there exists difference between the terms. The terms are explained below.

**Fundamental concepts:** They are broad basic assumptions, which underlie the periodic financial accounts of the business enterprises. The following are fundamentals accounting concepts:

- I. **Going concern concept:** - This concept assumes that the enterprise will continue in operational existence for the foreseeable future i.e. the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation. To abandon this concept means that assets will be valued on a realizable value basis. Criticism of this concept includes: -
  - It is not necessarily true that firms do not cease trading. Therefore, balance sheet valuation based on the concept may give investors an incorrect view of the assets particularly when firms cease trading shortly after the last published balance sheet due to various circumstances.
  - It is misleading to suppose that the going concern concept applies equally to the continuity in the firm's operations in a particular sector or as regards a particular product. In this respect, the going concern concept finds no support in any other formal study of economic behaviour.
  - The concept precludes the consideration of the alternative courses of action and prevents the provision of the relevant accounting information for this purpose.
- II. **Accrual concept:** - The concept requires that effects of transactions and other events are recognized when they occur and not when cash or cash equivalent are received or paid and they are recorded in accounting records and reported in the financial statements for the period to which they relate. The importance of accrual basis is users to get information about past performance involving cash and also information about obligations to pay cash in future and resources, which represent cash to be received in future.

## ACCOUNTING STANDARDS

Sources of authority

- 1) Legislation e.g. cost accounting
- 2) The stock exchange
- 3) Accounts principles and conventions
- 4) Accounting standards

## INTERNATIONAL HARMONIZATION

Need for:

1. **Investors** – They would want to compare financial results of costing both nationally and internationally. Differences in accounting practice acts as a barrier to such cross border analysis.
2. **Multinationals**
  - They would have better access to foreign funds
  - Material control would be improved because harmonization helps internal communication of financial information.
  - Appraisal of foreign enterprises for takeovers and managers.
  - It would be easier to conform to the reporting requirements of the overseas stock exchange.
  - Consolidation of foreign subsidiaries and associated companies would be easier.
  - May reduce their audit cost.
  - Transfer of accounting staff across borders would be easier.
3. **Government – particularly of developing countries**

By use of the same accounting standards, governments may be able to control multinationals.
4. **Tax authorities** – It would become easiest to calculate tax liability on income received from overseas.
5. **Regional economic groups**

It would aid regional economic groups as the members would understand one another's accounting practices.
6. **Large International auditing firms**

## FUNDAMENTAL ACCOUNTING ASSUMPTIONS AND GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

### Introduction

The basic objective of accounting is to provide information useful in making economic decisions. It is therefore of vital importance that the information be relevant, reliable, clearly understandable and comparable. There is therefore need for a well defined body of accounting assumptions and principles to offer guidance in the preparation of financial statements and reports.

Fundamental accounting assumptions are the factors that are taken for granted in explaining the conceptual structure of accounting. The accounting principles on the other hand constitute the ground rules for financial reporting and are referred to as 'the Generally accepted accounting principles (or GAAP)'. They are broad in nature and have been developed by accountants in an effort to meet the needs of the users of financial statements.

Accounting assumptions and principles are not like physical laws; they do not exist in nature awaiting discovery by man. Rather, they are developed by man in light of what man considers to be the most important objectives of financial reporting. In many ways generally accepted accounting principles are similar to the rules established for an organized sport, such as football or basketball. For example, accounting principles, like sports are rules:

- Originates from a combination of tradition, experience and financial decree.
- Require authoritative support and some means of enforcement.
- Are sometimes arbitrary
- May change over time as shortcomings in the existing rules come to light
- Must be clearly understood and observed by all participants in the accounting process.

An important aspect of accounting assumptions and principles and principles is the need for consensus within the economic community. If these assumptions and principles are to provide a useful framework for financial reporting they must be understood and observed by the participants in the financial reporting process.

### FUNDAMENTAL ACCOUNTING ASSUMPTIONS

#### The Economic /Accounting Entity assumption

An accounting entity is any economic unit which controls resources and engages in economic activities. An individual, a business enterprise whether organized as a proprietorship, partnership or corporation, governmental agencies, non governmental organizations and all non profit making entities are all accounting entities regardless of the form of the organization. The accounting entity of concern is assumed to be **separate and distinct** from all other entities regardless of the form of the organization. The affairs of the accounting entity are distinguished even from those of its owners and information is compiled for the entity alone. The accounting and reporting process is concerned with the transactions and events that affect each accounting entity as a separate and distinct entity from others.

### **The 'Going concern' or Continuity Assumption.**

In accounting for an accounting entity, it is to be assumed that the accounting entity will continue in operation for the foreseeable future i.e. indefinitely. It is assumed that the accounting entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. This assumption provides the foundation for accrual accounting. When the accounting entity ceases to be a going concern, the accounting approach changes from accrual to realization and liquidation.

### **The Periodicity Assumption.**

The results of an accounting entity would be most accurately measurable at the time when the entity liquidates. Users of accounting information, however, cannot wait indefinitely for such information. The periodicity or time assumption implies that the assumed indefinite life of the accounting entity can be divided into artificial time periods. Accountants, therefore, measure the operating progress and changes in economic position at relatively short time intervals during this indefinite life. Users of financial statements need periodic measurements for decision-making purposes.

The need for frequent measurement creates many of the accountant's most challenging problems. Dividing the life of an enterprise into time segments, such as a year or a quarter of a year requires numerous estimates and assumptions. For example, estimates must be made of the useful lives of depreciable assets and assumptions must be made as to appropriate depreciation methods. Periodic measurements of net income and financial position are, thus, at best only informed estimates. The tentative nature of periodic measurements should be understood by those who rely on periodic accounting information.

### **The Monetary or Unit of Measure Assumption.**

The assumption implies that money is used as a standard measuring unit for financial reporting. The impact of transactions is qualified and assessed in terms of some unit of measure. In Kenya the monetary unit is the shilling. It is assumed that the Monetary unit is a stable unit of value capable of acting as the common denominator of values. The continuing relative and rapid inflation, however, points to the shillings as an unstable unit of measure. Inflation introduces a sizeable limitation on financial statements as accurate and precise reflections of operating results and resources position. Support for this assumption lies in the fact that the monetary unit is relevant, simple, universally available, understandable and useful.

## **GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.**

### **The Historical Cost principle**

Generally accepted accounting principles requires that most transactions and events be recognized in the financial statements at the amount of cash and cash equivalent paid or received or the fair value ascribed to them when they took place. Historical cost is usually definite and verifiable. As per this principle, assets are initially recorded at cost. In most cases no adjustment is made to this valuation in later periods; except to allocate a portion of the original cost to expense as the assets

expire. At the time the asset is acquired, cost represents the fair market value as evidenced by the arm's length-transaction.

With the passage of time, the fair market value of an asset may change greatly from its original (historical cost). These changes in the 'fair market value' are generally ignored in the accounts and the assets have continued to be shown at historical cost less the portion that has been allocated to expenses.

The cost principle is derived, in large part, from the principle of objectivity. Those who support the cost principle argue that it is important that users have confidence in financial statements and that this confidence can be maintained if accountants recognize change in assets and liabilities only on a basis of completed transactions. Objective evidence generally exists to support cost. Current market values, however, often are largely a matter of personal opinion.

The question of whether to value assets at cost or estimated market value is a classic illustration of the "trade-off" between the relevance and the reliability of accounting information.

### **The Revenue Realization Principle**

This principle provides guidance in answering the question of when should revenue be recognized. Revenue is generally recognized when the earning effort is substantially expended or completed. Revenue is realized when both of the following conditions are met

- i) The earning process is essentially complete.
- ii) Objective evidence exists as to amount of revenue earned.

### **The Matching Principle**

To measure the profitability of an economic entity, revenue is to be matched against costs associated in generating this revenue. The matching of business enterprise's expenses (the cost of goods and services to be used to obtain revenue) with its revenue is the primary activity in the measurement of the results of operations for that period.

Costs are matched with revenue in two ways:

- 1. Direct association of costs with specific revenue transactions.
- 2. Systematic allocation of costs over the 'useful life' of the expenditure.

### **The Objectivity Principle**

The term objective refers to measurements that are unbiased and subject to verification by independent entities. The parties involved in any transaction have opposing interests and bargain to arrive at the equilibrium of exchange equivalents. If a valuation is objective, a disinterested third party within the same facts would come up with the same valuation. This is generally referred to as an 'Arms length transaction'.

Accountants rely on various kinds of evidence to support their financial measurements but they seek always the most objective evidence available. Despite the goal of objectivity, it is not possible to divorce completely accounting information

from opinion and judgment. For example, the cost of a depreciable asset can be determined objectively but not the periodic depreciation expenses. Objectivity in accounting has its roots in quest for reliability.

#### **The Consistency Principle.**

The principle of consistency implies that there should be consistent treatment of similar or the same items from one accounting period to another. In principle once an accounting procedure has been adopted for a class of items, it should be consistently applied from period to period. The principle of consistency does not mean that a company should never make a change if a proposed new accounting method will provide more useful information than does the method presently in use. Where a significant change has been made, the fact that a change has been made and the shilling effects of the change should be fully disclosed in the financial statements. Consistency facilitates both comparability and understandability.

#### **The Disclosure Principle.**

Adequate disclosure means that all materials and relevant facts concerning financial position and the results of operations are communicated to users. This can be accomplished either in the financial statements or in the notes accompanying the financial statements. Such disclosure should make the financial statements more useful and less subject to misinterpretation.

Adequate disclosure does not require that information be presented in great detail. It does require, however, the no important facts be withheld. For example, if a company has been named as a defendant in a large lawsuit, this information must be disclosed. Other example of information which should be disclosed in financial statements include:

1. A summary of accounting methods used in the preparation of the statements
2. Shilling effects of any changes of these accounting methods during the current period.
3. Any contingent losses that may have material effect upon the financial position of the business.
4. Contractual provisions that will affect future cash flows, including the terms and conditions of borrowing agreements, employee pension plans, and commitments to buy or sell materials amount assets.

Even significant events which occur after the end of the accounting period but before the financial statements are issued may need be disclosed. These are referred to as 'Post balance sheet events'.

Naturally, there are practical limits to the amount of disclosure that can be made in financial statements and the accompanying notes. The key points to bear in mind are that the supplementary information should be relevant to the interpretation of the financial statements.

On reporting the impact of transactions, the economic substance of the transaction takes precedence over the legal (i.e. Substance over Form.)

## **EXCEPTION PRINCIPLE**

### **Materiality.**

The term materiality refers to the relative importance of an item or an event. An item is 'material' if it might reasonably influence the decisions of users of financial statements. Accountants must be sure that all material items are properly reported in the financial statement.

However, the financial reporting process should be cost-effective. The value of the information should exceed the cost of its preparation. By definition, the accounting treatment accorded to immaterial items is of little or no value to decision-makers. Therefore, accountants should not waste time accounting for immaterial items; these items may be treated in the easiest and most convenient manner. In short, the concept of materiality allows accountants to ignore other accounting principles with respect to items that are not material.

Materiality of an item is relative matter; what is material to one entity may not be material to another entity.

### **Conservatism/Prudence Principle.**

The principle holds that where equally acceptable alternatives for valuation exist, the alternative with the smallest yield to avoid exaggeration of economic values should be selected. This principle is most useful when matters of judgment or estimates are involved and is regarded as a powerful influence against the danger of overstating earnings of financial position. The concept does not mean deliberate understatement of net assets and profits.

## **REGULATIONS AND INFLUENCES ON FINANCIAL REPORTING.**

Kenya companies like other companies operating in the developed world have to comply with a wide range of regulations concerning financial reporting. The regulations have the following basis; -

1. Legislation
2. Accounting Standards
3. Stock Exchange Rules.

### **THE LEGISLATION.**

Chapter 486 of the Laws of Kenya, the Companies Act, imposes a requirement for all companies to prepare regular accounts and provides detailed rules on the minimum information which must be disclosed in those accounts.

Section 147 of the Act states in part that " Every Company shall cause to be kept in the English language proper books of accounts with respect to:-

- a) All sums of money received and expended by the company and all the matters in  
Respect of which the receipts and expenditure takes place;
- b) all sales and purchases of goods by the company;
- c) the assets and liabilities of the company'

Further more, a company must comply with the rules stipulated in the specific Acts under which it is operating. For example, commercial Banks have to comply further

with the requirements of the Banking Act and Insurance companies have to comply with the requirements of the Insurance Act.

The accounting obligation imposed upon companies is contained in section 149 of the Companies Act. Every Company is required to prepare and submit the following financial statements to the Registrar of Companies and the general body of shareholders.

- a) Profit and Loss account – Financial performance
- b) Balance sheet-Financial position.

Subsection 1 section 149 (Cap 486) goes on to state that, every balance sheet of a company must give a true and fair view of the state of affairs of the company as at the end of its financial year and every profit and loss account of a company must give a true and fair view of the profit or loss for the financial year.

The phrase "true and fair" is important, because it may be possible to comply with the detailed legal requirements with exactness and yet nevertheless produce accounts which, overall, would not strictly be regarded as being "true and fair" The companies Act, however, has not defined these terms neither have the International Accounting Standards explained the meaning of the same.

G.A, Lee States, "Today " the true and fair view" has become a term of art. It is generally understood to mean a presentation of accounts, drawn up according to accepted accounting principles, using accurate figures as far as possible, and reasonable estimates otherwise' and arranging them so as to show, within limits of accounting practice, as objective a picture as possible free from willful bias, distortion, manipulation or concealment of material facts'.

This implies therefore that it is necessary for the accountant to have recourse to a body of accounting principles that have developed over many years.

Section 149(2) of the Companies Act requires that the balance sheet and profit and loss account of a company must comply with the Sixth Schedule of the Companies act.

## **ACCOUNTING STANDARDS**

### **Introduction**

The law by its very nature is not dynamic. It will usually fall behind new ideas and developments and will not always cover the technical aspects of financial reporting. In addition to the legal stipulations, accounting practice is heavily influenced by the pronouncements issued by professional accounting bodies in the form of Accounting Standards. Companies not only need to meet the requirements of the law but must also comply with the requirements contained in these statements of Accounting Standards operating in their countries. In Kenya, these standards were issued by the institute of Certified Public Accountants of Kenya (ICPAK) which is also a member of the International Accounting Standards Committee.

With effect from 1<sup>st</sup> January 1999 Kenya adopted International Accounting Standards issued by International Accounting Standards Committee.

### **Definition**

Accounting Standards are methods or approaches to preparing accounts, which have been chosen and established by the bodies overseeing the accounting

profession. They are essentially working rules established to guide accounting practice. Accounting Standards usually consist of three parts.

- A description of the problem to be tackled.
- A reasonable discussion of ways of solving the problem.
- The prescribed solution.

The purpose of the standards is to reduce the number of acceptable alternative treatments of accounting issues and facilitate comparison of financial statements.

The need for and objectives of Accounting Standards. Need and Objectives of Accounting Standards;

Financial statements can hardly be said to be useful if they are produced on numerous acceptable bases. There is great need for uniformity. In an attempt to reduce the range of choice of accepted accounting approaches to improve the users confidence in the accounting figures and make accounting reports more understandable it was deemed necessary to introduce accounting standards.

The prime objective of accounting standards is to improve the quality and uniformity of reporting and introduce definitive approach to the concept of what is 'true and fair'

#### **Advantages and disadvantages of accounting standards.**

- a) They provide the accounting profession with useful working rules.
- b) They force improvement in the quality of the work of accountants.
- c) They strengthen the accounts resistance against pressure from directors to use an a  
Accounting policy, which may be inappropriate in the circumstances.
- d) They ensure that users of financial statements get more complete and clearer  
Information on a consistent basis from period to period.
- e) They assist in the comparison users may make between the financial  
statements of  
One organization and another.
- f) They direct financial statements towards establishing the economic trust of  
the organization performance.
- g) They provide a focal point for debate and discussion about accounting practice
- h) They are a less rigid alternative to enforcing conformity by means of  
legislation.

### **Disadvantages:**

- a) Accounting Standards are bureaucratic and lead to rigidity. The quality of the work of accountant is restricted since firms and industries differ and change also environment within which they operate.
- b) The official acceptance of an accounting standards reduces the account's power  
To resist the use of accounting Standards applications of inappropriate standards when the directors wish to follow it.
- c) Accounting Standards reduce the scope for professional judgment of Accountants. Accountants are thus reduced to technicians rather than being professional.
- d) Most users of financial reports are made to believe that financial statements produced using accounting standards are infallible. This is misleading.
- e) Standards have been derived through social or political pressures, which may reduce the freedom or lead to the manipulation of the profession.
- f) Standards inhibit the development of critical thought (why think when the standards are there?).
- g) The more standards there are the more costly the financial statements are to produce.

### **Application of accounting Standard in Kenya**

They are intended for application to all financial statements issued by public companies, parastatals and organizations including: co-operative societies, sole proprietorship, no-trading concerns, estates and trusts, and other business entities reporting to the public.

How far have the accounting standards improved the usefulness of accounting information?

#### **a) Understandability**

Standards make financial statements more understandable by requiring increasing disclosure of accounting policies.

#### **b) Objectivity**

Standards are not objective because there is no universally agreed theory of Accounting and a universally accepted Conceptual Framework of Accounting.

#### **c) Comparability**

Standards have definitely improved comparability as they call for consistency and disclosure of the effect of any deviation from the existing practice or standards.

#### **d) Completeness**

Standards help financial statements be more complete as they call for the production of such additional figures as those in the Cash Flow Statements, Statements of Changes in Equity and notes to the financial statement

#### **e) Relevant**

Standards make information more relevant but some standards are said to make financial statements less relevant.

#### **f) Reliable**

There is no reason to believe that Accounting Standards improve reliability of financial statements.

**g) Consistency.**

It is useful to the extent that it assists comparability. With standards there is now greater consistency in the application of accounting concepts and policies.

**h) Timeliness.**

The standards have not improved timeliness of accounting reports and may in fact have largely contributed to the late production of reports.

**i) Prudence:**

Writers as introducing bias into accounts have criticized standards and therefore prudence should not be regarded as a desired characteristic of financial reports.

**J) Economy of presentation.**

Standards may in fact call for extra information and therefore result in extra cost. On the whole, accounting standards setting is an attempt to improve the reporting system and generally, the standards have improved the quality of financial reports.

### **THE STOCK EXCHANGE RULES**

Where companies are listed on the stock exchange, they must comply with additional requirements laid down by the stock exchange. The rules require the provision of both greater and more frequent information than that required by law. For example, those companies listed on the Nairobi Stock

Exchange, publish an interim report which contains certain minimum information. The interim report must either be circulated to shareholders or published in at least one newspaper.

### **ARGUMENTS FOR AND AGAINST THE REGULATION OF THE ACCOUNTING PROFESSION**

The question that has been extensively debated is whether or not the accounting profession should be regulated. This has been argued on the basis that companies have certain incentives that force them to report to interested parties without necessarily making them to do so through regulation. Thus the need to unregulated the accounting profession. The arguments for and against an unregulated the accounting profession are discussed below.

#### **Arguments for unregulated Accounting Profession.**

**1. Agency theory.**

The theory argues that since management is engaged in agency contracts with the owners of the company, they must ensure that information is supplied to the shareholders regularly and management since the shareholders would like to monitor management and such monitoring costs like audit fees may have a direct bearing on the compensation paid to management, is compelled to report regularly so as to enhance their image and compensation. Thus firms will disclose all information voluntarily.

**2. Competitive Capital market**

Firms have to raise capital funds from a competitive environment in the capital markets. This will compel them to disclose voluntarily so as to attract such funds from investors. It is generally accepted that firms that report regularly in the capital markets have an enhanced image and could

Easily attract funds from investors. Thus firms have an incentive to give regular financial reports otherwise they cannot secure capital at a lower cost. Thus regulating accounting will be imposing rules in a self-regulating profession.

### **3. Private contracting opportunities theory.**

It has been argued that users who need information may enter into a contract with private organizations that can supply them with such information. This will ensure users get detailed and specific information suiting their requirements instead of the general-purpose information provided by financial report as regulated by the legislation. Such all-purpose data may be irrelevant to the users' need. Under such circumstances there is no need to regulate accounting profession.

### **Arguments against unregulated Accounting Reporting.**

Arguments in support of accounting regulation are usually based on the doctrine of 'market failure'. Market failure refers to a situation where the market is unable to efficiently allocate resources because of imperfection that exist in that market or because the way the market is structured is poor.

Market failure occurs when the market is unable to provide information to those who are in need of it. Because of the existence of market failure in providing accounting information, it has been argued that the accounting profession should be regulated so as to serve its users effectively and efficiently.

Specific Reasons why market failure occur include the following:

#### **1. The monopoly in the supply of such information in the accounting entity.**

The reporting entity is the enterprise that is in control of the supply of internal information about the entity; this introduces certain imperfections in the supply of such information. There will be restriction in the supply of absolute information about the accounting entity and the information may not be available to those who need it.

Even if suppliers of such accounting information were to charge prices fears have been expressed that such prices will be prohibitive for most users. Further doubts have been expressed on whether firms can supply all the necessary information, both positive and negative, especially where such firms operate in a competitive environment. This will be common in countries like Kenya where the capital markets are not well developed.

There is therefore an urgent need to make financial reporting mandatory through a regulatory framework.

#### **2. Failure of Financial Reporting and Auditing.**

Financial reporting standards have failed to correct instances of public fraud through fraudulent reporting and this has been so because of laxity in regulating accounting practices. The existence of a variety of methods of doing one thing and too much flexibility in accounting practice, have enabled the management of firms to manipulate accounts to suit their needs.

Auditing itself has been inadequate and not geared towards detection of fraud because auditors hardly ever carry out 100% examination of records and transactions.

There is therefore a serious need to control accounting practice through stringent standardization guidelines. This calls for a regulated accounting profession.

#### **4. Public good characteristics of Accounting Information.**

Accounting information has the characteristics of a public good. The moment accounts are released to one person; the information contained therein cannot be restricted from getting to other persons. This implies that purchasing accounting information through private contracting will be virtually impossible because its supply cannot be restricted and thus they cannot make money out of it and will be difficult to decide on the price to charge.

### **PROBLEMS CREATED BY THE REGULATIONS OF THE ACCOUNTING PROFESSION.**

In practice, regulation of any field leads to a misallocation of resources because production is not geared towards the market forces of demand and supply. Regulating the accounting profession has led to the following problems:

#### **Standard Overload.**

Overstatement of demand for standards, there led to over-production of standards. Many people who contribute during the standards setting may not be active demanders of information to be supplied by such standards and very often, the standard setting committee takes into account the views of such people leading to the misallocation of resources.

This was the case in the United States of America prompting the Security Exchange Commission to exempt small companies from complying with certain standard requirements.

#### **2. Politicization of Standard Setting**

Regulating is a political process intended to protect the conflicting interests of various user groups. This leads to dilution of accounting standards, as they are compromised by being based on bargaining instead of technical suitability.

#### **3. Social Legitimacy.**

The standard setting process requires social legitimacy in order to be effective. The regulating bodies should consist of persons presenting various user groups of financial reports.

#### **4. Economic Consequences.**

Regulations, sometimes, overburden companies with unnecessary regulations which might have negative economic consequences. This is

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especially so when companies devise ways and means of avoiding certain regulations for one reason or another.

For instance, when FASB No 13 on accounting for leases was used in America requiring companies to capitalize certain leases and reflect in the balance sheet as both asset and liabilities, companies tended to restructure their leases so as to improve their debt structure. This means incurring unnecessary legal costs due to regulation.

## **ADOPTION OF INTERNATIONAL ACCOUNTING STANDARDS AND INTERNAL STANDARDS ON AUDITING (INTERNATIONAL STANDARDS)**

### **Background**

Back in the early 80s, ICPAK made a decision to develop its own standards in both accounting and auditing (Kenyan Standards). This decision was primarily driven by the young Institutes desire to be associated with truly national standards which addressed the unique circumstances prevailing in Kenya at the time. Those standards borrowed heavily from existing international Standards on auditing and addressed those components which were considered to be most common in financial reporting in Kenya.

Since that time, the accounting profession has undergone tremendous change, as have the economies that the profession serves. New alliances and affiliations have taken root and globalization continues unabated. It is against this background that council has decided to adopt International Standards and to phase out Kenyan Standard in the next two years.

### **Why adopt International Standards?**

Council believes that there are compelling reasons why the change to International Standards is necessary:

#### **a) International trends.**

The last few years have seen dramatic developments and changes on the International Standards setting scene. Along with this has come a rapid adoption of international Standards in a number of countries which previously had their own national standards-take most of Europe and a number of countries in the pacific rim for example International Standards are now virtually accepted as the common yardstick for international reporting, with the only major pockets of resistance being the US and the UK. By the time we start the new millennium, acceptance and use of use of International Standards will be virtually universal. International flows of investment capital and capital instruments across geographical boundaries will add a new impetus to the current push for adoption of International Standards.

#### **b) Regional Considerations**

Kenya is a member of both IFAC and ECSAFA, organizations which strongly support adoption, rather than adaption, of International Standards. With the current trend in

which most countries in the region have decided to adopt International Standards, Kenya will be risking its leadership role if it lags behind on this issue.

**c) Local Pressure**

Regulators particularly the Central Bank of Kenya and the capital markets Authority) have continuously turned to International Standards rather than Kenyan Standards as an indicator of what the best practice should be. The capital markets Authority is currently in the process of developing disclosures standards for listed companies as well as those seeking to be listed. In doing so the authority is turning to international, rather Kenyan Standards. The institute runs the distinct risk of being marginalized in this important exercise unless it takes initiative on adoption of international Standards.

In addition, the increasing numbers of entities operating in Kenya that are part of a bigger group which reports under a number of jurisdictions has fuelled the pressure for adoption of International Standards.

**d) Resource Limitations**

Over the last few years, some major changes have been made to the International Standards as part of the "comparability" exercise. These changes have affected virtually all the Kenyan Standards in force. Following these changes, the existing Kenyan Standards are hopelessly out of date.

Updating Kenyan Standards to comply with International Standards and to also cover areas which are not covered currently is a monumental task. The institute just does not have the resources, human or financial, to carry out this task to a satisfactory level of proficiency. And even if it did, what purpose would it serve?

Council believes that an effort to update Kenyan Standards will merely reproduce International Standards under a different name. In the circumstances, therefore the resources available to ICPAK could be put to better use if they were used to interpret International Standards, assess their implication on local practice and where necessary, to issue technical bulletins and local guidance on those standards.

**e) Past Experience**

Every Kenyan Standard issued so far is intended to comply with IAS and says so in a paragraph labeled "Compliance with International Standards". ICPAK has never found it necessary to challenge any International Standards and no Kenyan Standard has ever been designed to deviate from International Standards. This then begs the question as to whether it is worthwhile expending scarce resources and energy in paraphrasing of existing International Standards which leads to no discernible change in substance.

**Implication On Local Reporting**

Council does not anticipate much of a problem in the larger entities in Kenya adopting International Standards- most of this are already in compliance. However, the adoption of International Standards would have an impact on smaller national businesses, but so would a wholesale revision of Kenya Standards.

The question therefore, is how quickly reporting entities operating in Kenya can conform fully with the requirements of International Standards. Council believes that a reasonable transition period is necessary to give reporting entities a chance to conform in a systematic manner

**Advantages of adopting International Standards.**

By adopting International Standards, ICPAK will reap certain benefits:

Kenya will be recognized as a leading International player in cross-border reporting in the region.

The institute will remain on top of events taking place in the accounting and auditing fields, particularly where International players or regulators are concerned.

The scale and voluntary human resources available to the institute will be relieved of Standard development responsibilities and will therefore be available to devote their energy to helping members interpret International Standards and to communicating their implications to technical bulletins.