INTRODUCTION TO ACCOUNTING FOR LAWYERS

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Okelo

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Accounting is simply a language of business

INTRODUCTION

LESSION ONE: THEORETICAL FRAMEWORK OF ACCOUNTING

Definition- it's a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature accounting

Importance

– For standard setting

– For better understanding and confidence of financial repotting

– Enhance comparability among companies

– Any new practical problem solved easily

What is accounting?

Accounting is simply a language of business. It's a man made means of communication of certain business information. It derives its usefulness from the social value of the environment in which it is developed. Its scope and definition change with the passage of time. In general, it is argued that accounting is concerned with the provision of information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of potential users in making economic decisions.

People involved in accounting are:-

(a) Business owners/ Entrepreneurs

(b) Managers

(c) Bankers.

(d) Stock brokers & lawyers.

Accounting information describes the events that make up the day existence of every business. Its information is used for controlling the use of resources owned by a business.

It's also used for measuring the performance of a business entity

Summary: use of accounting information.

(a) Describe the events taking place in a business

(b) Used to control resources owned by a business

(c) Used in meaning performance of a business.

The financial accounting environment

The nature of financial Accounting

Accounting can easily be treated as an information system.

Purpose of accounting therefore is to identify, collect, measure & communication of information about economic units' i.e.

-Sole traders: for example, doctor, dentist, small shopkeeper. Each is the sole owner of his or her business.

-Partnerships: for example, as above. The main difference is that a business formed under a partnership structure has shared ownership between at least two people.

-Limited companies: for example, ICI, Marks & Spencer. There are two types of limited company, namely, private (ltd) and public limited companies

-Other corporations: for example, enterprises owned by the government.

-Not-for-profit organizations Charities: such as Oxfam, Help the Aged, Save the children.

-Clubs and societies: such as students' union, golf clubs.

-Government and quasi-governmental bodies: such as local councils,

-Others: such as trusts and mutual associations.

The users of accounting information are divided into two

1). External Users

2). Internal Users

External Users – Shareholders, Potential investors, creditors, rank & file employees' customer, competitors, financial analysts & advisors, brokers, underwriters, the stock exchange, lawyers, economist, taxing & regulatory authorities, legislature, the financial press departing agencies, labor unions, trade association, Business, researches, teachers students and the public.

They make decision on:-

a) Whether to invest

b) Whether to extend credits

c) Whether to do business

The process of developing and reporting accounting information to external decision makers is called **financial accounting**

Finance accounting is concerned with the manner and extent to which business communicate financial information about themselves to the outside world / public.

Outside world / Public – Individual who invest in them, lend money etc

These people rely on a company's financial investment and other financial decision related to the company.

NB/ Many issues involved in the public accounting are controversial, and difference of opinion & interpretations may have a substantive impact on the public's decision making process.

Only rarely there is a single, correct resolution or definitive answer to financial accounting issues.

The accounting body has set a net of accounting concepts principle and procedures to assume that external financial statements are relevant known as GAAP (General Acceptable Accounting Principles.)

Internal decision makers – are the managers of an entity

Management is responsible for:-

a) Planning the future of a business

b) Implement plans

c) Control daily operations

d) Dispatch information to other operating officers

The process of developing and reporting financial information for internal users is called management accounting.

To accomplish the necessary reporting, two basic financial statements are used:-

1. **The Balance Sheet –** show the company's financial position as of a specific point in time. It shows the assets, liabilities and owners' equity. Also called a statement of financial positions

2. Statements that relate to a specified period of time a. **Income statement –** reports the company revenue, gains, expenses, losses & net income. Also called the statement of income

b. **Statement of retained earnings –** reports changes of the company's accumulated earnings.

c. **Statement of cash flow –** report the company cash flow from operating investing and financial activities.

Features/ characteristics of accounting information

1. Financial reporting should provide information that is useful to present and potential investors & creditors

2. Information should be comprehensive to those who are reasonably understanding the business & economic activities

3. It should help investors and creditors to assess the amounts, timing & uncertainty of prospective cash receipts

4. To assess the prospects of cash resale redemption & maturity of loan

5. Provide information about the economic resource of an enterprise

Functions of accounting

It is generally accepted that accounting should serve the following functions:

1. **Recording**: accounting systems supply a means of recording and classifying data as to enable the production of summarized financial statements relating to the entity's results and current state of affairs. Records also enable one-off requests for data to be complied with.

2. **Measuring**: accounting tries to assist in the measurement of the economic results of the entity's activities, usually with a view to sharing out the results among the various interested parties: for example, government (taxes), employees (wages), shareholders (dividends).

3. **Stewardship**: accounting provides a record of how the funds entrusted to managers have been used by them, and to what ends.

4. **Monitoring, planning and control**: accounting should provide sufficient information on the results of past activities to enable management to monitor the results, and take action if necessary, and to formulate plans for the future.

5. **Information for decisions**: accounting should assist investors, for example in deciding how to allocate their limited resources.

6. **Communication**: accounting should communicate information to both internal and external users. (Financial statements are the main tools used to achieve this function for external users.)

Interaction of Financial accounting with its Environment/ importance of financial reporting

1. Accounting helps decision makers evaluate opportunities by providing measurements such as net income, total assets etc

2. It define the tax payment given by the statutory condition

3. Establishes the attractiveness of a company as a takeover target

4. Evaluate the effectiveness of individual managers

5. Determine whether bond & other contract provisions are satisfied

6. Acts as a regulator for decision making

7. Helps lenders to measure the risk of their loans

8. Influence the effectiveness of a company to its workers
9. Suggests bargain strategies for union organizers
10. Affects willingness of supplies to enter into long-term contracts
11. Attracts the attention of the government unit because of unusual profit performance
12. Affects customer' willingness to purchase co- products

Factors that influence accounting information compilation and reporting procedures

1). Accounting principles & standards

2). The legal system of the country

3). Regulatory structure e.g. public untidy regulatory commission

4). Company dilemma in a competitive environment not the release its information for few years reducing the competitive advantage

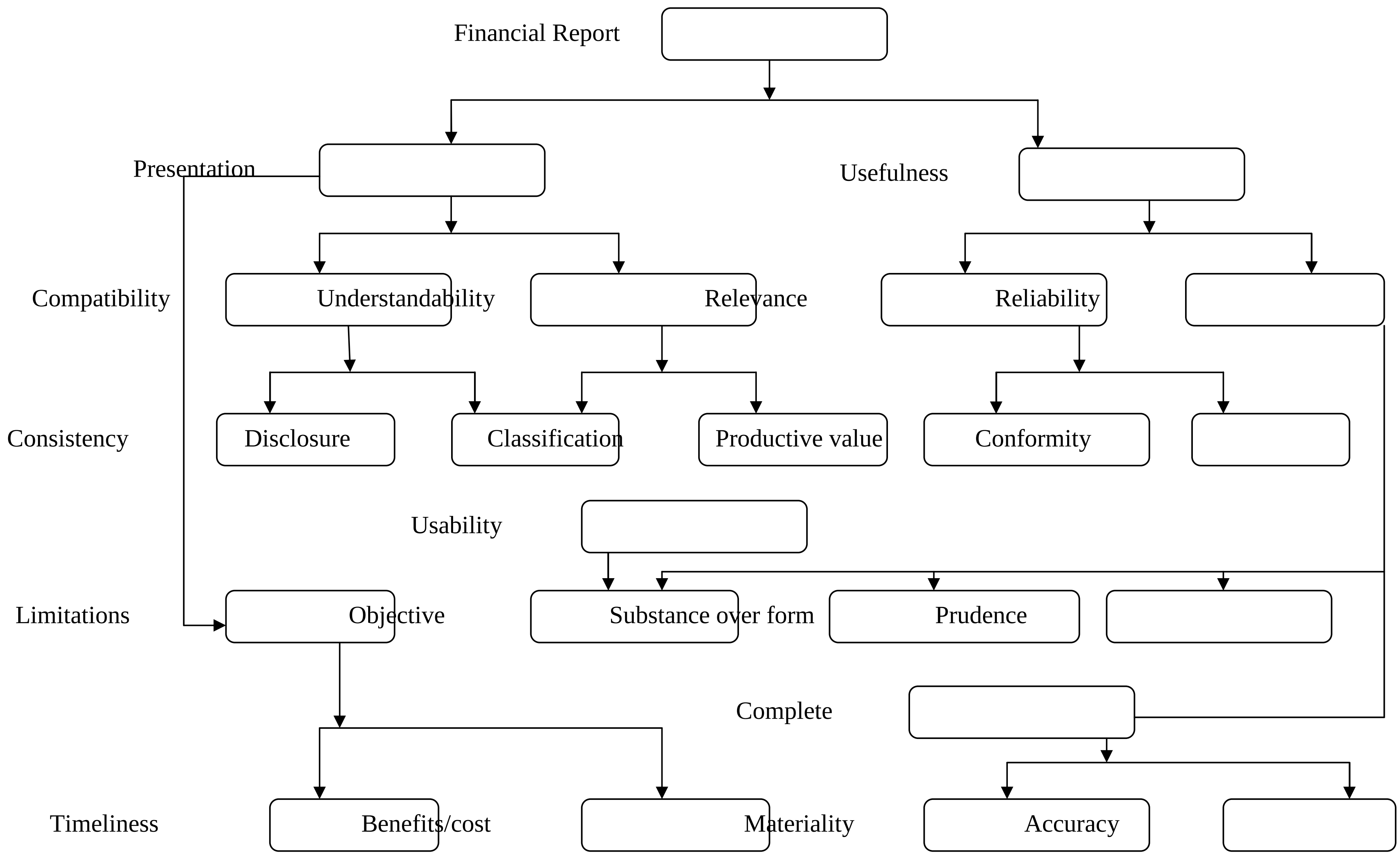
5). The demand for information by the users.

6). The cost and benefits of alternative reporting

7). The importance of the quality of information supplied

8). The development of new financial instruments – e.g. computerization

Conceptual framework of Accounting



LECTURE II: THE FUNDAMENTAL THEORY OF ACCOUNTING AND THE ACCOUNTING CONCEPTS

THEORY OF ACCOUNTING

The nature of any theory is to provide a logical basis for the practice or procedure to which the theory is applied. Accounting theory has evolved through a long passage of time during which substantial changes in human behavior and market structures have taken place.

(a) History of accounting goes to ancient Mesopotamia in Egypt. Accounting records were kept as rudimentary documents

(b) In Greek and Roman, accounts were mostly based on the "charge & discharge principles."

A steward, a public official or other person entrusted with money or property rendered account periodically to his master during the period of his stewardship. The "Charge" consisted of the balance due to his master at the beginning of the period. The "Discharge" consisted of sums disbursed or goods sold or consumed during the period, plus the balancing figure of money or goods due to the accountant's master.

(c) The next most important development that occurred in Italy was doubled entry book – keeping in 13th & 14th Century. The principles of charge & discharge were extended to the cashier of the firm who was charged with the receipts & discharged with payments

(d) It refinement of the above system was developed by Luca Pacioli (1445-1515).

Luca developed the murder system of book keeping and double entry system of accounting. He developed the use of journal as a book of original entry and ledger as the book of accounts. The only notable shortcoming of Pacoili's system was the failure to distinguish between the proprietor of a business as an individual & the business as an entity independent of its own.

(e) The development of modern accounting practices began within the industrial revolution, the development of the railway, the creation of just stock companies and as a manger academic discipline. The theory of scientific management has also had some influence on the development of modern accounting through practices.

What is meant by the term 'accounting concepts'?

It is a common misconception for financial statements to be considered as 'right' in an absolute sense, especially as regards profit. There is, as yet, no universally accepted measure of profit as there is for, say, weight (though even this is subject to different units of measurement, which may need to be converted). Because of this, accountants have, in the light of experience, identified certain broad assumptions on which the financial results of a business are prepared. These assumptions, also known as ‘accounting concepts’, define the rules under which the financial statements of an entity should be prepared.

These are the common basis for the preparation and reporting of financial information usually referred to as “the generally accepted accounting principle”.

Accounting principles are also referred to as standard, assumption, postulates and concepts.

Accounting principles includes:-

(a) Going concern

(b) Consistency

(c) Prudence

(d) The accruals concept

(e) Substance over firm

(f) Materiality.

1. Going concern

The valuation of assets used in business is based on the assumption that the business is continuity. One not in the verge of collapse

Assets on a closing down business fetch lower value. This means if a business is to continue to operate in a foreseeable future, its considerable sensible to the use of the cost concept when arriving at the valuation of assets. Example Where a business is to close in future, ii) Where shortage of cash is almost certain, business will close down.

2. **Substance over form**

It can happen that the legal form of a transaction can differ from its real substance. Where this happens accounting should show the transaction in accordance with its real substance which is basically how the transaction affects the economic situation of the firm. In this case, it will not reflect the exact legal position concerning that transaction. E.g. Hire purchased vehicle

Under normal circumstance, it belongs the personal using it, but the exact legal position it belongs to the seller until the buyer finishes paying the installments.

3. Accrual / matching concept

It makes the distinction between the receipt of cash and right to receive cash and the payment of cash and the legal obligation to pay cash. Expenses(trading events) leading to reduction in wealth, are matched to particular revenue that they helped to generate in the same period e.g.

where the sale of goods is recognized as revenue in a particular accounting period , the cost of acquiring those goods should be treated as an expense of the same period irrespective of when goods were acquired. In practice there is no coincidence in time between cash movements and the legal obligations to which they relate

Example

Accrual concepts apply to revenue/ or receive cash in various ways i.e. cash received may occur in different ways

(i) Concurrently with the sale

(ii) Before right to receive arise

(iii) After the right to receive has been created

(iv) In error

The accrual concept provides a guideline as to how to treat these cash receipts and the rights related to them.

The concept of consistency

If you have to make comparison and come up with a decision, the information must always be given a change to reach the conclusion.

The comparability of financial statements depends largely upon the choice of accounting method and the consistency with which they are applied.

If firms wish to change their method for treating a particular problem such as the valuation of stocks they may do so but should mention the effect on profit of the change in accounting of the previous method. Consistence should be observed. In accounting it’s important to be consistent in the methods used before a decision is arrived to change or not.

Materiality

In accounting there is one overriding rule applied to anything that appears in a financial accounting statement. It must be material - i.e. it should be of interest to the stakeholders, i.e. those people who make use of financial accounting statements. It need not be material to every stakeholder, but it must be material to a stakeholder before it merits conclusion.

Prudent / Convertism

- Sensible and careful attitudes that make an investor to avoid making unnecessary risks. It is a guiding principle in resolving uncertainties. Accounting must not anticipate profit and should provide for all foreseeable losses and when faced with two or more methods valuing an asset, the accountant should choose the method which gives the lesser value.

Concept of capital and capital maintenance

Assets – liabilities = owners equity/ Capital

-Capital maintenance concept arises from the fact that distribution made to owners should not exceed the amount of profit generated if capital is to be maintained.

-Excess distribution would obviously lead to depression of capital. There are two concepts which attempts to explain capital statement.

1. Financial capital maintenance concept - Under this concept profit is earned only if the difference between the financial (monetary value of the net asset at the end of the period, after any distribution to and contribution by the shareholders exceed the net asset at the beginning of the period. Capital = net asset or equity.

The financial capital can be measured in either monetary value (units) or constant purchasing power.

2. Physical capital maintenance -This is where profit is earned only if the physical productive capacity cooperating capacity of the enterprise at the end of the year exceeds the physical productive capacity at the beginning of the year.

Capital is equal to the production capacity of an enterprise. It requires adoption of current cost basis of measurement.

LECTURE III: ACCOUNTING STANDARDS

These are the common basis for the preparation and reporting of financial information usually referred to as "the generally accepted accounting standards"

Accounting standards are also referred to as principles assumption, postulates and concepts.

Board /Organizations that have responsibilities for setting accounting standards

1). Financial Accounting Foundation (FAF)

2). Financial Accounting Standard Board (FASB)

3). Government Accounting Standard Board (GASB)

4). Financial Accounting Advisory Council (FAAC)

5). Government Accounting Advisory Council (GAAC)

6). International accounting standards board (IASB)

The major difference in Financial Accounting Standard Board and the others are:-

1). Membership Number

2). Financial Independence

3). Reporting autonomy

4). Board representation

5). Increased staff & advisory support

Since 1973, the Financial Accounting Standards Board (FASB) has been responsible for establishing the accounting standard that constitute generally accepted accounting procedures

The FASB currently follows a **due process** procedure in developing accounting standards. This process uses an open format that provides an opportunity for interested parties to express their views.

The standard process uses the following steps:-

i. Select and prioritize issues of the Boards Agenda

ii. Appoints a representation task force to identity & define the problems & alternatives related to each and conduct a research & analysis about it.

iii. Prepare a discussion memorandum on the issue to interest parties

iv. Invite public comment of the memorandum

v. Schedule public hearing following the discussion memorandum, Analyze the comments given.

vi. Determine whether to issue a standard, if yes prepare an exposure draft of the standard & distribute to all interested parties

vii. Analyze the comments about the explosive draft from the public

viii. Public hearing

ix. Approve / disapprove the exposure as revised by a vote for at least of the seven Board members. If approved, it becomes a new standard.

NB

For complex and controversial issues some of these steps can be repeated

Question: What is Generally Acceptable Accounting Principle (GAAP)? How are they prepared?

Solution

This refers to the board guideline, conventions, rule and procedures of accounting

This body has noted the following as controversial issues

1. Capitalization Vs expensing a) Research development costs

b) Software development costs

c) Interest costs

d) Oil and Gas accounting

2. Off-balance sheet financing a) Leasers

b) Pensions

c) Unconsolidated finance subsidence's

d) Purchase commitments

3. Income taxes

a) Deferred taxes

b) Investment tax credit

4. Changing Prices

a) Price Level Adjustment

b) Current value

These issues have more than one solution and that the choice of treatment makes a substance difference in the amounts reported in the financial statement

The complex changes affecting business include

- The growth of absentee ownership and increasing importance of stock exchange securities / share
- Increase in power of national government tax
- Confidence of the public in financial reporting

SUMMARY (I AS))

International accounting standards

These are guidelines & working notes and procedures formulated by the international accounting standard board (IASB) to guide accounting practice.

They describe the methods of accounting deemed mandatory for application to all financial statements other than those prepared for internal rules.

Procedure for development of IAS

(1) A problem / topic identified and presented to the board. Issues identified and reviewed.

(2) A study / research is taken / conducted and views collected.

(3) Consultations conducted within the board.

(4) Formation of advisory board (steering committee)

(5) Publishing for public comment

(6) An exposure draft approved by at least 2 board members published.

(7) Consideration of comments

(8) Public hearings.

(9) Approval of the standards by at least ¾ of the board.

Benefits of IAS

o Uniformity

o Quality

o Saves time

o Promotes growth in accounting methodology.

Disadvantages

1. Financial statements are to be used by a variety of users and it is uncertain that a single prescribed standard can be suitable for all use.

2. They stifle the creativity, as the accountants are restricted to laid down procedures & rules.

3. They at times offer too many alternatives thus creating room for subjectivity

4. They may at times be incompatible with the laws of the country.

Reasons for the change from Kenya accounting standards to / as International trends

1Due to the flow of international investment across geographical boundaries it became necessary to adopt IAS. 2. Regional consideration- Kenya was a member of ECASAFA which strongly support adoption of IASICPAK. Felt that it will be risking its leadership position if it rugs behind on the issue. 3. Local pressure- Regulators have continuously turned to IAS rather that KAS as an indicator of what the best practice should be. The institute therefore was marginalized by the regulators e.g. central bank, market authority, stock exchange e.t.c. **4.** Resource limitations- The institute did not have resources to develop standards and it would be a great saving to use already developed standards. 5. Past experience**-** Every KAS issue intended to comply with IAS as such as possible because the institute has never found it necessary to challenge any IAS. Prolonged inflation periods e.g. weakness of historical cost based accounting. Demand arose for some uniformity in recording business transaction and presenting financial statements of public owned and standards had to be put in place.

Process of measurement of financial statements

-It’s the assignment of numbers to properties and characteristics of objects.

In accounting several measurement systems can be used:-

1. Historical cost measurement- assets recorded at their actual/ original cost
2. Replacement cost measurement / assets value carried at the replacement cost
3. Rate of return measurement / realizable- assets carried at the amount they would be disposed
4. Present value /Discounted cash flows – assets carried at present discounted value of the future cash flow

To enable users to implement statement with confidence companies in similar industries should use the same measurement concept and principles.

In some countries this concepts and principles are prescribed by Government bodies. In U.S.A they are embodied in the generally accepted principles (GAAP) which is a consensus of various experts in accounting.

Direct measurement- occurs if a number assigned to an object is an actual measurement of the desired property.

This measurement may not be accurate.

Indirect measurement – One that must be made by roundabout means for measuring the desired attributes. This may include average price of commodities.

NB/ Direct measurement are usually preferable to indirect one.

Assessment & prediction measures

Assessment measures are concerned with particular attributes of objects. They can be direct or indirect.

Prediction measures Are concerned with factors that may be indicative of conditions of a future point in time e.g. income of a present period be used as a predictor of dividends for the following year.

Types of measurement

1. **Nominal scale –** A simple classification system e.g classifying students according to provinces they came from.

1. Coast
2. Central.

2. **Ordinal scale**

Where numerals are assigned in ordinary ratings that indicate an order of preference of 1, 2, 3 good, very good

In accounting, ordinal measurement is used to determine liquidity in the balance sheet.

Internal scale

- Here the change in the attributes measures between assigned numbers e.g. 1-5-9.

Ratio scale

-Assigns equal value of intervals between assigned numbers.

¼ -½ - ¾

LECTURE 4 : REVIEW OF ACCOUNTING CYCLE

Definition

It's the sequence of activities beginning with the occurrence of a transaction. It's a series of sequential steps leading to the financial statements.

-Depending on the information processing technology used, certain accounting cycle steps are combined or some cases omitted. The fundamental process, however, is independent on the technology used.

-Many systems are computerized to increase speed and accuracy in the cycle worksheets and can be used to perform several task /steps at a go.

Steps in the accounting cycle

Identify the transaction: Identify the event as a transaction and generate the source

Analyze the Transaction: Determine the transaction amount, which accounts are affected, and in which direction.

Journal Entries: The transaction is recorded in the journal as a debit and a credit.

Post to Ledger: The journal entries are transferred to the appropriate T-accounts in the ledger.

Trial Balance: A trial balance is calculated to verify that the sum of the debits is equal to the sum of the credits.

Adjusting Entries: Adjusting entries are made for accrued and deferred items. The entries are journalized and posted to the T-accounts in the ledger.

Adjusted Trial Balance: A new trial balance is calculated after making the adjusting entries.

Financial Statements: The financial statements are prepared.

Closing Entries: Transfer the balances of the temporary accounts (e.g. revenues and expenses) to owner's equity.

After-Closing Trial Balance: A final trial balance is calculated after the closing entries are made.

This diagram shows that the financial statements as being prepared after adjusting entries and adjusting trail balance.

- The financial statement can also be prepared before the adjusting entries with the help of a worksheet that calculates the impact of the adjusting entries before they are actually posted.

Identifying transaction or events to be recorded

The purpose of this is to collect relevant data about the transaction.

Events that change a firm's resource are categorized into 3 types.

1. Exchange of resources between the reporting firm and outside parties e.g. sale of goods for cash or otherwise require a journal entry.
2. Internal events within the firm that affects its resource but do not involve outside parties e.g. recognition of depreciation and amortization for assets. These events also require a journal entry.
3. Economic and environmental events beyond the control of the company. E.g changes in market value of assets and liabilities and casualty losses. Only some of these require journal entry.

Transactions are often accompanied by a source document. Source document are paper records that describes the transaction, the parties involved, the date, amount and other aspect of the event

Examples of source documents- includes: - Sale invoices, fright bills, cash register receipts etc.

In certain events, eg accrual of interest, are not singled by a separate transaction or source document. Recording Sources documents are also used for subsequent tracing and verification for evidence in legal proceeding and for this transaction requires reference to the underlying contract or other source document supporting the original exchange or resources.

Accounts, transaction recording, and financial statement

Financial accounting information is recorded in accounts that are formal records of specific resources, obligations and their changes.

The seven major types of accounts are grouped into two fundamental classifications

1. Permanent accounts (assets liabilities and owners equity accounts)
2. Temporary accounts. (Revenues, expenses, gains and losses)

The permanent accounts appear in the balance sheet (This accounts are carried over to a future accounting period)

The following accounting equations / identify relates to the balances of the permanent A/CS.

Assets = Liabilities + Owners' Equity

This identity indicates the recorded value of assets and their sources. The equation facilitates the computation of capital as long as the assets & liabilities of the business are known at a given time. This difference is also referred to as "Net-worth" of the business to the proprietor. There is a balance on the assets to the liabilities and owners' equity resulting to a balance sheet

A statement of financial position – A statement showing the layout of the assets, liabilities and Net-worth of a business

Characteristics

(a) Total assets must be equals to total figure of liabilities & owner equity.

The two sides of the balance sheet are always equal

(b) Its only true at a given time only.