To know or not to know: that is the question

Richard Poole explains why knowing the Conceptual Framework will take the slog out of learning accounting standards

As a tutor of financial reporting papers of many years' experience, I always find that students are overwhelmed by the number of Accounting Standards that they need to remember in financial reporting papers. Well, they think that they need to know them all! What is in fact more important is to remember the Conceptual Framework.

This contains the concepts and principles that created all of the Accounting Standards.

The Conceptual Framework

The Framework identifies the five elements of financial statements:

- **Assets:** These are resources controlled by an entity as a result of a past event that will lead to a probable inflow of economic benefits into the business.
- **Liabilities:** These are obligations of an entity arising as a result of a past event that will lead to a probable outflow of economic resources from the business.
- **Equity:** This is the residual net assets of an entity after deducting its liabilities.
- **Income:** This increases the economic benefits for the business during the period.
- **Expenses:** These decrease the economic benefits for the business during the period.

The Conceptual Framework also identifies when the elements can be recognised in the financial statements. It says that an element should be recognised in the financial statements if:

- It meets the definition of an element.
- It is probable that future economic benefits will flow to or from the entity.
- The item can be measured reliably.

I always reassure my students that they can give a very good answer for most exam questions that are testing accounting standards just by knowing the Conceptual Framework.

Let me explain this further, with examples of how easy it is to talk about an accounting standard, even if you don't know the accounting standard, as long as you know which element is being addressed in the accounting standard. There are many examples, but I will focus on just three accounting standards.

Revenue

IFRS 15 asks a lot more questions now about whether we should recognise revenue than the previous revenue standard did.

In terms of the element that we are talking about from the conceptual framework, this standard is addressing 'income'.

Even if I don't know what IFRS 15 says and I am asking whether income should be recognised, most scenarios can be answered by looking at the recognition criteria of the Conceptual Framework:

- It meets the definition of an element.
- It is probable that future economic benefits will flow to or from the entity.
- The item can be measured reliably.

IFRS 15 asks us to address a number of steps. Within these steps, the key things that the standard tells us to do is:

- 'Identify the contract'
  – Is it probable that the selling entity will receive consideration?
- 'Determine the transaction price'
  – The entity must estimate the amount it expects to receive.
  – It is highly probable that a significant reversal in the amount of revenue recognised will not occur.

It can be seen that with a reasonable knowledge of the Conceptual Framework that it is possible to conclude on whether we should or shouldn't recognise revenue in most scenarios.

Intangible assets

When we consider intangible assets (including Research and Development expenditure) we are considering the recognition an 'asset' as the element here.

In some cases, development expenditure may meet the recognition criteria.

IAS 38 Intangible Assets stipulates that this is only the case if ALL of the following conditions are met:

- Completion of the asset is technically feasible.
- The intention is to complete and use or sell the asset.
- The asset can be used or sold.
- The asset will generate future economic benefits.
- Adequate resource is available to complete the asset.
- The expenditure on the asset can be measured reliably.

It can be seen again that by knowing the Conceptual Framework we can generally identify if development expenditure should be recognised.

Leasing

In relation to Leasing, IFRS 16 says that a lease is probably a finance lease if one of the following applies:

- Ownership of the asset transfers at the end of the lease term.
- The leasee has the option to purchase the asset for less than its expected fair value and this is reasonably certain (probable) to occur.
- The lease term (including secondary periods) is for the major part of the asset's economic life.
- At the inception of the lease, the present value of the lease payments amounts to substantially all of the fair value of the leased asset.
- The leased assets are specialised.
- The leasee will benefit from changes in the asset's residual value.
- The leasee can continue the lease for a secondary period in exchange for rent payments that are much lower than market rates (probability needs to be considered).

To conclude

I am not in any way suggesting that students shouldn't try and learn their accounting standards. However, it is a very useful tool to have in your exam technique repertoire to know the code (Conceptual Framework) that created the accounting standards. PQ

• Richard Poole FCCA is a freelance classroom lecturer and online tutor with FME Online