Chapter objectives

- To introduce the balance sheet and the income statement and to discuss whether primacy should be given to the balance sheet (as in the IASB’s Framework) or to the income statement (as with the matching principle)
- To consider the principles that govern the reporting of assets under the IASB’s rules for the principal categories of assets, with reference to questions of definition, recognition and measurement.
- To set out the principles that govern the depreciation and impairment of assets
- To examine the reporting of assets by the largest MNEs and the asset valuation methods used in the Pentad

15.1 THE BALANCE SHEET VERSUS THE INCOME STATEMENT

15.1.1 The primacy of the balance sheet

The next three chapters consider the two primary financial statements: the balance sheet and the income statement. The balance sheet is considered first. This reflects the primacy given to this statement in the IASB’s Framework, as evidenced by the Framework’s definitions of the elements of the two statements as presented in Exhibit 13.4. These definitions will be examined in more detail later. For the moment, the important point to note is that the definitions of income and expenses (the elements of the income statement) refer to assets and liabilities, but that the latter (the elements of the balance sheet) are defined independently – they do not refer to income and expenses. Income is defined as
increases in the value of assets or decreases in the value of liabilities; expenses are negative income. The elements of the income statement are determined by the elements of the balance sheet; the balance sheet is the dominant statement; the income statement is subordinate to it.

The relationship of the balance sheet and the income statement, as set out in the IASB’s Framework, is illustrated in Exhibit 15.1. The values of assets and liabilities are first established. Equity is defined as net assets (assets less liabilities). The total value of equity is broken down into its component parts: contributed capital (increases in net assets resulting from transfers from the owners) and reserves (increases in net assets resulting from other transactions and events). Reserves are broken down into two elements: valuation adjustments (increases in net assets that have not been reported in the income statement) and retained profits (increases in net assets that have been reported in the income statement less dividends).

There are two important points to be made about Exhibit 15.1:

(a) The balance sheet and the income statement are interconnected. The figure for the profits for the year 2000 appears both in the income statement and in the balance sheet (as a component of equity). Accountants use the term ‘articulation’ to describe the interconnection of the balance sheet and the income statement.

(b) The values of assets and liabilities are established independently of the income statement. Hence the figure for profit in the income statement is determined by the values for assets and liabilities reported in the balance sheet, given that the two statements are articulated.

However, there are two exceptions to this articulation:

(a) Transfers to and from the enterprise’s owners. The payment of a dividend reduces the assets but the dividend is not considered to be an expense to be reported in the income statement. Instead it is regarded as a distribution of profit and deducted from the balance of retained profits in the balance sheet. Fresh injections of capital are added to contributed capital.

(b) Valuation adjustments. On occasions, increases/decreases in the value of assets/liabilities are not passed through the income statement but are included in the balance sheet as a separate component of equity. An example is given in IAS 16 Plant, Property and Equipment: when plant is valued at fair value, any increase in its value above historical cost is not reported as income in the income statement but is transferred to equity in the balance sheet. In Exhibit 15.1, the relevant equity component is entitled ‘Valuation adjustment’. In fact there is no consensus as to the appropriate title: in the Framework, it is termed ‘Capital maintenance adjustment’; the term used by IAS 16 is ‘Revaluation surplus’.