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Chapter 5

# Principles of financial accounting

## Introduction

In the first four chapters we developed a simple procedure for producing a balance sheet and income statement for a small business. Using the accounting equation we demonstrated how different transactions could be analysed into those which transformed assets from one type into another, how liabilities were created and, most importantly, how value could be added to the owner. Three principles were necessary to operate the model: identity, matching and additivity. In this chapter we build upon the ideas and techniques developed earlier: first by an examination of the matching principle in greater depth, focusing on the problems of accruals, depreciation and inventory valuation and, second, by reviewing in more detail how businesses create value. As we proceed we will also introduce some of the traditional terminology that professional accountants use and how business accounting systems operate in practice.

## Learning objectives

There are seven outcomes you should achieve in this chapter. Split into three learning sections these outcomes are as follows.

### *The principles of value creation and the matching principle*

- That you understand the principal ways that value is created in business, distinguishing, in particular, between the transactional and the transformational drivers of value.
- That you obtain a deeper understanding of the concept of matching through the practical application of the accruals principle.

### *Accounting for real assets: depreciation and inventories*

- That you understand and can calculate appropriate depreciation charges using a range of different methods and know the various factors which influence the choice of method to use in practice.
- That you can measure the value of inventory using the FIFO, LIFO and average cost methods and know, in principle, the difference between marginal and absorption inventory valuation systems.

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- That you understand the difference between the cost of goods sold and the cost of sales and can calculate the cost of goods sold using opening and closing inventory figures.

*Extending your understanding of the principles of accounting*

- That you understand the practical principles used by financial accountants in producing accounts.
- That you understand the difference between transaction- and valuation-based accounting systems and know the significance of different asset valuation and capital maintenance concepts.

# The principles of value creation and the matching principle

In this section we review the four fundamental ways in which companies can create value. Each way has different implications for accounting, which will be a feature of our work in this and later chapters of this book. We will also outline the rules that accountants use for deciding whether a particular cash inflow into a business can be counted as revenue and an outflow as a cost in the financial accounting period concerned.

## Reflection on the ways that businesses create value

As you will remember from Chapter 1, financial accountants are particularly concerned about how businesses perform over time. As shown in Exhibit 5.1 it is possible to measure or, perhaps more accurately, estimate the net value of a firm's assets at the beginning and end of a set period of time (the period of account). The difference between the two is the total value added to the owner's account over the period concerned.

**Exhibit 5.1** Value changes over a single period of account