

**A. THOMPSON MONTGOMERY**

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# **Financial Accounting Information**

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**An Introduction to its  
Preparation and Use**

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**SECOND EDITION**

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**An Introduction to Its Preparation and Use  
Second Edition**

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**A. Thompson Montgomery**



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To Natalie for her inspiration, patience, support, and love; and  
to those students who may find that accounting is far more than bookkeeping.

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# Preface

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In this second edition, I have retained and expanded upon the many unique features of the first edition that were so favorably received by the faculty and students using the text. More than three-fourths of the book is either new or completely rewritten to incorporate these expansions and the numerous constructive suggestions from users acknowledged below.

The text continues to be designed for use in a single course or a two-course sequence devoted to financial accounting at the undergraduate or graduate foundation level. Different coverage combinations for different course lengths, levels, and objectives are detailed in the Instructor's Manual. In this preface, I will first describe many of the book's distinctive features that may not be readily apparent to one who has not used the first edition in the classroom. Those who already know and appreciate these features may wish to skip ahead to the section entitled "Supporting Materials."

## Distinctive Approach

This book's approach differs significantly from that found in other elementary financial accounting texts. Through more than six years of classroom testing prior to publication of the first edition, it proved more effective than traditional approaches. Four years of enthusiastic response by users of the first edition provide further validation. The approach is distinctive in three major ways:

1. **Most basic accounting topics are introduced in the context of solving a simple practical business problem to which the student can first readily relate.** The "why" thus precedes the "what" as a motivation for learning; and the student can perceive from the outset accounting information in its critically essential service role rather than as an end in itself.

In contrast to many other basic texts, this book does not assume that the student is sufficiently interested in accounting to identify solely with the accountant's objectives. Such an assumption is valid at the intermediate level where a tentative career commitment has been made. Since most elementary students are still involved in the career-decision process, the reader in this text is only asked to assume a businessperson's viewpoint and thus to appreciate the accountant's contribution.



2. **The student is continually asked to focus upon the financial statement effect of each transaction and adjustment rather than just its effect on particular accounts.** This subtle but important difference provides a progressively integrated perspective on the importance and usefulness of the accounting system as a whole and on the fact that correct entries, and other accounting tools have no intrinsic value to anyone but bookkeepers. The accountant's standards and objectives are set forth and emphasized as pragmatic, feasible, proven solutions to difficult measurement choices, while bookkeeping procedures *per se* are deemphasized as simply traditional means for achieving such ends. This perspective is reinforced by the segregation of bookkeeping practices and procedures into a separate chapter and subsequent chapter supplements.
3. **Subjects are sequenced and introduced only as needed to:**

- Develop an overall understanding of the operation of the basic accounting system as rapidly as possible, and
- Thereafter develop a series of progressively more sophisticated layers of understanding.

My own testing of alternative approaches to basic accounting instruction, and numerous studies covering other disciplines, has shown that subject matter grouping logical to the individual once all material has been mastered does **not** necessarily provide the most effective or efficient sequence for the first introduction of such material. For example, whereas receivables, collections, discounts, and uncollectibles allowances form a logical grouping to treat exhaustively at the intermediate level, the elementary student can experience confusion and overload unless these topics are picked up in several consecutive passes, separated by sufficient time to allow complete "digestion" of the previous exposure. Also, although exhaustive treatment of logically-related topic groups works well at the intermediate level, after an integrated overview has been established, it is **not** an efficient approach to creating and reinforcing such a perspective.

The advantage of this text's orientation has been obvious for graduate MBA students and for those undergraduates not intending to become accounting majors. Not so obvious is its **even greater** benefit for the future accountant. Tradition and past practice have readily led to the inference that the future accounting major should start with intensive training, as distinct from education, in bookkeeping procedures. Six years of controlled experimentation prior to initial publication and four years of experience with the first edition indicate the opposite conclusion. Accounting majors having the integrated overview and perspective obtainable from this book's approach find that they have a framework into which they can fit intermediate and advanced detail. At the intermediate and advanced levels, they consistently outperform others without such an overall perspective. This fact has recently been acknowledged in the AICPA's recommendations for a minimum of procedure in the elementary course. With accounting now a dynamic, constantly changing system, perhaps the simple answer is that initial emphasis on the "why" and the "what" rather than the "how" provides a better framework for ready integration of change.

## Topic Sequence

Consistent with the approach of developing progressively more sophisticated layers of overall understanding, the first seven chapters cover the entire operation of the accounting system for a proprietorship without the complications of bad debts, discounts and premiums, price changes, and accelerated methods of depreciation and amortization. The balance sheet is first introduced as the core of the system, even though not necessarily the most important statement. Returning to the classical balance sheet approach, as opposed to the income statement approach, has proved the key to subsequent ease of understanding the funds flow and constant dollar/current cost adjustment.

Immediately following a description of the environment of accounting (Chapter 1) and the balance sheet (Chapter 2), elementary balance sheet analysis is presented in Chapter 3 to reinforce the interrelationships of the various parts of this statement. Chapter 3 also serves to lay the foundation for funds flow understanding sufficiently early so that there is adequate time for the underlying concepts to be thoroughly assimilated before funds flow statements are introduced. Simple transactions and adjustments first appear in Chapter 4 to integrate balance sheet changes with income measurement. The income statement and income measurement are then discussed along with funds from operations in Chapter 6. This pairing demystifies the otherwise often troublesome reconciliation of funds flow and income measurement and also serves as a bridge to the coverage of the statement of changes in financial position in Chapter 7. Variations from the common working capital approach to this statement, and the details of deriving the data for its preparation, are deferred to Chapter 14. More specialized aspects of income measurement including alternative timing of revenue recognition, extraordinary items, and prior period adjustments have also been set off in an Appendix to Chapter 6.

After the essential aspects of all financial statements and the basic accounting system have been introduced, a second layer of sophistication is provided by Chapters 8 and 9. These chapters focus on those GAAP alternative methods having the greatest impact on income—inventory flow and assumptions and depreciation electives. Two topics often ignored in elementary texts are briefly and simply introduced in these chapters: dollar-value LIFO and capital leases. To leave the elementary student with the impression that all or even most firms electing LIFO maintain layered records for every product or part, or that all long-lived assets in use are owned by the firm, is simply false. The details of dollar-value LIFO computation are deferred to the Chapter 7 Appendix, which also includes the gross profit method, the retail method, and a brief introduction to inventories for a manufacturer. In the Appendix to Chapter 8 and in Chapter 9 reference to constant dollar and current cost reporting for inventories and plant assets is included. The details of the computation of such data are deferred to Chapter 16.

Chapter 10 introduces accounting for partnerships and corporations. At this stage, such otherwise complex materials can be readily understood as minor variations having no effect upon the basic accounting system previously introduced and understood. A beginning student, even at the graduate level, can more readily iden-

tify with a small proprietorship than with an abstract corporation. Delaying corporate accounting complexities until Chapter 10 facilitates their assimilation.

With an appreciation of the advantages of the progressive layering approach, the logic behind the collection of topics in Chapter 11 and 12 becomes obvious. Chapter 11 covers the remaining asset-related topics for a single firm, none of which are essential to the earlier development of a basic understanding of the accounting system's operation and usefulness. Chapter 12 serves the same function for liabilities. Students without preconceptions that certain topics logically belong together have no difficulty accepting each topic in these two chapters independently as simply a more sophisticated measuring and recording problem related to a unique situation. Each topic can be viewed as an accessory compatible with, but not essential to, the basic system.

Since present value can no longer be ignored in the valuation of assets and liabilities, it is introduced conceptually in Chapter 11 with the techniques of computation segregated in the Chapter Appendix. Several topics not covered in many other elementary texts are briefly introduced in Chapters 11 and 12. They include capital lease accounting, accounting for fully amortized loans, debt refunding and conversion, tax allocation, and pension accounting. The treatment of these topics is highly simplified and not included with any intention of preempting traditionally intermediate territory. In recent years these items have become so significant for so many firms that to completely ignore their presence in a basic text would be tantamount to pretending computers did not exist. A brief introduction to income taxation is also included in the Appendix to Chapter 12.

Chapters 13 through 17 may all be considered as providing optional coverage. In Chapter 13, statement analysis is used to reinforce the statement content and usefulness introduced in the preceding 12 chapters. Chapter 14 provides an introduction to cash flow statements and, in response to pleas from numerous adopters, a brief overview of cash budgeting. The preparer supplement also covers SCFP preparation for those feeling it desirable. The preparer material is split from the coverage in Chapter 7 to allow prior development of the relevant, more sophisticated, and numerous details included in Chapters 8 through 12. Emphasis on details of SCFP preparation is questionable at the introductory level, since access to the records underlying the financial statements is usually a necessity.

Even if only as outside reading, you are urged to provide your students with some exposure to the subjects of consolidation, common dollar and current cost accounting, and nonprofit accounting, covered in the last three chapters. For future accounting majors it will complete their overview of the road ahead. For the majority of your students who will have no exposure to accounting beyond managerial, this will be their last and only opportunity to become familiar with these vitally important areas.

## **Special Features**

The book has many special features in addition to those enumerated above:

- Students focus upon objectives throughout the text. They start with learning objectives (introduction); move to the social-economic objectives of financial



accounting (Chapter 1); then to the objectives and usefulness of each financial statement; and finally to the accountant's objective in measuring and reporting economic events—how the statements should reflect the effect of each transaction.

- The book is written in an informal and conversational tone that is less severe and less intimidating than in other texts. This informality also encourages student involvement.
- A complete annual report and another set of complete financial statements are included in an appendix to provide familiarity with the total financial statement package.
- Each chapter starts with a preview of the material to be covered and its relevance, and each concludes with a summary of behavioral skills that the student should have developed from the chapter.
- Important common business and financial accounting terms are shown in color when first introduced and then listed for review at the end of each chapter. An extensive glossary of more than 600 terms is included in an appendix for easy student reference and review. Since a significant portion of elementary accounting involves language learning, students find a combined glossary, in lieu of individual chapter glossaries, a distinct advantage.
- Chapter review questions cover all important concepts introduced in the chapter.
- Chapter problems are designated as essential and supplementary, the latter group having particular relevance to graduate MBA foundation and more rigorous undergraduate courses.
- Complete solutions to all odd-numbered chapter-end essential and supplementary problems are included in an appendix. The student therefore has available additional examples of applications in each topic area beyond the minimum necessary included with the chapter text material. The student also has the opportunity to solve the odd-numbered problems and have immediate reinforcement in a manner similar to that in a programmed text.
- Chapters contain mini-cases and questions for class discussion and also include several structured and unstructured cases. These materials are designed to highlight many unresolved accounting issues and to stimulate interest beyond material covered in the text. They are particularly effective for foundation-level graduate students.
- The core accounting chapters contain pairs of integrative problems (one with solutions as a model) for the same two firms covering 18 periods of operation. The problems successively incorporate new materials as introduced and may be used independently or in conjunction with available practice sets (see below). Although integrative in intent, each integrative problem is written so that it may be assigned sequentially or independently as you desire.
- The inclusion of business applications in the text has proven helpful for those teaching assistants with limited business experience who desire practical examples to make accounting instruction continuously relevant.

The final, and perhaps the most welcomed, feature is that of **flexibility**. This text is larger than most because it incorporates optional materials enabling you to tailor your course to your personal course objectives. Several chapters are divided into two parts and six have the more complex material set off in appendices. These parts and appendices can be assigned independently or omitted at your discretion. Similarly, individual topics in Chapters 11 and 12 and Chapters 13 through 17 may be included or omitted depending upon course coverage objectives.

For courses with a bookkeeping emphasis, Chapter 5 including its Preparer Procedures and Problems Supplement and its Appendix should be assigned in sequence. Thereafter the Preparer Procedures and Problem Supplements to Chapters 6 and 8 through 12 should also be assigned in turn. A text appendix contains solutions to odd-numbered preparer problems in Chapter 5 including a complete accounting cycle for one firm for illustrative purposes. This appendix also contains a chart of all accounts introduced in this text. You may also wish to use the available practice sets with such a course. Even without the use of the practice sets, you should find that Chapter 5 and the subsequent chapter preparer supplements provide students with a firm and adequate grounding of bookkeeping essentials.

For different elementary courses with less emphasis on procedures, Chapter 5 should be assigned without its appendix and the preparer supplements in subsequent chapters may be omitted. Chapter 5 is written so that it may be assigned in sequence, at any subsequent point, or as collateral reading.

## Supporting Materials

A complete set of both customary and unique supporting materials is available to adopters of this text including:

- **Instructors Manual:** In addition to solutions for review questions, problems, and cases, the instructor's manual contains:
  - Alternative recommended assignments for courses of different duration, level, and objective.
  - Masters (for local reproduction) of a brief 25-minute diagnostic test covering essential arithmetic skills. Weakness in such skills can prove an insurmountable barrier to the learning of accounting. You may wish to use the test in counseling or screening prospective course registrants.
  - Synopses for each chapter together with suggestions as to points requiring emphasis.
  - Separate listings of assignment problems and cases giving coverage, completion times, and level of difficulty.
  - Transparency masters of major text exhibits and illustrations for use with an overhead projector.
  - Masters (for local reproduction) of blank balance sheet diagrams and working papers.
  - Masters (for local reproduction) of key data sheets for even-numbered essential and supplementary problems.
  - Suggested quiz questions by chapter.

- Two 50-minute midterm examinations covering Chapters 1 through 4 and 6 through 9 and a two-hour final examination covering Chapters 1 through 13.
- Numerous additional midterm and final examination questions for each chapter.
- Solutions to all examination questions.
- **Tutorial Notes:** For students whose first exposure to business is the financial accounting course, a companion paperback of tutorial notes is available and recommended. The term study guide is not used since the notes are more than a guide and more personally adaptable to each individual student's needs. Paralleling the text by section within each chapter, the tutorial notes contain amplifications, further illustrations, and reinforcing questions with answers. Emphasized are those topics that have proven particularly troublesome to undergraduates. Solutions to odd-numbered preparer problems in Chapters 6 and 8–12 are also included for students in courses emphasizing bookkeeping.

Through classroom testing the tutorial notes have proven to enhance significantly the student's understanding of basic accounting. Linda Whitten, the author, has successfully taught from the first edition of the text since its original publication. Her guide reflects four years of positive classroom and laboratory experience with the book.

- **Integrative Practice Sets:** A unique book of practice sets co-authored with Professor Linda Whitten is available for use in conjunction with the text. Ten independently assignable practice sets may be used either with the second integrative problem series (see special features above) or with a third parallel problem series included with the sets. The first integrative problem series from the text is also included along with completed journals, ledgers, and worksheets to serve as a model. The practice sets are designed to require either full or partial completion. Masters (for local reproduction) of partial solutions, together with complete solutions for both problem series, are available in the accompanying Instructor's Manual.

## Changes From the First Edition

Although almost entirely rewritten, this second edition retains all of the essential features of the first edition. Purely procedural materials continue to be segregated; but the bookkeeping chapter has been expanded to include coverage of internal control and the chart of accounts. It has also been moved forward and is now Chapter 5. An Appendix to this chapter covering special journals, subsidiary ledgers, and the closing process has also been added.

For instructors who wish to emphasize procedure, this edition includes more optional bookkeeping problems and the nine aforementioned sequential pairs of integrative problems for the same two firms that may be used in conjunction with the practice sets. The transactions and adjustments for these firms become increasingly more sophisticated over successive periods paralleling topics as they are introduced in the text. The additional preparer materials, problems, and practice sets should satisfy instructors demanding exposure equivalent to the traditional "principles" texts.



The unique Balance Sheet Diagram introduced in the first edition has been extended to illustrate the statement effect of new transactions and adjustments throughout most chapters. The resulting statement-effect focus facilitates student understanding of funds flow and inflation adjustment that can otherwise prove troublesome within the confines of the debit/credit model. Throughout all chapters, problems have been revised and more challenging problems added. Structured and unstructured cases have also been included for use in graduate and more rigorous undergraduate courses. The new integrative problems previously mentioned may also be used independently of the practice sets, and in conjunction with the Balance Sheet Diagram, to provide a basic continuity of the student's accumulating knowledge.

Most chapters have been substantially or completely rewritten to incorporate many more illustrations, additional coverage, and the numerous suggestions received from users of the first edition. The concepts of capital structure and sources of funds have been advanced to Chapter 3 to provide a foundation for the subsequent introduction of funds from operations and the funds flow statements in Chapters 6 and 7. Chapters 5 and 6 in the first edition have been combined into a new Chapter 6, with extraordinary items deemphasized and segregated to an appendix, and with expanded coverage of alternate timing of revenue recognition.

Present value coverage has been moved forward to the Chapter 11 Appendix as necessary for asset valuation; and an introduction to income taxation has been added as an Appendix to Chapter 12. Chapter 14 has been expanded to include a brief introduction to the net liquid assets funds flow approach that is widely used by financial managers. This chapter now also includes a brief introduction to cash budgeting. Chapter 16 has been rewritten to incorporate the provisions of FASB No. 33; and a basic introduction to fund accounting has been added as new Chapter 17. The many other expanded areas of coverage are listed in the detailed Table of Contents.

Finally, the flexibility of the book for adaptation to different course emphasis has been further enhanced. Chapters 6 and 7 are now both divided into two parts to facilitate separate assignments. Chapters 5, 6, 8, 11, 12, and 14 now each have appendices containing more sophisticated topics that may be included or omitted without impairing the continuity of the main text portions.

## **Background and Acknowledgments**

### **From the First Edition**

Acknowledgments are so necessary, so deserved, and so numerous. The origins of the approaches used in this book go back through 15 years of work experience starting in 1949. During this period, as a new business analyst for a New York investment banking firm, an operations research and later materials and production control manager for a mid-Western manufacturer, a methods research manager responsible for developing a computerized accounting system for one of the nation's largest merchandisers, and finally as controller of an electronics firm, I was continuously involved with the uses and the users of accounting information. In developing and conducting accounting seminars for nonaccounting managers and other employ-

ees, I learned that accounting can be more efficiently introduced by initially emphasizing involvement with outputs and their uses, rather than focusing upon the details of the recording process. Many individuals too numerous to acknowledge by name contributed to this insight and to some of the approaches and techniques developed.

My additional exposure to accounting and accounting education in the Middle Management Program at Harvard Business School and subsequently in the doctoral program at Stanford further reinforced the usefulness orientation. I am particularly indebted to Professor Charles Bliss at Harvard and to Professors Charles Horngren, Gerald Wentworth, and James Porterfield at Stanford. These men provided both inspiration and much needed push and support for me to complete the doctorate years ago.

At San Francisco State, I am indebted to George Stenberg, William Niven, Julien Wade, and Dean Arthur Cunningham for providing the scheduling opportunity over a period of eight years to validate in the classroom the somewhat distinctive approaches in this text. At State I learned that most night students learn accounting more readily than do day students. I observed this difference to result primarily from the working students' ability to make relevant connections between accounting and practical business problems with which they were already familiar, could identify, and therefore could become involved. I found that available texts assumed a student interest and identification with the goals of an accountant, and that this identification was rarely present at the elementary level. And I discovered that the student without working experience could still achieve an adequate level of understanding, identification, and involvement provided that the introduction of new accounting information was preceded by a readily understandable business problem. I am thus indebted most to my students for their patience while I learned the simple truths cited above and incorporated into this book.

I am also grateful to the many individuals who reviewed portions of earlier drafts of the manuscript for the first edition. Earl K. Littrell (Willamette University), James M. Weglin (North Seattle Community College), Serge Matulich (Texas Christian University), and Paul Frishkoff (University of Oregon) were identified on reviews received while the others were anonymous. I hope they all will see the benefits of their constructive comments.

I am deeply indebted to three individuals. Anthony DiFrancesco and Jonas Mittelman, both colleagues at San Francisco State University, and Lawrence A. Tomassini at the University of Texas, each reviewed in detail the entire first edition manuscript. Their suggestions were consistently valuable.

#### Acknowledgments—Second Edition

More than 3,000 undergraduate and graduate students in different courses at San Francisco State University have successfully used the first edition of this book. Many have provided constructive feedback to the new approaches as they were developed. One hundred graduate students successfully used a preliminary edition; and I am particularly indebted to John Jago, Karen Stratvert, and to 74 others from this group for their many ideas and specific recommendations, most of which were incorporated.

As a sole author, I improperly anticipated my experience to be a lonely one. It would be an understatement to say that I have been overwhelmed and humbled by the support and carefully reasoned constructive suggestions received from more than 100 faculty and students from other schools using the first edition. With limited space I still wish to acknowledge the following professors at State and other universities for their special contributions: Edna Andrews, Anthony DiFrancesco, Robert Doud, Michael Duffy, Russell Langer, Jean Logsdon, Lawrence Mohrweiss, William Niven, Marc Paulsen, Don Stone, Robert Taylor, Anita Tyra, Audrey Warren, and Joe Zimmerman.

Deserving of additional recognition not only for general contributions but in specific areas designated in parentheses are Professors Doug Cerf and William Brueining (Chapter 5); Leonard Savoie (Chapters 8 and 14); John McWilliams and Thomas White (Chapter 12 Appendix); Earl Littrell and Gerald Platt (Chapter 17); S. Aurora N. Riel (Glossary); and Linda Whitten (problems and solutions). Professor James Southam also contributed to the final validated version of the Arithmetic Skills Diagnostic Test.

Professors John Durham of Northern Arizona University, Charles Grant of Skyline College, and Arnold Olenick of Boston University each reviewed in painstaking detail the entire manuscript. Their numerous suggestions were invaluable and I only hope they will recognize the many improvements for which they deserve credit.

Debbie Reid, Susan Maise, and Marj Tomlin labored without complaint over numerous drafts of the manuscript and were especially unselfish coping with tight deadlines. Natalie Montgomery's assistance in proofreading was far greater than could reasonably be asked of anyone, especially of one's fiancée and now bride.

Last but by no means least I appreciate the efforts of my copy editor, Fran Fulton, and of Frank Burns and Sue Zorn at the Addison-Wesley Publishing Company. These three, in the final analysis, brought this volume into print.

Obviously none of the foregoing individuals is responsible for any errors that may be contained herein.

A.T.M.  
Sausalito, CA  
January, 1982



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New vocabulary and concepts 426 Review questions; Mini-cases and questions for discussion; Essential problems; Supplementary problems; Cases; Preparer procedures: additions to charts of accounts, new transactions; Preparer problems.