THE ALLOWANCE FOR DOUBTFUL ACCOUNTS

There is no way of telling in advance which accounts receivable will prove to be uncollectible. It is therefore not possible to credit the accounts of specific customers for our estimate of probable uncollectible accounts. A practical solution, therefore, is to credit a separate account called **Allowance for Doubtful Accounts** with the amount estimated to be uncollectible.

The Allowance for Doubtful Accounts often is described as a *contra-asset* account or a *valuation* account. The Allowance for Doubtful Accounts has a credit balance which offsets the Accounts Receivable control account to produce a more useful and reliable measure of a company's liquidity. Because the Allowance for Doubtful Accounts is merely an estimate and not a precise calculation, professional judgment plays a considerable role in determining the size of this valuation account.

Monthly Adjustments of the Allowance Account In the adjusting entry made by World Famous Toy Co. at January 31, the amount of the adjustment ($10,000) was equal to the estimated amount of uncollectible accounts. This is true only because January was the first month of operations and this was the company's first estimate of its uncollectible accounts. In future months, the amount of the adjusting entry will depend on two factors: (1) the *estimate* of uncollectible accounts and (2) the *current balance* in the Allowance for Doubtful Accounts. Before we illustrate the adjusting entry for a future month, let us see why the balance in the allowance account may change during the accounting period.

WRITING OFF AN UNCOLLECTIBLE ACCOUNT RECEIVABLE

Whenever an account receivable from a specific customer is determined to be uncollectible, it no longer qualifies as an asset and should be written off. To *write off* an account receivable is to reduce the balance of the customer's account to zero. The journal entry to accomplish this consists of a credit to the Accounts Receivable control account in the general ledger (and to the customer's account in the subsidiary ledger) and an offsetting debit to the Allowance for Doubtful Accounts.

To illustrate, assume that, early in February, World Famous Toy Co. learns that Discount Stores has gone out of business and that the $4,000 account receivable from this customer is now worthless. The entry to write off this uncollectible account receivable is as follows.

Allowance for Doubtful Accounts	4,000	
Accounts Receivable (Discount Stores)		4,000
To write off the account receivable from Discount Stores as uncollectible.		

A=L+OE Writing off a receivable "against the allowance"

The important thing to note in this entry is that the debit is made to the Allowance for Doubtful Accounts and *not* to the Uncollectible Accounts Expense account. The estimated expense of credit losses is charged to the Uncollectible Accounts Expense account at the end of each accounting period. When a specific account receivable is later determined to be worthless and is written off, this action does not represent an additional expense but merely confirms our previous estimate of the expense.

Notice also that the entry to write off an uncollectible account receivable reduces both the asset account and the contra-asset account by the same amount. Thus writing off an uncollectible account does not change the net realizable value of accounts receivable in the balance sheet. The net realizable value of World Famous Toy Co.'s accounts receivable before and after the write-off of the account receivable from Discount Stores is as follows.

A=L+OE What happens to net realizable value?

Before the Write-off		After the Write-off	
Accounts receivable	$250,000	Accounts receivable	$246,000
Less: Allowance for doubtful accounts	10,000	Less: Allowance for doubtful accounts	6,000
Net realizable value	$240,000	Net realizable value	$240,000

Let us repeat the point that underlies the allowance approach. Credit losses are recognized as an expense in the period in which the sale occurs, not the period in which the account is determined to be uncollectible. The reasoning for this position is based on the matching principle.

Write-offs Seldom Agree with Previous Estimates The total amount of accounts receivable actually written off will seldom, if ever, be exactly equal to the estimated amount previously credited to the Allowance for Doubtful Accounts.

If the amounts written off as uncollectible turn out to be less than the estimated amount, the Allowance for Doubtful Accounts will continue to show a credit balance. If the amounts written off as uncollectible are greater than the estimated amount, the Allowance for Doubtful Accounts will acquire a temporary debit balance, which will be eliminated by the adjustment at the end of the period.

MONTHLY ESTIMATES OF CREDIT LOSSES

At the end of each month, management should again estimate the probable amount of uncollectible accounts and adjust the Allowance for Doubtful Accounts to this new estimate.

To illustrate, assume that at the end of February the credit manager of World Famous Toy Co. analyzes the accounts receivable and estimates that approximately $11,000 of these accounts will prove uncollectible. Currently, the Allowance for Doubtful Accounts has a credit balance of only $6,000, determined as follows.

A=L+OE **Current balance in the allowance account**

Balance at January 31 (credit)	$10,000
Less: Write-off of account considered worthless (Discount Stores)	4,000
Credit balance at February 28 (prior to adjustment)	$ 6,000

To increase the balance in the allowance account to $11,000 at February 28, the month-end adjusting entry must add $5,000 to the allowance. The entry will be as follows.

A=L+OE **Increasing the allowance for doubtful accounts**

Uncollectible Accounts Expense	5,000	
Allowance for Doubtful Accounts		5,000
To increase the Allowance for Doubtful Accounts to $11,000, computed as follows:		
Required allowance at Feb. 28	$11,000	
Credit balance prior to adjustment	6,000	
Required adjustment	$ 5,000	

In the World Famous Toy illustration, estimates of the required allowance for doubtful accounts at January 31 and February 28 were simply given. There are actually two general approaches to estimating credit losses: (1) a *balance sheet approach,* and (2) an *income statement approach.*

Estimating Credit Losses—The Balance Sheet Approach The most widely used method of estimating the probable amount of uncollectible accounts is based on **aging the accounts receivable.** This method is sometimes called the *balance sheet approach* because the method emphasizes the proper balance sheet valuation of accounts receivable.

"Aging" accounts receivable means classifying each receivable according to its age. An aging schedule for the accounts receivable of Valley Ranch Supply is illustrated in Exhibit 7–8.

An aging schedule is useful to management in reviewing the status of individual accounts receivable and in evaluating the overall effectiveness of credit and collection policies. In addition, the schedule is used as the basis for estimating the amount of uncollectible accounts.

The longer an account is past due, the greater the likelihood that it will not be collected in full. On the basis of past experience, the credit manager estimates the percentage of credit losses likely to occur in each age group of accounts receivable. This percentage, when applied

VALLEY RANCH SUPPLY
ESTIMATED UNCOLLECTIBLE ACCOUNTS RECEIVABLE
DECEMBER 31, 2018

	Total	Not Yet Due	1–30 Days Past Due	31–60 Days Past Due	61–90 Days Past Due	Over 90 Days Past Due
Animal Care Center	$ 9,000	$ 9,000				
Butterfield, John D.	2,400			$ 2,400		
Citrus Groves, Inc.	4,000	3,000	$ 1,000			
Dairy Fresh Farms	1,600				$ 600	$1,000
Eastlake Stables	13,000	7,000	6,000			
(Other customers)	70,000	32,000	22,000	9,600	2,400	4,000
Totals	$100,000	$51,000	$29,000	$12,000	$3,000	$5,000

EXHIBIT 7–8
Accounts Receivable Aging Schedule

to the total dollar amount in the age group, gives the estimated uncollectible portion for that group. By adding together the estimated uncollectible portions for all age groups, the required balance in the Allowance for Doubtful Accounts is determined. Exhibit 7–9 provides a schedule listing the group totals from the aging schedule and shows how the estimated total amount of uncollectible accounts is computed.

VALLEY RANCH SUPPLY
ESTIMATED UNCOLLECTIBLE ACCOUNTS RECEIVABLE
DECEMBER 31, 2018

	Age Group Total		Percentage Considered Uncollectible*		Estimated Uncollectible Accounts
Not yet due	$ 51,000	×	1%	=	$ 510
1–30 days past due	29,000	×	3	=	870
31–60 days past due	12,000	×	10	=	1,200
61–90 days past due	3,000	×	20	=	600
Over 90 days past due	5,000	×	50	=	2,500
Totals	$100,000				$5,680

EXHIBIT 7–9
Estimated Dollar Amount of Uncollectible Accounts

*These percentages are estimated each month by the credit manager, based on recent experience and current economic conditions.

At December 31, Valley Ranch Supply has total accounts receivable of $100,000, of which $5,680 are estimated to be uncollectible. Thus, an adjusting entry is needed to increase the Allowance for Doubtful Accounts from its present level to $5,680. If the allowance account currently has a credit balance of $4,000, the month-end adjusting entry should be in the amount of $1,680, determined as follows.[6]

[6] If accounts receivable written off during the period *exceed* the Allowance for Doubtful Accounts at the last adjustment date, the allowance account temporarily acquires a *debit balance*. This situation seldom occurs if the allowance is adjusted each month but often occurs if adjusting entries are made only at year-end.

If Valley Ranch Supply makes only an annual adjustment for uncollectible accounts, the allowance account might have a debit balance of $10,000. In this case, the year-end adjusting entry should be for $15,680 in order to offset the $10,000 debit balance and to bring the allowance up to the required credit balance of $5,680.

Regardless of how often adjusting entries are made, the balance in the allowance account of Valley Ranch Supply should be $5,680 at year-end.

A=L+↑OE **Determine the difference between the current balance and the required balance**

Credit balance at December 31 (prior to adjustment)	$4,000
Credit adjustment required	1,680
Credit balance required at December 31 (per aging schedule)	$5,680

Thus, the following adjusting entry is made at December 31.

A=↓L+↓OE **The difference between the current balance and the required balance is the Uncollectible Accounts Expense matched to the period**

Uncollectible Accounts Expense	1,680	
Allowance for Doubtful Accounts		1,680
To increase the Allowance for Doubtful Accounts to its required balance of $5,680.		

Estimating Credit Losses—The Income Statement Approach An alternative method of estimating and recording credit losses is called the *income statement approach*. This method focuses on estimating the uncollectible accounts expense to be reported in the income statement for the period. On the basis of past experience, the uncollectible accounts expense is estimated at some percentage of net credit sales. The adjusting entry is made in the full amount of the estimated expense, without regard for the current balance in the Allowance for Doubtful Accounts.

To illustrate, assume that a company's past experience indicates that about 2 percent of its credit sales will prove to be uncollectible. If credit sales for September amount to $150,000, the month-end adjusting entry to record uncollectible accounts expense is as follows.

A=L+↓OE **The income statement approach**

Uncollectible Accounts Expense	3,000	
Allowance for Doubtful Accounts		3,000
To record uncollectible accounts expense, estimated at 2% of credit sales ($150,000 × 2% = $3,000).		

This approach is fast and simple—no aging schedule is required and no consideration is given to the existing balance in the Allowance for Doubtful Accounts. The aging of accounts receivable, however, provides a more reliable estimate of uncollectible accounts because of the consideration given to the age and collectibility of specific accounts receivable at the balance sheet date.

In past years, many small companies used the income statement approach in preparing monthly financial statements but used the balance sheet method in annual financial statements. Most businesses today have computer software that quickly and easily prepares monthly aging schedules of accounts receivable. Thus most businesses now use the balance sheet approach in both their monthly and annual financial statements.

RECOVERY OF AN ACCOUNT RECEIVABLE PREVIOUSLY WRITTEN OFF

Occasionally a receivable that has been written off as worthless will later be collected in full or in part. Such collections are often referred to as *recoveries* of bad debts. Collection of an account receivable previously written off is evidence that the write-off was an error; the receivable should therefore be reinstated as an asset.

Let us assume, for example, that a company wrote off a $500 account receivable from Brad Wilson on February 16. The write-off of this account was recorded as follows.

A=L+↑OE **Wilson account considered uncollectible**

Allowance for Doubtful Accounts	500	
Accounts Receivable (Brad Wilson)		500
To write off the account receivable from Brad Wilson as uncollectible.		

If the customer, Brad Wilson, pays the account in full on February 27, the entry to reverse the previous write-off is as follows.

Accounts Receivable (Brad Wilson)	500	
Allowance for Doubtful Accounts		500
To reinstate as an asset an account receivable previously written off.		

A=L+↓OE Wilson account reinstated

Notice that this entry is exactly the opposite of the entry made when the account was written off as uncollectible. A separate entry will be made to record the cash collected from Brad Wilson and to remove his reinstated account from the system.

Cash	500	
Accounts Receivable (Brad Wilson)		500
To record the collection of account receivable from Brad Wilson.		

A=L+↓OE Wilson account previously reinstated is finally collected

DIRECT WRITE-OFF METHOD

Some companies do not use any valuation allowance for accounts receivable. Instead of making end-of-period adjusting entries to record uncollectible accounts expense on the basis of estimates, these companies recognize no uncollectible accounts expense until specific receivables are determined to be worthless. This method makes no attempt to match revenue with the expense of uncollectible accounts.

When a particular customer's account is determined to be uncollectible, it is written off directly to Uncollectible Accounts Expense, as follows.

Uncollectible Accounts Expense	250	
Accounts Receivable (Bell Products)		250
To write off the account receivable from Bell Products as uncollectible.		

When the **direct write-off method** is used, the accounts receivable will be listed in the balance sheet at their gross amount, and no valuation allowance will be used. The receivables, therefore, are not stated at estimated net realizable value.

The allowance method is preferable to the direct write-off method because the allowance method does a better job of matching revenues and expenses. In some situations, however, use of the direct write-off method is acceptable. If a company makes most of its sales for cash, the amount of its accounts receivable will be small in relation to other assets. The expense from uncollectible accounts should also be small. Consequently, the direct write-off method is acceptable because its use does not have a *material* effect on the reported net income.

It is important to note that current income tax regulations require taxpayers to use the direct write-off method in determining the uncollectible accounts expense used in computing taxable income. From the standpoint of accounting theory, the allowance method is better because it enables expenses to be matched with the related revenue and thus provides a more logical measurement of net income. Therefore, most companies use the allowance method in their financial statements.[7]

FACTORING ACCOUNTS RECEIVABLE

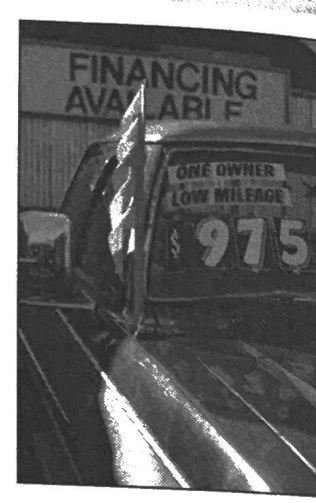
The term **factoring** describes transactions in which a business sells its accounts receivable to a financial institution (often called a *factor*). These arrangements enable a business to obtain cash immediately instead of having to wait until the receivables can be collected.

[7] An annual survey of the accounting practices of 600 publicly owned corporations consistently shows more than 500 of these companies use the allowance method in their financial statements. All of these companies, however, use the direct write-off method in their income tax returns.

Factoring accounts receivable is a popular practice among small business organizations that do not have well-established credit. Large and liquid organizations often can borrow money using unsecured lines of credit.

YOUR TURN You as a Used Car Purchaser

Assume you purchased a car from John's Used Cars for $500 down and 24 payments of $150 per month. After making three months of payments to John's Used Cars, you are notified that John's plans to factor your account receivable to the Barb Smith Collection Agency. You are concerned about owing money to this particular collection agency because you have heard it uses very aggressive tactics to collect overdue payments. You call the car lot and speak directly with John. You question the legality and ethics of factoring accounts receivable. You state that you entered into a contract with him and not a collection agency. You state that you did not give permission to sell your receivable and that selling the receivable to another organization eliminates your obligation to pay it. John says factoring accounts receivable is legal and suggests that you consult the Uniform Commercial Code. What would you do?



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(See our comments in Connect.)

CREDIT CARD SALES

By making sales through credit card companies, merchants receive cash more quickly from credit sales and avoid uncollectible accounts expense. They also avoid the expenses of investigating customers' credit, maintaining an accounts receivable subsidiary ledger, and making collections from customers.

Bank Credit Cards Some widely used credit cards (such as **Visa** and **MasterCard**) are issued by banks. When the credit card company is a bank, the retailing business may deposit the signed credit card drafts directly in its bank account. Because banks accept these credit card drafts for immediate deposit, sales to customers using bank credit cards are recorded as cash sales.

In exchange for handling the credit card drafts, the bank imposes a monthly service charge that usually runs around 2 percent of the amount of the drafts. This monthly service charge is deducted from the merchant's bank account and appears with other bank service charges in the merchant's monthly bank statement.

Other Credit Cards When customers use nonbank credit cards (such as **American Express**), the retailing business cannot deposit the credit card drafts directly in its bank account. Instead of debiting Cash, the merchant records an account receivable from the credit card company. Periodically, the credit card company reimburses the merchant. Businesses, however, are not reimbursed for the full amount of the outstanding receivable. The agreement between the credit card company and merchants usually allows the credit card company to discount the amount reimbursed by around 3 percent.

To illustrate, assume that Bradshaw Camera Shop sells a camera for $1,200 to a customer who uses a Quick Charge credit card. The entry would be as follows.

Accounts Receivable (Quick Charge Co.)	1,200	
Sales		1,200
To record sale to customer using Quick Charge credit card.		

A=L+OE

This receivable is from the credit card company

At the end of the week, Bradshaw Camera Shop mails the $1,200 credit card draft to Quick Charge Company, which redeems the draft after deducting a 2 percent discount. When payment is received by Bradshaw, the entry is as follows.

Cash	1,176	
Credit Card Discount Expense	24	
Accounts Receivable (Quick Charge Co.)		1,200
To record collection of account receivable from Quick Charge Co., less 2% discount.		

The expense account, Credit Card Discount Expense, is included among the selling expenses in the income statement of Bradshaw Camera Shop.

Notes Receivable and Interest Revenue

L07-7

LEARNING OBJECTIVE
Explain, compute, and account for notes receivable and interest revenue.

Accounts receivable usually do not bear interest. When interest will be charged, creditors usually require the debtor to sign a formal promissory note. A promissory note is an unconditional promise in writing to pay on demand or at a future date a definite sum of money.

The person who signs the note and thereby promises to pay is called the *maker* of the note. The person to whom payment is to be made is called the *payee* of the note. In Exhibit 7–10, Pacific Rim Corp. is the maker of the note and First National Bank is the payee.

EXHIBIT 7–10
Simplified Form of Promissory Note

$200,000 Los Angeles, California July 10, 2018

One year AFTER DATE Pacific Rim Corp. PROMISES TO PAY

TO THE ORDER OF First National Bank

---Two hundred thousand and no/100--- DOLLARS

PLUS INTEREST COMPUTED AT THE RATE OF 6% per annum

SIGNED G. L. Smith

TITLE Treasurer

From the viewpoint of the maker, Pacific Rim, the illustrated note is a liability and is recorded by crediting the Notes Payable account. However, from the viewpoint of the payee, First National Bank, this same note is an asset and is recorded by debiting the Notes Receivable account. The maker of a note expects to pay cash at the *maturity date* (or due date); the payee expects to receive cash at that date.

NATURE OF INTEREST

Interest is a charge made for the use of money. A borrower incurs interest expense. A lender earns interest revenue. When you see notes payable in a company's financial statements, you

know that the company has borrowed money, so you should expect to find interest expense in its income statement. If you see notes receivable, you know that the company has loaned money, so you should expect its income statement to report interest revenue.

Computing Interest In Chapter 4, we introduced the following formula to compute interest:

$$\textbf{Interest} = \textbf{Principal} \times \textbf{Rate of Interest} \times \textbf{Time}$$

(This formula is often expressed as $I = P \times R \times T$.)

Interest rates usually are stated on an *annual basis*. For example, the total interest charge on a $200,000, one-year, 6 percent note receivable is computed as follows.

$$P \times R \times T = \$200{,}000 \times 0.06 \times 1 = \$12{,}000$$

If the term of the note were only four months instead of one year, the total interest revenue earned in the life of the note would be $4,000, computed as follows.

$$P \times R \times T = \$200{,}000 \times 0.06 \times \frac{4}{12} = \$4{,}000$$

It should be noted that these computations illustrate *simple* interest, meaning no interest accrues on the unpaid interest amounts each month. We will introduce *compound* interest in Chapter 10.

ACCOUNTING FOR NOTES RECEIVABLE

In some fields of business, notes receivable are seldom encountered; in other fields they occur frequently and may constitute an important part of total assets. In banks and financial institutions, for example, notes receivable often represent the company's largest asset category and generate most of the company's revenue.

All notes receivable are usually posted to a single account in the general ledger. The amount debited to Notes Receivable is always the *face amount* of the note, regardless of whether the note bears interest. When an interest-bearing note is collected, the amount of cash received may be larger than the face amount of the note. The interest collected is credited to an Interest Revenue account, and only the face amount of the note is credited to the Notes Receivable account.

Illustrative Entries Assume that on December 1, a 3-month, 6 percent note receivable is acquired from a customer, Marvin White, in settlement of an existing account receivable of $60,000. The entry for acquisition of the note is as follows.

A=L+OE **Note received to replace account receivable**

Notes Receivable	60,000	
Accounts Receivable (Marvin White)		60,000
Accepted 3-month, 6% note in settlement of account receivable.		

At December 31, the end of the company's fiscal year, the interest earned to date on notes receivable should be accrued by an adjusting entry as follows.

A=L+OE **Adjusting entry for interest revenue earned in December**

Interest Receivable	300	
Interest Revenue		300
To accrue interest for the month of December on Marvin White note ($60,000 × 6% × $\frac{1}{12}$ = $300).		

To simplify this illustration, we will assume our company makes adjusting entries only at year-end. Therefore, no entries are made to recognize the interest revenue accruing during January and February.

On March 1 (three months after the date of the note), the note matures. The entry to record collection of the note will be as follows.

Cash	60,900	
Notes Receivable		60,000
Interest Receivable		300
Interest Revenue		600
Collected 90-day, 6% note from Marvin White ($60,000 × 6% × $\frac{3}{12}$ = $900 interest, of which $600 was earned in current year).		

A=L+OE Collection of principal and interest

The preceding three entries show that interest is being earned throughout the term of the note and that the interest should be apportioned between years on a time basis. The revenue of each year will then include the interest actually earned in that year.

If the Maker of a Note Defaults A note receivable that cannot be collected at maturity is said to have been **defaulted** by the maker. Immediately after the default of a note, an entry should be made by the holder to transfer the amount due from the Notes Receivable account to an account receivable from the debtor.

To illustrate, assume that on March 1, our customer, Marvin White, had defaulted on the note used in the preceding example. In this case, the entry on March 1 would have been as follows.

Accounts Receivable (Marvin White)	60,900	
Notes Receivable		60,000
Interest Receivable		300
Interest Revenue		600
To record default by Marvin White on 3-month, 6% note.		

LO7-8

Notice that the interest earned on the note is recorded through the maturity date and is included in the account receivable from the maker. The interest receivable on a defaulted note is just as valid a claim against the maker as is the principal amount of the note.

LEARNING OBJECTIVE
Evaluate the liquidity of a company's accounts receivable.

PATHWAYS CONNECTION

Collecting accounts receivable on time is important; it spells the success or failure of a company's credit and collection policies. A past-due receivable is a candidate for write-off as a credit loss. To help us judge how good a job a company is doing in granting credit and collecting its receivables, we compute the ratio of net sales to average receivables. This **accounts receivable turnover rate** tells us how many times the company's average investment in receivables was converted into cash during the year. The ratio is computed by dividing annual net sales by average accounts receivable. The higher the turnover rate, the more liquid the company's receivables. Dividing 365 days by the turnover rate provides an estimate of the average number of days an account receivable remains outstanding before it is collected. High turnover rates result in shorter collection periods than low turnover rates. By computing and analyzing the accounts receivable turnover, management receives actionable information related to the company's credit and collection policies. Such information helps management make better decisions, a key objective of accounting per the Pathways model.

In some companies, such as restaurants, hotels, and public utilities, turnover rates are relatively high. For other enterprises, such as large manufacturing firms, turnover rates are relatively low, making the average time it takes to collect an outstanding receivable much longer.

To illustrate, Exhibit 7–11 contains information taken from recent financial statements issued by **Allete, Inc.** (an electric utility company), and **3M (Minnesota Mining and Manufacturing Company)**.

EXHIBIT 7–11
Accounts Receivable Collection Performance

	Allete, Inc.	3M
a. Net sales	$1,136.8 million	$ 31.8 billion
Accounts receivable (beginning of year)	96.3 million	4.3 billion
Accounts receivable (end of year)	103.0 million	4.2 billion
	$ 199.3 million	$ 8.5 billion
	÷2	÷ 2
b. Average accounts receivable	$ 99.65 million	$ 4.25 billion
c. Accounts receivable turnover rate **(a ÷ b)**	11.4 times	7.5 times
Average days outstanding **(365 days ÷ c)**	32 days	49 days

As shown in Exhibit 7–11, Allete's accounts receivable turnover rate is 11.4 times compared to 3M's turnover rate of only 7.5 times. Thus, Allete's accounts receivable remain outstanding an average of 32 days before being collected, whereas 3M's accounts receivable remain outstanding an average of 49 days prior to collection.

YOUR TURN — You as a Credit Manager

Assume that you were hired by Regis Department Stores in 2018 to develop and implement a new credit policy. At the time of your hire, the average collection period for an outstanding receivable was in excess of 90 days (far greater than the industry average). Thus the primary purpose of the new policy was to better screen credit applicants in an attempt to improve the quality of the company's accounts receivable.

Shown as follows are sales and accounts receivable data for the past four years (in thousands).

	2018	2017	2016	2015
Sales	$17,000	$14,580	$9,600	$9,000
Average accounts receivable	1,700	1,620	1,600	1,800

Based on the given data, was the credit policy you developed successful? Explain.

(See our comments in Connect.)

ETHICS, FRAUD, & CORPORATE GOVERNANCE

As discussed previously in this chapter, determining the balance in the allowance for doubtful accounts depends on management's judgments. Therefore, it is important to disclose material facts as to how management determines the allowance for doubtful accounts including changes in management's approach.

When such disclosures are deficient, securities laws are violated and the U.S. Securities and Exchange Commission (SEC) can bring an enforcement action against the company and/or against senior management. The SEC brought an enforcement action against the chief accounting officer of Integrated Electrical Services, Inc. (IES) for improper disclosure related to IES's allowance for doubtful accounts.

IES was headquartered in Houston, Texas, and during the relevant time period IES was a leading provider of electrical contracting services. IES changed the percentage basis for estimating the allowance for doubtful accounts from approximately 1 percent to 0.25 percent. This resulted in IES reducing the allowance account by up to $1.1 million in a quarterly filing with the SEC, and increasing its pre-tax income by a like amount. This amount was material to IES's financial statements. Notwithstanding the material effect of this change on IES's financial statements, the change in the percentage used to compute the allowance for doubtful accounts was not disclosed.

A public company's chief accounting officer signs the Form 10-K and is responsible for ensuring that the financial statements are fairly presented in accordance with GAAP. Inadequate disclosure, if material, prevents financial statements from being fairly presented in accordance with GAAP.

Concluding Remarks

This is the first of three chapters in which we explore the issues involved in accounting for assets. The central theme in these chapters is the *valuation* of assets. In Exhibit 7–2, we have summarized how a company's financial assets are reported in the balance sheet.

We have illustrated numerous transactions involving the financial assets throughout this chapter. In addition to addressing balance sheet valuation issues, we have also determined whether these transactions are reported in the income statement and the statement of cash flows.

In the next two chapters, we explore the valuation of inventories and of plant assets. For each of these assets, you will see that several alternative valuation methods are acceptable. These different methods, however, may produce significantly different results. An understanding of these alternative accounting methods is essential to the proper use and interpretation of financial statements and in the preparation of income tax returns.