

Teaching Notes for Financial Accounting

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Ethics Question 1

During discussion of receivables

Why is it important to establish an appropriate amount for the allowance for doubtful accounts? Is it wrong for management to be biased when establishing the estimate? Why or why not?

The allowance for doubtful accounts is an excellent example of an area where management has discretion. It is impossible to come up with an amount that is 100% correct. While the written answers from students will vary, below are some thoughts that can be incorporated into class discussion. (Taken from Haen. 2013. "Integrating Catholic Social Teaching into Undergraduate Accounting Courses" *Journal of Catholic Higher Education*, 32, 1, 95-96).

Another area in which accountants have discretion is the annual adjustment to the allowance for doubtful accounts. Acceptable methods include percentage of sales, percentage of receivables and the direct write-off method for immaterial amounts. This is an area of significant judgment for accountants, since the amount cannot be verified until a later date – sometimes years later.

The exposure most students receive in this area from their textbooks is straightforward. Students are told that the appropriate rate is X percent, so the calculation is simply a math formula. There is little discussion about how the percentage is determined, except that historical default rates and the general economy are typically sources of information.

A way to integrate CST into these discussions is to describe what could happen if the estimate is purposely overstated or understated. Overestimating the estimate lowers net income. Many students will recognize this as inappropriate, as investors are not given a true picture of the company's financial condition. An additional point to make is how this can be viewed as violating *The Dignity of Work and the Rights of Workers*. Negotiations between an employer and union typically will include a review of the financial health of the company. Overstating the allowance for doubtful accounts may allow the company to hide its financial strength in order to seek additional concessions from its employees. Help them to understand that a company's reputation hinges on its honesty and integrity both of which are key principles of CST. Reporting accurate data is one way that companies develop and maintain a good reputation.

If the estimate for the allowance for doubtful accounts is purposely understated, net income will be overstated. Most students will again identify this as wrong since investors are not receiving accurate financial information. Help them to see how others might be negatively affected by this inaccurate data, such as workers whose bonus is affected by a company's bottom line. Or ask what pressures a company might be under, once it establishes a higher threshold of net income, to take extraordinary measures to maintain or exceed it. Wage and benefit concession, lay-offs, and unsafe labor practices could all be employed by a company to maintain an earnings level that was artificially inflated.

The discussion should also include the personal responsibility of the student to make sure the allowance for doubtful accounts is a truthful representation. According to CST components *Rights and Responsibilities* and *Solidarity*, we are all one family who must ensure that our brothers and sisters have what is required for human decency. Any intentional misrepresentation of financial information that adversely affects others violates these components. An individual has the responsibility to stop these harmful misrepresentations and cannot ignore them in the hope that other individuals will take action.