S8-5 Ethical Decision Making: A Mini-Case

LO 8-2

LEVEL UP

Having just graduated with a business degree, you're excited to begin working as a junior accountant at Clear Optics, Inc. The company supplies lenses, frames, and sunglasses to opticians and retailers throughout the country. Clear Optics is currently in the process of finalizing its third quarter (Q3) operating results. All Q3 adjusting entries have been made, except for bad debt expense. The preliminary income statement for Q3 is shown below, along with reported results for Q2 and Q1.

CLEAR OPTICS, INC.
Quarterly Income Statements
(amounts in thousands of U.S. dollars)

	Q3 (preliminary)	Q2 (as reported)	Q1 (as reported)
Net Sales	$135,800	$135,460	$130,100
Cost of Goods Sold	58,400	58,250	55,990
Gross Profit	77,400	77,210	74,110
Selling, General, and Administrative Expenses	56,560	53,975	53,690
Bad Debt Expense	—	6,050	4,200
Income before Income Tax Expense	20,840	17,185	16,220
Income Tax Expense	5,620	5,155	5,020
Net Income	$ 15,220	$ 12,030	$ 11,200

The corporate controller has asked you to examine the Allowance for Doubtful Accounts and use the aged listing of accounts receivable to determine the adjustment needed to record estimated bad debts for the quarter. The controller states that, "Although our customers are somewhat slower in paying this quarter, we can't afford to increase the Allowance for Doubtful Accounts. If anything, we need to decrease it—an adjusted balance of about $8,000 is what I'd like to see. Play around with our estimated bad debt loss rates until you get it to work."

You were somewhat confused by what the controller had told you, but you chalked it up to your lack of experience and decided to analyze the Allowance for Doubtful Accounts. You summarized the transactions recorded in the Allowance for Doubtful Accounts using the T-account below:

Allowance for Doubtful Accounts (xA)

		7,900	**January 1 bal. fwd.**
Q1 Write-offs	4,110	4,200	Q1 Bad debts estimate
		7,990	**March 31 adjusted**
Q2 Write-offs	4,120	6,050	Q2 Bad debts estimate
		9,920	**June 30 adjusted**
Q3 Write-offs	4,030	—	
		5,890	**September 30 unadjusted**

Required:

1. What bad debts estimate for Q3 will produce the $8,000 balance that the controller would like to see?
2. Prepare the adjusting journal entry that would be required to record this estimate.
3. If the entry in requirement 2 is made, what does it do to the Q3 income and the trend in earnings? (Assume that Income Tax Expense does not change.)
4. Reconsider the statement the controller made to you. Is his suggestion a logical way to use the aging method to estimate bad debts?

5. What would be the Q3 net income if the Bad Debt Expense estimate was 3.8 percent of sales, as in Q2 and Q1? What would this do to the trend in net income across the three quarters? (Assume that Income Tax Expense does not change.)
6. Is there any evidence of unethical behavior in this case? Explain your answer.