

## CREDIT AND COLLECTIONS CORPORATION

Credit and Collections Corporation (CCC) was in three lines of business, all related to the management and collection of accounts receivable. The company had grown dramatically, and that growth had necessitated an increase in equity. Management was considering an offering of stock to a group of private investors but, in the process of preparing for that offering, some questions had been raised about the company's historic accounting practices. Those arguments had escalated, and the debate had quickly become polarized. The accounting practices issue threatened the company's recent profitability trend, and part of the emotion generated by the debate was due to the threat that a change could pose to management's pride in the rising trend. But also, part of the polarization could be traced to the fact that any significant change in reported earnings would change the picture of the company that was presented by the financial statements, and that different picture would probably derail the equity offering.

### The Credit and Collection Business

The company's original business was a basic collection service. A commercial enterprise would proffer all its delinquent accounts receivable to CCC. The CCC staff would review them with care looking for collections it could assume. As a result of that review process, those accounts where the payor was in bankruptcy and those where the delay in payment was the result of an argument over product performance were removed from the portfolio. CCC agreed to assume collection responsibility for the remaining accounts in exchange for a management fee. The collection contract gave CCC exclusive rights to the collection effort and established that CCC would be entitled to a specific share of the funds it collected, usually 30%. Over the years, CCC had developed a very effective routine for the collection of delinquent accounts. The details of the accounts were fed into a computer system, which generated dun letters and scheduled follow-up phone calls on a predetermined schedule. The wording of those letters and phone calls were designed to become progressively more threatening, and were generally quite effective. If the computerized approach was unsuccessful, senior, more experienced collection officers exerted their influence on the payor. The company had statistics from the past 10 years, which indicated that within 6 months of taking over a portfolio of accounts, the system would collect 30% of the dollar value of that portfolio.

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For this basic collection business, CCC recognized income when it signed the contract with the originating business. For example, if CCC agreed to accept accounts with a face value of \$1,000, it would record an account receivable of \$300, payable of \$210, and income of \$90. As the collection process went forward, every dollar collected would reduce the accounts receivable: As the originator's share of the proceeds was paid, the payable would be reduced.

CCC's second line of business was a factoring operation. In this business, the originator would proffer all its current and delinquent accounts receivable to CCC, and, after a somewhat limited review of the files and some culling of accounts proffered, CCC would accept responsibility for a large group of those accounts. At the time of transfer, CCC paid the originator a specified amount, usually 95% of the face value of the accounts taken over. Any account that subsequently turned out to be uncollectible would be returned to the originator, and the originator would replace it with a new account of equal value or would refund the 95% originally paid by CCC.

CCC employed virtually the same collection program for those accounts as it did in its original collection business, although the early statements and follow-up letters were a little less demanding. In this factoring business, CCC recorded a receivable equal to the face amount of the accounts it took over at the time the contract was signed and recorded income equal to the 5% difference between the cash paid out and that face amount. All subsequent collections went to reduce CCC's receivable directly.

CCC's third line of business was relatively new, but was growing rapidly. Here, the originators were all hospitals, clinics, or doctors. The health-care reimbursement system in the United States had become so bogged down in paperwork that resolution of a health-care account could take many months, or even years, and the health-care providers were frequently strapped for cash. CCC agreed to accept responsibility for the collection of those accounts from the third-party payors (usually an insurance company or Medicare or Medicaid). CCC reviewed the accounts proffered by the provider and made its own assessment of the amounts that would ultimately be paid by the third-party payors. Very often, the provider recorded its receivable at its standard rates for the procedure, even though the payors had established a lower standard-reimbursement rate. CCC's assessment of the amount that the payor would ultimately agree to pay was based on the company's experience in the health-care field. CCC paid the provider 95% of the amounts it had determined would be paid. As with the factoring business, any individual accounts that subsequently turned out to be uncollectible were replaced by the provider.

For this business, CCC recorded a receivable equal to the aggregate of the amount it had determined would be paid—the assessed value of the accounts. The 5% difference between that amount and the amount that had been paid to the provider was taken as income over the expected average life of the accounts. As the accounts were collected, CCC's receivable was reduced.

## The Accounting Dispute

When CCC management talked to its advisors about the possibility of an equity offering, it became clear that the local CPA firm who had serviced the company for many years would be an unknown name to the prospective investors, so the local firm's opinion on the financial statements was unacceptable. CCC management contacted one of the big CPA firms, and several of that firm's partners came to interview CCC people and to study the financial data. After several days of discussions, the lead partner from the CPA firm suggested a lunch meeting. In the ensuing discussion, she said that—while the firm would be delighted to work with the company—they had serious reservations about the accounting practices CCC had been following.

The CPA firm partner said that her firm had come to the conclusion that revenue from the basic collection business and the factoring business should be recognized as the accounts were collected. When the CCC people asked what that would mean, she explained that pushing that revenue out over the collection period would reduce income in all of the earlier years, but would defer that income to be recognized in future years. When pressed, she explained that this accounting would significantly increase the losses reported in the two prior years and would convert the income reported in the most current year to a small loss. She again emphasized that the revenue would not be lost, but would simply be deferred. (**Exhibit 1** provides balance sheet and income statement information for the last three years, and demonstrates the effect of the proposed change in accounting.)

When CCC management challenged her further, she was quick to acknowledge that there were no accounting rules directly on point for CCC's businesses. But she explained that there were some concepts statements that addressed revenue recognition generally, and there were a number of industry-specific analogies that were on point. She said that all those materials suggested a different accounting than CCC had been using. For example:

- Rules for franchise accounting now required the franchisor to recognize revenue from the sale of a franchise only as the services it promised to provide were completed.
- Real estate accounting rules required the deferral of revenue from a real estate sale, so long as the seller had any continuing involvement with the development of the property sold.
- New accounting for the software industry permitted the recognition of revenue on sales of software only if the creator had no commitment for additional work to be done on the product sold.

She explained that the accounting standards' setters had been struggling for years to develop an overall statement on revenue recognition for service industries, but that for a number of reasons the effort had not come to fruition. She also said, however, that the standards' setters at the Financial Accounting Standards Board (FASB) had produced a series of concepts statements that were designed to help think through specific problems. The most applicable concepts statement