

Handout 7

Widget, Inc. is a publicly-traded company with a December 31 year-end. Widget is having a small and hopefully temporary cash flow problem in addition to a potential drop in earnings due to the slowdown in the economy. Projections show that Widget could miss their Wall Street earnings target by as much as \$700,000 or 2%. This would result in a significant decline in the market value of Widget's stock.

As a precaution, the Widget CEO called a meeting of her management team to discuss this problem and develop a strategy to address it. At the meeting, the Widget CFO, Tyrus Winnington, outlined the current financial condition of the company and defined the issues to be addressed. The CEO directed each executive to return in a week with a written plan to improve the company's cash flow and earnings. Additional borrowing would not be an option due to existing debt covenants that limit the amount that Widget can borrow in the future without approval of all current lenders.

At the next meeting, Winnington presented the following plan:

On May 1, 2025, Widget will sell \$5,000,000 (Widget's cost) of its existing inventory to User Friendly, Inc. (Friendly), one of Widget's supply chain partners. Legal title will pass at the time of the sale. Friendly will use the inventory as collateral to obtain a \$5,800,000 loan (with Widget guaranteeing the loan), which will be paid to Widget on June 15, 2025 as payment for the inventory. Widget will agree to repurchase the same inventory from Friendly on January 15, 2026 (after Widget's year-end) for \$5,900,000 (which will include storage and insurance charges, plus any interest paid by Friendly to the bank). Friendly will transport the inventory and store it in a public warehouse until the repurchase.

After rejecting the other plans that were presented, the CEO declared Winnington's plan as a win-win for everyone because the pressure on cash flow would be relieved and Widget would meet its earnings target as the result of an increase in sales revenue of \$5,800,000 and gross profit of \$800,000 (\$5,800,000 - \$5,000,000). It would also have the added benefit for Friendly of increasing its sales revenue by \$5,900,000 when the inventory is repurchased.

Amelia Emerson, the Widget Controller, has concerns about this plan and how to account for it, but does not want to reveal her concerns until she can support a position with absolute certainty. She vaguely remembers something called a "product financing arrangement." Amelia wants you to recommend how to account for the proposed plan and evaluate whether it will accomplish the financial goals of the CEO and CFO. Amelia was only recently hired as the Controller of Widget and doesn't want to upset the CEO and CFO in case she is wrong. Even though it's Amelia's responsibility to decide how to account for the proposed plan, Amelia is tempted to just let the CEO and CFO do whatever they want and abdicate her responsibility. However, she doesn't want to become involved with financial statements that violate GAAP and, therefore, are misleading. Financial statements issued by a publicly-traded company that are misleading could violate federal securities laws and result in criminal and civil penalties.

Required:

You must complete this assignment independently on your own and not work with or collaborate in any way with any other person, including but not limited to your ACCT 350 classmates. Failure to work alone will constitute academic dishonesty.

Prepare a letter (not a memo) addressed to Amelia Emerson, Controller, Widget, Inc., 350 Accounting Avenue, Northridge, California 91330, advising her about the proposed plan. You must support your advice by citing any applicable accounting standards (don't give legal advice). Do not include a reference page. You must limit your letter to one page (single spaced with double space between paragraphs) and one-inch margins. Only submit the one page and nothing else. Create your own letterhead for the accounting firm you represent. The date should be placed no less than one-half inch below the letterhead (or 1.5 inches from the top of the page).

Remember what we discussed in class about not citing section 55 in the Codification unless you also cite the primary source to which it refers. In other words, citing only section 55 isn't enough. You must cite at least one primary standard.

In addition to analyzing the accounting issue(s) in your letter, include a brief comment about any ethical issue that Amelia faces. You should look at the AICPA Code of Professional Conduct rule on "Integrity and Objectivity". Briefly explain to Amelia the one part of this rule she should most consider in her current situation (subordination of judgment). But be aware (and be careful) that the CEO and CFO may be "secondary readers" of your letter, and that you are creating a written record on this issue. Please note that it is Certified Public Accountants (CPAs) like Amelia who are considered "members" of the AICPA and must uphold the AICPA Code of Professional Conduct.

You may ignore any "Pending Content" sections for this case only.

Remember that textbooks are not recognized as authoritative sources in accounting research. Therefore, do not use your textbook as support for your recommendation.

Submission

To submit your letter through Canvas, follow these instructions.

- In the Course Navigation, click the Assignments link.
- Click Handout 7 -- Submission.
- Use the "Browse" button to select your document.
- Click the "Submit Assignment" button.

Failure to submit an acceptable letter will result in you losing 10 points in ACCT 350.

Additional Information

To access the applicable section of the AICPA Code of Professional Conduct, go to page 29 of https://pub.aicpa.org/codeofconduct/Handlers/DownloadDocument.ashx?docid=25770&d_ft=2 [copy and paste].

To cite this rule, use the following in-text citation:

(AICPA, 2019, ET Section 1.100.001.01)