

Handout 7

Widget, Inc. is a publicly-traded company with a December 31 year-end. Due to an economic slowdown, Widget is having a small and hopefully temporary cash flow problem in addition to a potential drop in earnings. Projections show that Widget could miss its 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, Widget CEO Lois Lane called a meeting of her management team to discuss this problem and develop a strategy to address it. At the meeting, Widget CFO Tyrus Winnington outlined the current financial condition of the company and defined the issues to be addressed. Lane directed each Widget executive to return in one week with a written plan to improve the company's cash flow and earnings. Additional borrowing would not be an option because existing debt covenants 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 June 1, 2016, Widget will sell \$5,000,000 of its existing inventory to User Friendly, Inc. (Friendly), one of Widget's supply chain partners. Legal title of that inventory 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 April 15, 2016 as payment for the inventory. Widget will agree to repurchase the same inventory from Friendly on January 15, 2017 (after Widget's year-end) for \$5,900,000. This repurchase price 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, Lane declared Winnington's plan as a win-win for all stakeholders 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). The plan would have the added benefit for Friendly of increasing its own sales revenue by \$5,900,000 when the inventory is repurchased.

Amelia Emerson, the Widget Controller, has concerns about how to account for the plan, but does not want to reveal her concerns until she can support a position with absolute certainty. 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 Widget Controller and does not want to upset Lane or Winnington 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 let Lane and Winnington do what they want. However, she does not want Widget's financial statements to violate GAAP or mislead investors.

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. Further, your assignment will serve as a diagnostic tool for 351COM next semester; submitting work that is not your own will undermine the purpose and value of the feedback you will receive near the beginning of that course.

Prepare a letter (not a memo) addressed to Amelia Emerson, Controller, Widget, Inc., 350 Accounting Avenue, Northridge, California 91330, advising her about how to account for the proposed plan. You must support your advice by citing any applicable accounting standards. Do not include a reference page until you complete a follow-up assignment in ACCT 351COM. 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 a section 55 in the Codification unless you also cite the primary source to which it refers. In other words, citing only section 55 does not suffice.

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. But remember (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 “members” of the AICPA and must uphold the AICPA Code of Professional Conduct.

For purposes of this case only, you may ignore any “Pending Content” sections.

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

Turnitin

In addition to submitting your letter to Professor Weiss, you must also submit your letter to Turnitin. To use Turnitin, access Moodle and click “**Turnitin Assignments**” located in the “**Activities**” menu on the right-hand side of the page. Next, click “**Handout 7 (Turnitin)**”. Finally, click “**Submit Paper**” where you see the  symbol and upload your letter by dragging and dropping your file. Don’t forget to click “**Add Submission**” before you exit. Failure to use Turnitin will result in you losing 10 points in ACCT 350, and your letter will not be accepted in ACCT 351COM.

Additional Information

To access the applicable section of the AICPA Code of Professional Conduct, go to pages 31 and 32 of <http://www.aicpa.org/research/standards/codeofconduct/downloadabledocuments/2014december15contentasof2014may15codeofconduct.pdf>

To cite and reference this rule, use the following:

Reference

AICPA, ET Section 1.100.001.01 (2016).

In-text Citation

(AICPA, 2016, ET Section 1.100.001.01)