

Case 09-6
UpBeat, Inc.

Tommy Toe, the controller of UpBeat, Inc., a successful company in Greenville, South Carolina, was whistling. Sales in the last quarter substantially exceeded budgeted amounts, and the order backlog indicated that the next quarter would be even better. All of a sudden, Tommy frowned. When he reviewed the monthly reporting package and cash flow projections, he noticed that the debt-to-equity ratio had deteriorated. This poses a problem under UpBeat's debt covenants. In addition, at present liquidity is tight and the company is having difficulty keeping current on taxes and on payments to suppliers and employees.

Tommy immediately called UpBeat's local bank. The bank manager recommended that UpBeat sell off some of its accounts receivable to increase its liquidity and improve its debt covenant ratios. UpBeat agreed to sell the bank \$50 million of accounts receivable at 90 percent of face value. The following provisions are included in the sale agreement:

- Transfer Provision 1 — The bank has to obtain permission from UpBeat if it decides to sell/pledge the accounts receivable, which UpBeat would not unreasonably withhold.
- Transfer Provision 2 — UpBeat has the option to repurchase the accounts receivable at a fixed price if it obtains sufficient liquidity from new investors or other sources.

Tommy knows that legal isolation is often an issue in sale accounting. As a result, he was not surprised when his auditor asked for a legal opinion. The legal letter Tommy obtained included a "would" opinion stating that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee. Tommy's auditor evaluated the legal letter and found it adequate to support legal isolation of the accounts receivable transferred.

Tommy has requested your assistance in determining whether the transfer provisions preclude sale accounting.

Required:

- For each of the transfer provisions included in the agreement, determine whether the provision would preclude sales accounting.
- If one or more of the provisions preclude sale accounting, but subsequently, after the transfer, UpBeat and the bank amend the agreement to eliminate the provision(s) in question, would sale accounting be appropriate after the initial transfer?