

**DEPARTMENT OF ACCOUNTANCY
CLAP NOW, INC.
MEMORANDUM**

TO: Board of Directors of Summit Distributors, Inc.
FROM: Clap Now Inc.
DATE: September 27, 2005
SUBJECT: LIFO/FIFO decision and consequences

This memo discusses the advantages and disadvantages facing Summit Distributors, Inc. if it changes its inventory valuation system. It then addresses the impact this decision would have on Summit's external constituencies.

DECISION SUMMARY

If Kathy Hutton, the CEO of Summit, has two options: she could continue to use the LIFO method to value her inventory, or she could change to the FIFO method. If she chooses the LIFO method, she should also meet with Sandy from Prime Trust Bank and rework the loan covenants to prevent default. If she chooses FIFO, she should discuss the changes with her creditors, and disclose this information to the shareholders and auditors. She should also weigh the costs and benefits associated with this decision. We advise Ms. Hutton to switch to the FIFO method of inventory valuation.

RECOMMENDATIONS

The CEO has three major reasons to switch to the FIFO method at this point. First, the FIFO method would result in a more representative presentation of Summit's inventory. To compete successfully, Summit must keep inventory in strategically located warehouses to meet the immediate needs of its customers. Because the inventory Summit ships out is its older inventory,

the FIFO method would more accurately match the inventory cost flow assumption (FIFO) with the physical flow of inventory. Second, if the company switched from the LIFO to FIFO method, the refundable taxes would be less. Summit wants to minimize the difference in refundable taxes; therefore, switching to FIFO in a period of net loss would accomplish this goal. Third, the switch would prevent an unnecessary default on the bank loan if Prime Trust bank refuses to rework the loan covenants. The loan covenant of interest is tangible net worth, which the bank has set at a minimum of \$12 million. Without the switch, the LIFO method would report a tangible net worth of \$9,828,000, which would violate this loan covenant. Under the FIFO method, the tangible net worth would increase by \$4,215,000, and would yield a total of \$14,043,000.

IMPACT

The decision to change to FIFO would impact three main groups: Prime Trust Bank, shareholders, and auditors. The primary impact on Prime Trust Bank would be that Summit would not default on the loan in 1992. According to Ms. Hutton's strong future economic predictions, Summit would have a chance to recover and continue to make all payments to Prime Trust. Furthermore, the inventory revaluation impacts Prime Trust because the value of inventory would increase by \$4,802,000. Based on the loan covenant, the loan outstanding balance would increase to the point of 80% of accounts receivable and 50% of inventory. These statistics mean that Summit can borrow an additional \$2,401,000 from Prime Trust in the coming year.

This inventory valuation change would have both positive and negative impacts exist for shareholders. Positive impacts would include an increase in retained earnings (\$4,215,000) and

avoidance of bankruptcy (assuming Prime Trust Bank would not rework the loan covenants), which allows for recovery and possible future growth. One negative impact of such a rapid change of inventory valuation methods over the past three years would be the negative reactions of the shareholders.

The impact on auditors would involve the increased time and effort auditors would spend in reviewing Summit's financial statements because of the change from LIFO to FIFO. Auditors would need information to calculate LIFO to FIFO changes and to assure that Summit remains a going concern. This may increase the price of the audit.

JUSTIFICATIONS

The switch to FIFO more accurately represents the actual inventory value. The nature of the industry requires meeting the immediate delivery demands of customers, which implies that Summit must complete the inventory before customers order any items. Even though prices of supplies are increasing, the inventory immediately shipped to customers is of lower value. The change from LIFO to FIFO would result in a higher and more accurate taxable income. This change would benefit creditors, shareholders, and Summit Distributors, Inc. because of its more accurate representation.