Inventory cost flow assumptions

Business, Accounting

4. 3| As a management accounting compare and contrast the above methods and recommend suitable method to achieve the organizational objective| P2. 3, M3. 3, D1. 1| Assignment| One of the most important knowledge about accounting is 3 basic inventory techniques or cost flow assumptions: FIFO (stands for first-in, first-out), LIFO (stands for last-in, first-out) and WAVG (stands for weighted – average). In this article, I just want to focus on FIFO and LIFO. Let's review these concepts:

FIFO means that the oldest inventory items are recorded as sold first but do not necessarily mean that the exact newest physical object has been tracked and sold. LIFO on the other hand means the exact opposite, the most recently purchased items are recorded as sold first. For example, a bakery produces 100 cakes on Monday at a cost of $1 each, and 100 more on Tuesday at $1. 25 each. FIFO states that if the bakery sold 100 cakes on Wednesday, the COGS is $1 per one cake (recorded on the income statement) because that was the cost of each of the first cakes in inventory. The $1. 5 cakes would be allocated to ending inventory (appears on the balance sheet). In contrast, LIFO states that the same bakery would assign $1. 25 per cake to COGS, while the remaining $1 cakes would be used to calculate the value of inventory at the end of the period. Any company can use either FIFO or LIFO to sell their stuffs. If inflation didn't exist, both FIFO and LIFO methods would produce the exact same results. As the example above, when prices are stable, our bakery would be able to produce all of its loafs of bread at $1, and FIFO, LIFO would give us a cost of $1 per one cake.

But our economy seems more complicated; prices tend to rise, which means the choice of accounting method can dramatically affect company profit. We

can easily see that, if the selling price is increasing day by day, choosing the FIFO method of accounting will have the opposite affect. FIFO will help company gain more profit. It means the inventory that you sell costs you less than the inventory that you have remaining. Therefore, the choice of FIFO accounting results in lower COGS on the income statement vs.

LIFO and a higher inventory valuation on your balance sheet vs. LIFO LIFO isn't a good choice in inflation because the leftover inventory might be extremely old and, perhaps, obsolete. This results in a valuation that is much lower than today's prices. But we can't always use FIFO method because in some special situations, LIFO is the better choice. For instance, in the deflation economy, we should choose LIFO because the price will go down gradually. The newer products we sell first, the better profit we will get.

One more reason for companies to consider LIFO is Tax. Because FIFO results in lower COGS on the income statement, it will make higher earnings. But when earnings are higher, taxes are also higher. And when taxes are higher, after-tax earnings become lower. On the other hand, LIFO results in lower pre-tax earnings (since COGS are higher) and therefore it gets lower taxes and higher after-tax earnings. The process to choose FIFO or LIFO isn't simple at all, it requires the accountants to analysis carefully to give the best choice for any company.