Lifo and fifo in accounting

Business, Accounting

LIFO, last-in-first-out and FIFO, first-in-first-out the two most common inventory accounting methods. The choice of the method of inventory accounting by a small business can directly impact its balance sheet, income statement, and statement of cash flows. Not only do companies have to track the number of items sold, but they have to track the cost of each item. These two methods are ways in which they can do that. Each will have a different effect on their financial statements.

How is Inventory Determined? Inventory can be broken down into three categories: raw materials, work-in-process, and finished goods. Raw materials are inventory used to produce assets for sale. Work-in-process is assets in production for sale. Finished goods are assets intended for sale. The inventory equation is the following: 1. Beginning Inventory + Net Purchases - Cost of Goods Sold = Ending Inventory There are two common methods for accounting for this inventory. LIFO - Last-In, First-Out LIFO assumes that the last items put on the shelf are the first items sold.

LIFO is a good system to use when your products are not perishable or become obsolete. Under LIFO, when prices rise, the higher priced items are sold first and the lower priced products are left in inventory. This increases a company's cost of goods sold and lowers their tax liability and, as a result, their net income. This inventory accounting method seldom approximates replacement costs for inventory, which is one of its drawbacks. In addition, it usually does not correspond to the actual physical flow of goods. Let's use the gasoline industry as an example. Let's say that a tanker truck delivers 2, 000 gallons of gasoline to Alan’s Service Station on Monday and the price at that time is $2.

35/gallon. On Tuesday, the price of gasoline has gone up and the tanker truck delivers 2, 000 more gallons at a price of $2. 50/gallon. Under LIFO, the gasoline station would assign the $2. 50 gallon gasoline to Cost of Goods Sold and the remaining $2. 35 gallons of gasoline would be used to calculate the value of ending inventory at the end of the accounting period. FIFO - First-In, First-OutFIFO assumes that the first items put on the shelf are the first items sold, so your oldest goods are sold first.

This system is generally used by companies whose inventory is perishable. If prices go up, FIFO will give you a lower cost of goods sold because you are using your older, cheaper goods first. Your bottom line will look better to your investors, if you have any, but your tax liability will be higher because you have higher profit. A positive thing about the FIFO method is that it represents recent purchases and, as such, more accurately reflects replacement costs. Going back to the gasoline industry example, under FIFO, the gasoline station would assign the $2. 35 gallon gasoline to Cost of Goods Sold and the remaining $2. 50 gallons of gasoline would be used to calculate the value of ending inventory at the end of the accounting period.

Financial StatementProblems with LIFO A LIFO liquidation can result when your company experiences declines in your inventory quantities. In this case, a lot of your older inventory is sold or liquidated. This creates an inflated profit margin that isn't real and seriously distorts net income. This has across the board impacts. You should add the LIFO liquidation profits to the current ratio numerator and adjust the denominator to reflect FIFO inventory instead of LIFO inventory in order to properly state your liquidity position. You should

make exactly the same adjustments to the inventory turnover ratio. Inventory accounting is only one part of a company's management of their inventory investment, but an important one.

So being a potential business owner in the near future, this information does play an impact on any decisions made, if you're going for the quick buck or if you are shooting to make your business look better through the books. My personal opinion on the two methods is to go with the FIFO method, to me it's more logical because the stuff that can go out of date is sold first, and that's how I manage my at home life with my kids, in order to get stuff you got to give stuff, so in a business aspect that would be in order to get the new stuff you have to purchase the old stuff to make room.