

Average cost

[Literature](#), [Russian Literature](#)



The average cost for each item is calculated and this figure is then used until another receipt of goods, when another recalculation is needed. Each different method of valuation provides different costs, therefore resembling different profits. " It is therefore important that the method chosen is the one that is closest in its assumptions to the nature of the business" (Wood and Sangster, 2002: 311). The determination of which method to use should relate to what the objectives of the pricing are. Mainly these will be to determine the cost of materials for decision-making and product pricing and to allocate material costs.

FIFO appears to be the most logical method, in that it follows the physical flow of materials through an organisation. The outcomes of this method are a lower cost of sales calculation, which consequently shows a higher profit. Record keeping is also relatively expensive too. (see appendix) LIFO results in a higher cost of sales and therefore lower profits, as the stock is valued at its latest (and usually higher) prices. (see appendix)

AVCO is the most popular method (UWM, 2003). LIFO is not an acceptable method of pricing for taxation purposes, unless reports are adjusted, but this can create more confusion and is not a popular choice by organisations. The Statement of Standard Accounting Practice on Stock and Work in Progress (SSAP 9) however, states that LIFO does not bear a reasonable relationship to actual costs obtained during the period and implies that that this method is inappropriate for external reporting.

In view of this, FIFO or AVCO should be applied. When making the decision of which method to use, it is necessary to consider that the value of stock must

give a true and fair view of the state of affairs the business is in. However, there is no precise definition of what a 'true and fair view really is, and is sensitive to individual judgement.

There is much controversy regarding material pricing. Although the objectives are clear - " that a charge to production on a consistent and realistic basis for cost of materials used" (Fong, 2003) there are problems with several issues. 1. Rapidly changing prices for purchases, 2. Stock at different prices held, 3. Impossible to identify items with their delivery consignment. 4. Sensitivity of product cost to materials pricing method used.

The valuation of materials is important also because if there is an error in the costs assigned to an ending inventory, then this will create an opposite error in the cost of goods sold, thus repetition of the original error in the amount of gross profit. The only certain thing about valuation is, according to Wood and Sangster, " that the concept of consistency should be applied". One-way to do this is to adopt an inventory system, which should be followed at all times. Perpetual Inventory is a method for tracking and knowing the value of inventory and quantity of merchandise on hand at any time by tracking sales, returns and receipts with information systems.

The perpetual inventory system requires a separate inventory ledger to be maintained for each product. These ledgers provide detailed information on purchases, cost of goods sold and inventory on hand. Each column gives information on quantity, unit cost and total cost. (see appendix ??? for a worked example)