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Inventory Accounting

Inventory accounting may sound like a huge undertaking but in reality, it is quite straightforward and easy to understand. You start with the inventory you have on hand. No matter when you sell product, the value of your inventory will remain constant based on accepted and rational methods of inventory accounting. Those methods include weighted average, first in/first out, and last in/first out.

Weighted average

Weighted average measures the total cost of items in inventory that are available for sale divided by the total number of units available for sale. Typically this average is computed at the end of an accounting period.

Suppose you purchase five widgets at $10 apiece and five widgets at $20 apiece. You sell five units of product. The weighted average method is calculated as follows:

Total Cost of Goods for Sale at Cost (divided)
Total Number of Units Available for Sale =
Weighted Average Cost per Widget
-
Five widgets at $10 each = $50
Five widgets at $20 each = $100
Total number of widgets = 10
Weighted Average = $150 / 10 = $15
$15 is the average cost of the 10 widgets

First in/first out

First in, first out means exactly what it says. The first widgets you bring into inventory will be the first ones sold as product. First in, first out, or FIFO as it is commonly referred to, is based on the principle that most businesses tend to sell the first goods that come into inventory.

Suppose you buy five widgets at $10 apiece on January 3 and purchase another five widgets at $20 apiece on January 7. You then sell five widgets on January 30. Using first in, first out, the five widgets you purchased at $10 would be sold first. This would leave you with the five widgets that you purchased at $20, which would leave the value of your inventory at $100.

Last in/first out

This method, commonly referred to as LIFO, is based on the assumption that the most recent units purchased will be the first units sold. A “widget” is an imaginary item that could be just about any product. The advantage of last in, first out accounting, or LIFO, is that typically the last widgets purchased were purchased at the highest price and that by considering the highest priced items to be sold first, a business is able to reduce its short-term profit, and hence, taxes.

Suppose you purchase five widgets at $10 apiece on January 4 and five more widgets at $20 apiece on February 2. You then sell five widgets on February 20. The value of your inventory, using LIFO, would be $50, since the most recent widgets

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purchased, at a total value of $100 on February 2, were sold. You were left with the five widgets valued at $10 each.

*** Source Streetwise Small Business Start-Up**

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