

Comparison of Methods of Costing Inventory

In a period of rising or falling prices, the weighted average method of costing the inventory yields an inventory cost that is between fifo and lifo. This can be illustrated by summarizing the computations for each of the three methods.

	<i>Fifo</i>	<i>Weighted Average</i>	<i>Lifo</i>
Merchandise available for sale.....	\$1,210	\$1,210	\$1,210
Less ending inventory.....	615	550	480
Cost of goods sold	\$ 595	\$ 660	\$ 730

The inventory method being used has no effect on the amount of revenue from sales or the amount of operating expenses reported. The amount of cost of goods sold, which is affected by the choice of the inventory costing method, affects the amount of gross profit and the net income.

To illustrate this point, assume that sales of 30 units for the period totaled \$1,350 and that operating expenses for the period were \$475. The summary comparing the three methods of costing the inventory can now be expanded to include the computation of gross profit and net income.

	<i>Fifo</i>	<i>Weighted Average</i>	<i>Lifo</i>
Sales.....	\$1,350	\$1,350	\$1,350
Cost of goods sold.....	595	660	730
Gross profit.....	\$ 755	\$ 690	\$ 620
Operating expenses	475	475	475
Net income	\$ 280	\$ 215	\$ 145
Differences	\$ 65	\$ 70	\$ 70
Cost of ending inventory.....	\$ 615	\$ 550	\$ 480
Differences	\$ 65	\$ 70	\$ 70

It is apparent from the above schedule that the higher the ending inventory, the lower the cost of goods sold and thus the higher the net income. Consequently, the difference in the cost of the ending inventory under each method is equal to the difference in the net income reported under each method.

The above illustration is based on an assumption of a period of rising prices. Under these circumstances, the fifo method will yield the highest net income, because it has the highest prices included in its ending inventory and the lowest prices in its cost of goods sold.

A major advantage of using the lifo method during a period of rising prices is that the latest costs, which are the highest, are assigned to the cost of goods sold. This results in a lower taxable income and consequently a smaller income tax liability. In the examples above, the inventory costed at fifo was assigned a value of \$615 and the amount of cost of goods sold was \$595. The lifo method resulted in an inventory cost of only \$480 and a cost of goods sold of \$730. Cost of goods sold was \$135 more when using lifo than when using fifo. Therefore, the lifo method resulted in a net income of \$135 less than the fifo method. When unit cost is decreasing, the use of the lifo method will result in reported income being higher than for the fifo method.