

Date of Class : 29/04/2021 THURSDAY [ 10 am to 11 am & ]  
Period - I MBA - SEM I [ 11:05 :: 12:05 PM ]  
SUBJECT : MB 104 - AFA

## TOPIC : AVERAGE PRICE METHOD

This method is based on the theory that all the materials on hand is so intermingled that an issue cannot be made from any particular Lot, but represents an average of the entire supply. This method can be used when market prices are subject to constant changes, when the materials consist largest of small items issued to in small quantities.

In period of rapid increasing & decreasing material prices (cost), an average cost tends to narrow the extreme prices, the trend upward & downward is more gradual, as contrasted with the sharp increase or decrease (decline) when prices are taken from the actual invoices under the FIFO method. Thus, instead of charging materials at any of the prices at which materials might have been actually purchased by the factory, or at which they could have been purchased from the market. On the date of issue, a price is adopted in which are reflected the effect of all the prices at which the various instalments of materials have been actually purchased from time to time. From this point of view this method is the most scientific one.

\*Average may be of two types viz.

① Simple

② Weighted

## Simple Average Method

Simple average means the average of prices at which materials in question have been purchased from time to time from date of the last issue to the date of the present issue. It is found out by adding the price and dividing the total by the number of different price at which materials have been purchased.

### For example

On August 5	1000 units @ ₹ 2.00 per unit
On 4 20	500 units @ ₹ 2.50 per unit

The average rate will be as follows

$$\frac{2 + 2.50}{2} = \frac{4.50}{2} = \underline{\underline{2.25 \text{ per unit}}}$$

only the rate is taken for calculation. There is no any hurdle to calculate the average whether prices increase or decrease.

### Advantage

1. In this; there is uniformity in various rates. So, the units issued to various deptt or sections more or less the same rate.

2. This system is the mixture of CP and MP because the merit of both the system are found in it.

### Disadvantage

The following disadvantages are as follows —

(2) Ignore Extreme prices: The pricing of issues at the last month's rate ignores possible heavy fluctuation of the price during the current month.

(ii) This is not an exact system of valuation of stock because it becomes erroneous and sometimes fictitious balance of material's values such as quantity without value or minus value, or value without quantity may be shown.

(iii) In this heavy calculation work is involved at the end of the accounting period because issue rates for all the items have to be worked out at a time. This way, to some extent, be obviated by spreading over the work by selecting different periods for working out prices of different items.

### WEIGHTED AVERAGE METHOD

The weighted average method is obtained by multiplying the price mentioned above by the quantities which have been purchased at those prices and dividing the total value of all these products by the total of quantities purchased. This is worked out after every material receipt. As example given in simple average method, we find out the following activity

$$\frac{800 \times 2 + 500 \times 2.50}{800 + 500} = \frac{1600 + 1250}{1300}$$

✓ here, the prices are calculated  $= 2.19$   
receipt of material but not on issue of material

Therefore, a new price (WAP) is calculated as and when a fresh lot is received.

### Advantage

- 1) This is very important method for removing the wide range fluctuation in the prices
- 2) It is not necessary to calculate the new rate with every new issue of material.
- 3) The total value of material issued does not show up a downward trend to the total value of material received, as is in the case of simple average method.

### Disadvantage:

- 1) The greatest drawback is that fresh calculation will have to be made every time fresh purchases are made.
- 2) Much more calculations are needed and likely to cause error.
- 3) Calculations are very tedious. Prices are worked out in decimals to get correct results.
- 4) Materials purchased at a high price reflect its effect in the average for a considerable time after it is exhausted.