MB-104-AFA

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UNIT-4. SUBJECT: AFA

TOPIC: LIFO – METHOD OF VALUATION

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This method is of recent ~~ao~~ origin and it was introduced in USA during the last war. The method operates in just the reverse order of FIFO Method. This method is based on the theory that the materials which are received in last are issued first. Materials are issued at cost. In times of rising prices, this method is considered best for applications as the current cost of materials contributes to the cost of production.

Examples:

1st March 2021 – 5 Tons @ 2.00 per Ton
5th March 2021 – 10 TONS @ 2.50 " "
27th Feb 2021 – 15 TONS @ 2.50 " "
15th feb 2021 – 15 TONS @ 3.00 " "

If on 31st March 10 Tons of materials were issued then its cost will be calculated Rs 3 per ton

This method values the stores issued at more nearly the current market price but leaves the materials stock at values closely approximating the price of the oldest materials.

Since LIFO uses the most recently acquired inventory to value COGS, (Cost of good sold), the left-over inventory might be extremely old or obsolete. As a result, LIFO doesnot provide an accurate or uptodate value of inventory because the valuation is much lower than inventory items at today's prices. Also, LIFO is not realistic for many companies because they would not leave their older inventory sitting idle in stock while using the most recently acquired inventory.

For example, a company that sells seafood would not realistically use their newly-acquired inventory first in selling & shipping their products. The seafood company would never leave the oldest inventory sitting idle since the product could spoil, leading to loss. As a result, LIFO ~~doesnot~~ is not practical for many companies, that sell perishable goods and doesnot accurately reflect the logical production forces of using the oldest inventory first.

IMPACT

When sales are recorded using the LIFO method, the most recent ~~method~~ items of inventory are use to value COGS and are sold first. In other words, the older inventory, which was cheeper would be sold later. In an inflationary condition or situation, the current COGS would be higher under LIFO because the new inventory would be more expensive. As a result, the company would record lower profits or net

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income for the period. However the reduced ~~forreduced~~ profit or earnings — it means the company would benefit from a lower tax liability.

In real world, prices tend to rise over the long term. Which means the choice of accounting method can affect the inventory valuation & profitability.

On the above discussion, we can point out the following advantage of LIFO system.

* Advantages:-

1. Like the FIFO system, this is very simple to operate and is quite useful where transactions are not too many and the prices are fairly steady or and rising.
2. This is suitable for bulky materials with high unit prices.
3. Reasonably correct effect of current market price is reflected in the cost of sales provided the stores are recently purchased.
4. During the fluctuating market quotation of prices for the company's products is more safe than in the other methods.

* DISADVANTAGES

This methods suffers from the following disadvantages:-

1. As in the FIFO system, calculations become tedious, complicated and cumbersome when rates of

receipts are highly fluctuating.

2. For pricing one requisition sometimes more than one price has to be adopted.
3. ~~For~~ pricing of issues being dependent on the last receipt rates, the work of pricing may be held up if the receipt rate is not readily available. This difficulty may be obviated by pricing the receipt and issue transactions provisionally and adjusting subsequently when the actual price is known.
4. Closing stock is valued at cost which does not represent current price or conditions.
5. As in the case of FIFO method, costs of different batches of production are distorted.
6. During falling ~~price~~ of market, issues are priced at lower rates and materials in stock purchased at higher rates should require adjustment at a lower value, on the principles of valuation of stock at the "Lower the cost or Market Value".
7. The contention that the effect of the current market price is shown in the cost of sales may not be always correct, e.g. when there is a change in the market price after last purchase or if the previous issue transactions have already consumed the latest receipts.