M5A2 FIFO and LIFO Inventory Methods

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Compare the accounting implications of valuing inventory under FIFO and LIFO methods of a fast moving consumer goods (FMCG) company during a period of rising prices.

FIFO and LIFO are methods of accounting for inventory in a sales environment. Which one (or the Average method) to use is optional under GAAP rules, but the principle of Consistency would dictate choosing one and sticking to it. Some analysis and fitting to the business type should demonstrate the most favorable method for a given company.

First In First Out intones that the first items purchased are the first items pulled off the rack (on paper at least) and sold. Accounting is done to figure cost based on the sale price of each unit when it was purchased. Therefore, a widget from a lot bought in February at $2.10/widget would be written off the books before widgets from the lot bought in June at $2.20/widget. In an environment of rising prices, this would mean that items are sold that were bought some time ago, ostensibly when prices were lower. This would mean Cost of Goods Sold would be low, creating a false impression of high profits, especially considering the replacement cost of those items sold, to provide inventory for next week’s or next month’s sales, for instance, will be high by comparison; so while profits look good by conventional GAAP methods of accounting, the actual outlook is much more bleak without pricing or other commensurate adjustments.

Last In First Out intones counting backwards from the most recently purchased item. This figures cost based on the purchase price of each unit when it was purchased, just like FIFO – but in reverse order. In LIFO, widgets sold this month are taken from the more recently purchased lot. As in the example above, the June lot of $2.20 widgets would be exhausted before digging into the February $2.10 lot. This way in August, with widget prices up to $2.25, the numbers are nearer true to form and the company is better able to absorb the disparity between the items sold and the new inventory that must be purchased to replenish stock. Therefore LIFO more closely declares present operating costs and approximates the actual replacement prices of the items being sold, and becomes a better predictor for future performance – and this keeps investors happy.

FIFO and LIFO are both valid methods of evaluating inventories, and either may be used under GAAP, though one should be used consistently as a matter of principal. In the interest of a FMCG company in a period of price inflation, the better method answers the need to accurately demonstrate present- and project future costs is LIFO.