The Advantages and Disadvantages of FIFO Method

Advantages:

The following are the main advantages of FIFO Method:

- The main advantage of FIFO method is that it is simple to understand and easy to operate.
- It is a logical method because it takes into consideration the normal procedure of utilizing first those materials which are received first. Materials are issued in order of purchases, so materials received first are utilized first.
- Under this method, materials are issued at the purchase price; so the cost of jobs or work orders is correctly ascertained so far as cost of materials is concerned. Thus, the method recovers the cost price of the materials.
- This method is useful when prices are falling.
- Closing stock of materials will be valued at the market price as the closing stock under this method would consist of recent purchase of materials.
- This method is also useful when transactions are not too many and prices of materials are fairly steady.

Disadvantages:

The following are the main Disadvantages of FIFO Method:

- This method increases the possibility or clerical errors, if consignments are received frequently at fluctuating prices as very time an issue of materials is made; the store ledger clerk will have to go through his record to ascertain the price to be charged.
- In case of fluctuations in prices of materials, comparison between one job and the other job becomes difficult because one job started a few minutes later than another of the same nature may be issued materials at different prices, merely because the earlier job exhausted the supply of the lower priced materials in stock.
- For pricing rise, the issue price does not reflect the market price as materials are issued from the earliest consignments. Therefore, the charge to production is low because the cost of replacing the material consumed will be higher than the price of issue.

The Advantages and Disadvantages of LIFO Method

Advantages:

The following are the Advantages of LIFO Method:

- Like FIFO method, this is simple to operate and is useful when transactions are not too many and the prices are fairly steady.
- Like FIFO, this method recovers cost from production because actual cost of material is charged to production.
- Production is charged at the recent prices because materials are issued from the latest consignment. Thus, effect of current market prices of materials is reflected in the cost of sales provided the materials are recently purchased.
- In time of rising prices, LIFO method of pricing issues is suitable because materials are issued at the current market prices which are high. This method thus helps in showing a lower profit because of increased charge to production during periods of rising prices and lower reduces burden of income tax.

Disadvantages:

The following are the Disadvantages of LIFO Method:

- Like FIFO, this method may lead to clerical errors as every time an issue is made, the store ledger clerk will have to go through the record to ascertain the price to be charged.
- Like FIFO, comparison between one job and the other job will become difficult because one job started a few minutes after another of the same type may bear a different charge for materials consumed, merely because the earlier job exhausted the supply of the lower priced or higher priced materials in stock.
- For pricing a single requisition, more than one price has often to be adopted.
- The stock in hand is valued at price which does not reflect current market price. Consequently, closing stock will be understated or overstated in the Balance Sheet.

The Meaning and Definition of FIFO Method. (Cost Accounting)

Under FIFO method material is first issued from the earliest consignment on hand and priced at the cost at which that consignment was placed in the stores. In other words, materials received first are issued first. The units in the opening stock of materials are treated as if they are issued first, the units from the purchase issued next, and so on until the units left in the closing stock of materials are valued at the cost of production according to their chronological order of receipts in the store.

FIFO method is most suitable in times of falling prices because the issue price of materials to job or works orders will be high (materials issued from the earliest consignments which were purchased at a higher rate) while the cost of replacement of materials will be low. But in case of rising prices this method is not suitable because the issue price of materials to production will be low while the cost of replacement of materials will be high.

Advantages of Last in First Out (LIFO) Method:

The advantages of the last in first out method are:

Materials consumed are priced in a systematic and realistic manner. It is argued that current acquisition costs are incurred for the purpose of meeting current production and sales requirements; therefore, the most recent costs should be charged against current production and sales.

Unrealized inventory gains and losses are minimized, and reported operating profits are stabilized in industries subject to sharp materials price fluctuations.

Inflationary prices of recent purchases are charged to operations in periods of rising prices, thus reducing profits, resulting in a tax saving, and therewith providing a cash advantage through deferral of income tax payments. The tax deferral creates additional working capital as long as the economy continues to experience an annual inflation rate increase.

Disadvantages of the LIFO Costing Method:

The disadvantages or limitations of the last in first out costing method are:

1. The election of last in first out for income tax purposes is binding for all subsequent years unless a change is authorized or required by the Internal Revenue Service (IRS)
2. This is a "cost only" method with no right down to the lower of cost or market allowed for income tax purposes. Furthermore, the IRS requires that when last in first out is adapted an adjustment must be made to restore any previous right downs from actual cost. Should the market decline below LIFO cost in subsequent years, the business would be at a tax disadvantage. When

prices drop the only option may be to charge off the older (higher) cost by liquidating the inventory, however, liquidation for income tax purposes must take place at the end of the year. According to IRS regulations, liquidation during the fiscal year is not acceptable if the inventory returns to its original level at the end of the year. Interim external financial reporting principles impose a similar requirement when inventory is expected to be replaced by the end of the annual period.

3. LIFO must be used in financial statements if it is elected for income tax purposes. However, for financial reporting purposes, the lower of LIFO cost or market can be used without violating IRS LIFO conformity rules.
4. Record keeping requirements under this method, as well as FIFO, are substantially greater than those under alternative costing and pricing methods.
5. Inventories may be depleted due to unavailability of materials to the point of consuming inventories costed at older or perhaps the oldest prices. This situation will create a miss matching of current revenue and cost, sometimes companies using this costing method counteract this problem by establishing an allowance for replacement of the LIFO inventory account. Cost of goods sold is charged with current cost. The allowance account is credited for the access of the current replacement cost over the LIFO carrying cost for the inventory temporarily liquidated. When this inventory is replenished, the temporary allowance (credit) is removed and the goods acquired are placed in inventory at their old last in first out cost.
6. In standard number 411 "accounting for acquisition costs of materials, " the cost accounting standards board "CASB" precludes the use of LIFO except when applied currently on a specific identification basis. As a result, the use of this method, when an annual LIFO adjustment is made, is ruled out for government contracts to which CASB regulations apply.

The decision to adopt the last in first out method has had increased appeal in the last few years, due to an accelerated rate of inflation; however its adoption should not be automatic. Long range effects as well as short term benefits must be considered

Advantages of Average Costing Method:

Average costing method has the following main advantages:

1. It is a realistic costing method useful to management in analyzing operating results and appraising future production.
2. It minimizes the effect of unusually high or low materials prices, thereby making possible more stable cost estimates for future work.
3. It is practical and less expensive perpetual inventory system.

The average costing method divides the total cost of all materials of a particular class by the number of units on hand to find the average price. The cost of new invoices is added to the total in the balance column; the units are added to the existing quantity; and the new total cost is divided by the new quantity to arrive at the new average cost. Materials are issued at the established average cost until a new purchase is recorded. Although a new average cost may be computed when materials are returned to vendors and when excess issues are returned to the storeroom, for practical purposes, it seems sufficient to reduce or increase the total quantity and cost, allowing the unit price to remain unchanged. When a new purchase is made and a new average is computed, the discrepancy created by the returns will be absorbed