LOGICIELS DCi SOFTWARE
110-6600 Transcanadienne
Pointe-Claire, QC H9R 4S2
(514) 694-4878
www.dcisoft.ca

The Different Inventory Valuation Methods
(Or How to Make Life Easier by complicating it!)

You know there are many ways to evaluate corporate inventory (stock). Have you wondered if the method used by your management system suited the needs of your business? The answer is perhaps not as simple as you think.

In the next newsletter we will analyze two of the most commonly used inventory valuation methods: The **FIFO Method** and the **Standard Cost Method**. And, we will extrapolate the conclusions to the other methods in a comparison table.

In order to make the analysis more structured, let's establish from the start the various criteria to be retained during the evaluation:

- **Accuracy** or how well the chosen method reflects the value of the company's inventory. For example, one can easily agree that one will not use the same valuation method for the stocks of a lumber merchant as for the stocks of crude oil in a refinery.
- **Ease of Use.**
- **Accountability.** The method chosen must make it possible to allocate the fair share of the profits and losses on inventory handling (Profits on Sales, Purchasing Efficiency, Manufacturing Yield, etc.) to the managers concerned.

The FIFO Method (First In First Out)

This commonly used method establishes the value of a product in stock as if the items on hand at all times were the last received and, as a corollary, that the oldest items are always delivered. This, regardless of the order used in practice when handling the product.

- **Accuracy**
  Since modern management practices require assigning a new product number each time one of the characteristics of a product changes; it can be assumed that all products with the same stock number are functionally identical regardless of the age of the item selected. The bias provided by the valuation method is therefore negligible, if not intangible.
- **Ease of Use**
  The cost of a product in inventory is made up of the sum of the purchase price, shipping costs, insurance, customs and brokerage fees and the exchange rate if it comes from abroad.

  However, each of these cost components comes from different suppliers whose invoices for these costs and services often apply to different batches, arrive at different dates and often in different currencies. The effort of matching the different supporting documents on each receipt in complex situations (typical in a free trade world) quickly becomes phenomenal. But remember that you have to be able to relate these cost components to each of the units of each product in stock.

- **Accountability**
  In the world of the quiet nineteen hundred years, one could be content with precisely evaluating company inventories once or twice a year to ensure that actual profitability matched the profitability expected when establishing price lists. If there was a material difference, we carried out ad hoc analyzes to try to find the cause. The answer often came several weeks later.

Modern management practices require that the Cost of Sales (corollary of the cost of inventory) be known for each transaction in order to assess in real time the profitability of each of the products and sectors of the company. Often products are sold long before invoices for the various cost components reach us, and these often reach us after the due date for the preparation of periodic company results. Thus, according to this method, matching costs with products sold becomes tedious, and this complexity factor is increased tenfold in companies where stock returns are common.

The situation becomes even more serious in the case of manufacturing companies where the cost of purchasing the material used must be tracked for each batch of each stage of production.

The Standard Cost Method

This method, once used almost exclusively by manufacturing companies, is becoming more commonly used by companies operating in several other industries. It involves theoretically determining the cost of a product at the start of the business cycle and using that cost throughout the business cycle to value that product.

- **Accuracy**
  This method could be criticized for its lack of objectivity with regard to the Real Costs of the products. However, any good computerized system makes it possible to compare at all times the Actual Cost to date for a product (FIFO, Average or Last Cost) with the Standard Cost. Any uncontrollable variation (attributable to factors external to the company) is therefore detected in real time and the company can choose to modify the standard used during the year.

- **Ease of Use**
  One of the great advantages of the Standard Cost Method is that it simplifies the monitoring of the costs associated with each handling of the product. When using the FIFO Method, one had to assign each handling accessories related costs. One of the undeniable advantages of the Standard Cost Method is that it easily integrates into the cost of each product all the costs relating to the purchase of raw materials:

  - Transport,
  - Customs,
  - Brokerage,
  - Warehousing,
  - Insurance…

  Even if these costs (invoice) come from suppliers other than the supplier of the product.

- **Accountability**
  The standard cost determination exercise is done in coordination with the company's stakeholders who have some control over the Actual Cost of the product.

  For example, the buyer will be asked to indicate which should be for the next season, the cost (including all costs) of commodities used by the company. Any subsequent purchases at a cost other than the Standard Cost will create an accounting difference called « Variance » which will go to an accounting account specific to the purchaser in question. Its performance can thus be constantly evaluated.

It can therefore be seen that the performance of each function of the company directly responsible for one of the components of the cost or the Profit Margin (Purchasing, Production, Sales, etc.) can thus be assessed. It follows that the difference between the Budgeted Gross Profit and the Actual Gross Profit of the company for any given period can be explained by functional responsibility and consequently better controlled.

At ***DCi Software***, we recommend the use of the **Standard Cost Method**, but also allow the use of the FIFO Method, the Average Cost and the Specific Cost when necessary.

Here is therefore a table summarizing the different methods of valuation of stocks commonly used as well as their ease to meet each of the three criteria chosen.

Inventory Valuation Method	Accuracy	Ease of Use	Accountability
FIFO Cost	Very Good	Difficult	Poor
Specific Cost	Excellent	Very Difficult	Good to Very Good
Average Cost	Good	Very Difficult	Poor
Standard Cost	Good to Very Good	Very Easy	Excellent

Please do not hesitate to contact us with any questions or for more details!