LIFO

LIFO is the acronym for last-in, first-out. It is a cost flow assumption that can be used by U.S. companies in moving the costs of products from inventory to the cost of goods sold.

Under LIFO the latest or more recent costs of products purchased (or produced) are the first costs expensed as the cost of goods sold. This means that the costs of the oldest products will be reported as inventory.

It is important to understand that while LIFO is matching the latest or most recent costs with sales on the income statement, the company can be shipping the oldest physical units of product. In other words, the flow of costs does not have to match the flow of the physical units. This is why LIFO is a cost flow assumption or an assumed flow of costs. (If the costs flowing matched the physical units flowing, it would be the specific identification method and there would be no need to assume a cost flow.)

LIFO has become popular because of inflation and the fact that the income tax rules permit companies to use LIFO**.** With LIFO a company is able to match its recent, more-inflated costs with its sales thereby reporting less taxable income than would occur under another cost flow assumption. Also, the matching of the latest costs with recent sales is a better indicator of the company's current profitability.

Advantages of the LIFO method

The main advantages of the LIFO method are as follows

1. LIFO method is suitable for cost and revenue match.
2. The LIFO method is easy to operate and easy to understand.
3. LIFO method facilitates full cost recovery of materials.
4. The LIFO method is best suited when prices rise.

Disadvantages of the LIFO method

The main disadvantages of the LIFO method are as follows

1. Inventory valuation does not reflect current prices and is therefore useless in the context of current conditions.
2. Due to the difference in prices, the cost of the similar job cannot be compared.

3. The accounts become complicated and cumbersome when the receipt rates are very volatile.
4. LIFO involves major written work.

Working of LIFO

Under LIFO, the business records its latest products and inventory as the first items sold. The opposite way is the FIFO, where the oldest stock is recorded as the first sale. Although the company may not literally sell newer or older stocks, it uses this assumption for cost accounting purposes. If the cost of purchasing the stock is the same each year, it will not make a difference whether the company uses LIFO or FIFO methods. But costs change because the price for many products goes up every year.

Example

Bike LTD purchased 10 bikes during January and sold 6 bikes, details of which are as follows:
January 1 Purchased 5 bikes @ $50 each
January 5 Sold 2 bikes
January 10 Sold 1 bike
January 15 Purchased 5 bikes @ 70 each
January 25 Sold 3 bikes
The value of 4 bikes held as inventory at the end of January may be calculated as follows:
The sales made on January 5 and 10 were clearly made from purchases on 1st January. However, all sales made on January 25 will be assumed to have been made from the purchases on January 15. Therefore, the value of inventory under LIFO is as follows:

Date	Purchase			Issues			Inventory		
	Units	$/Units	$ Total	Units	$/Units	$ Total	Units	$/Units	$ Total
Jan 1	5	50	250				5	50	250
Jan 5				2	50	100	3	50	150
Jan 10				1	50	50	2	50	100
Jan 15	5	70	350				5	70	350
Jan 15							7		450
Jan 25				3	70	210	2	50	100
							2	70	140
							4		240

As can be seen from above, LIFO methods allocates cost on the basis of earliest purchases first and only after inventory from earlier purchases are issued completely is cost from subsequent purchases allocated. Therefore value of inventory using LIFO will be based on outdated prices. This is the reason the use of LIFO method is not allowed for under IAS 2.

Difference between LIFO & FIFO

BASIS FOR COMPARISON	LIFO	FIFO
Meaning	LIFO is an inventory valuation technique, in which the last received stock of goods is issued first.	FIFO is an inventory valuation technique, in which the first received stock of goods is issued first.
Stock in hand	Represents the oldest stock	Represents the latest stock
Current market price	Shown by the cost of goods sold	Shown by the cost of unsold stock
Restrictions	IFRS, does not recommend the use of LIFO for valuing the	No such restriction

	inventory in accounting.	
Inflation	Income tax shows minimum amount, when there is inflation in the economy.	In inflationary condition, income tax shows a higher amount.
Deflation	In case of deflation, larger amount of income tax is shown.	Reduced income tax will be shown in deflationary conditions.