FIFO

The first in, first out (FIFO) method of inventory valuation is a cost flow assumption that the first goods purchased are also the first goods sold. In most companies, this assumption closely matches the actual flow of goods, and so is considered the most theoretically correct inventory valuation method. The FIFO flow concept is a logical one for a business to follow, since selling off the oldest goods first reduces the risk of inventory obsolescence.

Under the FIFO method, the earliest goods purchased are the first ones removed from the inventory account. This results in the remaining items in inventory being accounted for at the most recently incurred costs, so that the inventory asset recorded on the balance sheet contains costs quite close to the most recent costs that could be obtained in the marketplace. Conversely, this method also results in older historical costs being matched against current revenues and recorded in the cost of goods sold; this means that the gross margin does not necessarily reflect a proper matching of revenues and costs. For example, in an inflationary environment, current-cost revenue dollars will be matched against older and lower-cost inventory items, which yield the highest possible gross margin.

The FIFO method is allowed under both Generally Accepted Accounting Principles and International Financial Reporting Standards. The FIFO method provides the same results under either the periodic or perpetual inventory system.

Advantages of FIFO

Here are the advantages of the FIFO method.

1. FIFO method is easy to understand and operate.

2. The FIFO method is useful when transactions are not large and material prices decline.

3. FIFO method is suitable for bulky materials with high unit prices.

4. FIFO method helps avoid deterioration and aging.

5. The closing value of the stock of materials reflects the current market price.

Disadvantages of FIFO

Here are some disadvantages of the FIFO method.

1. FIFO method is not suitable if a lot of contracts were purchased during the period at different prices.

2. The goal of matching current costs with current revenue cannot be achieved under the FIFO method.

3. If the price of materials increases rapidly, the current production cost may be reduced.

4. FIFO method overstates profit, especially in inflation.

Working of FIFO

The FIFO method is used for cost flow assumption purposes. In manufacturing, as items progress to later development stages and as finished inventory items are sold, the associated costs with that product must be recognized as an expense. Under FIFO, it is assumed that the cost of inventory purchased first will be recognized first. The dollar value of total inventory decreases in this process because inventory has been removed from the company's ownership. The costs associated with the inventory may be calculated in several ways — one being the FIFO method.

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. Of the sales made on January 25, it will be assumed that 2 bikes relate to purchases on January 1 whereas the remaining one bike has been issued from the purchases on 15th January. Therefore, the value of inventory under FIFO 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				2	50	100			
				1	70	70	4	70	280

As can be seen from above, the inventory cost under FIFO method relates to the cost of the latest purchases, i.e. $70.