INVENTORY VALUATION METHODS 06 JUNE 2013

Lesson Description

In this lesson we:

- Seek to understand the theory behind the two stock valuation methods of FIFO and weighted average
- Apply the two stock valuation methods in a practical activity
- Compare the two stock valuation methods and advise a business

Key Concepts

Important Theory to Learn

- These methods are applied when we want to value our Trading Stock
- It may be challenging to value Trading Stock if prices rise continually (like in our economy!)
- A business can decide on one of several methods (FIFO and weighted average)
- The method chosen should be used consistently throughout the existence of the business (Why?)

Characteristics of FIFO

- Stands for First-In-First-Out
- The stock that was bought first is sold first (oldest stock sold first)
- Closing stock will be valued at the most recent price
- Suitable for any type of business
- Often used by businesses that sell perishable goods
- Shops will display their trading stock in such a way as to encourage customers to purchase the oldest stock first
- Realistic because stock values at the end of the year are calculated at the most recent prices

Characteristics of the Weighted Average Method (WAM)

- Calculate stock value by dividing the total cost of all the merchandise by the number of units in stock
- High prices are averaged with low prices – this means that the gross profit may not reflect current market conditions

Make sure you know how to calculate the following:

- No. of units on hand (closing stock) at the end of the month or year
- Value of the closing stock according to **both** methods
- Value of the cost of sales according to **both** methods
- Value of the gross profit according to **both** methods
- Also ensure that you can comment on your answers and compare the two systems!

Questions

Question 1

The following information relates to the trading activities of Nyathi Traders for the financial year ended 28 February 2013.

The business is owed by S Nyathi. The business sells only one type of overhead projector and has decided to keep the selling price constant throughout the year.

Mr Nyathi is keen to secure a loan from the bank. He wants to ensure that the profit in the financial statements creates a very favourable impression with the bank.

The business uses the periodic inventory system and the FIFO method of valuing stock.

Information

	Number of units	**Unit price R**	**Total R**
Sales for the year	?	1 400	252 000
Stock on hand on 1 March 2012	40 units	950	38 000
Purchases during the year	210 units		170 000
June 2012	30 units	900	27 000
October 2012	80 units	850	68 000
January 2012	100 units	750	75 000

Questions

a.) Calculate the total number of overhead projectors sold during the year. (3)

b.) Calculate the total number of overhead projectors on hand at 29 Feb 2008. (3)

c.) The business uses the FIFO valuation method.

i. Calculate the closing stock using the FIFO method. (3)

ii. Calculate the gross profit for the year ended 29 February 2008 using the FIFO stock valuation method. (5)

d.) In order to secure the loan the owner, S Nyathi, wants to change the stock valuation method to the weighted average method.

i. Calculate the value of the closing stock by using the weighted average stock valuation method on 29 February 2008. (5)

ii. Calculate the gross profit for the year ended 29 February 2008 using the weighted average stock valuation method. (3)

e.) In your opinion, will it be ethical for Mr Nyathi to change the method of stock valuation? Give ONE reason for your answer. (2)