ACCOUNTING

STOCK VALUATION METHODS

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1. Introduction

Many systems are used for the valuation of stock gives guidance on the accounting treatment of stocks. According to this accounting standard, the determination of profit for an accounting period involves the allocation of costs to reporting periods. As part of this process, the cost of unsold or unconsumed stocks is, to the that it is believed to be recoverable, carried forward until the period in which the stock is sold or consumed. It is for this reason that we include opening stocks but not closing stocks in the cost of sales in the trading account.

2. First-In-First-Out method (FIFO)

Where the market price of material shows a constant trend, this method is not only to be recommended but it can also truthfully be said that it is the most effective valuation method. The method functions on the principle that material that is **purchased first is used first.** The valuation is based on purchase price. This method makes provision for the fact that a unit and its price cannot be separated, since it is a basic principle to issue the oldest stock first.

2.1 The advantages of the system are as follows:

* Materials are used at their actual purchase value.
* Estimation is easy, since stock is issued on the basis of the purchase price.
* Control over stock is facilitated, particularly over the quantities that should still be in stock.
* It is easy to identify stock in conjunction with the current inventory system.

2.2 The disadvantages of the system are as follows:

* Such a system is often associated with a great deal of administrative work, since stock invariably
  becomes mixed up and it can be very difficult to determine which stock was purchased first.
* Changes in stock prices can confuse the warehouse staff to such an extent that they cannot keep
  up with the actual purchase price.
  Information regarding the actual purchase price would as a result not be reliable.
* Income statement information is misleading because profits and losses on stock are not
  accounted for.
* The value of stock on the balance sheet is too high or too low because it is not valued according
  to the current value.

3. Weighted average method

This method must be distinguished from the average method of valuation, which is not practicable. Stock is issued at a price calculated as follows:

Balance + value of current purchases = total value.
Then: total value ÷ total units = new issues price per unit

3.1 The advantages of the system are as follows:

* Since less stock is received than issued, there are fewer calculations than for the **FIFO** method.
* Material price high and low points are eliminated.
* With this system, all units in the issue group have the same unit price.
* Fluctuations in production profits and losses are at minimum.

3.2 The disadvantages of the system are as follows:

* A great deal of administrative work is required, such as the calculation of average price, keeping
  stock up to date and the valuation of material requisitions.
* Higher or lower prices affect the price long after the material has been purchased.
* The price at the end may be fictitious and never occur in the market.

3.3 Points to note: Weighted Average Method

* **Periodic inventory system:**

We divide the total cost of similar items for a specific period by the total number of items bought during that period. This gives us the weighted average per unit. We multiply the closing inventory units by the weighted average cost price per unit to find the value of the closing inventory.

* **Perpetual inventory system:**

We recalculate the cost on a weighted basis each time items are bought. We record the cost price of items that are sold in the cost of sales account at the new weighted average. We also refer to this method as the moving average method.

* In **GAAP** inventory is valued at the lower of cost value and net realisable value.

* The method used to allocate a cost to inventory items should be the one that results in the most **realistic** way to calculate the profit for the relevant business.

* When the **weighted average cost method** is used to establish the cost of closing inventory of a business that uses the **periodic inventory** method for recording inventory, We divide the total cost of similar items for a specific period by the total number of items bought during that period.

* When the **weighted average cost method** is used to establish the cost of closing inventory of a business that uses the **perpetual inventory** method for recording inventory, we recalculate the cost on a weighted basis each time items are bought.

* We must be **consistent** in applying a chosen method to calculate the cost of closing inventory, so that we can make worthwhile comparisons between the financial results of different accounting periods.

4. APPLICATION / EXERCISE / ACTIVITY

Gems, owned by S Sipho, sells cellphones. The business uses the inventory system and the weighted average of valuating stock. The financial year ends on 29 February 2008.

REQUIRED

1. Use the weighted average method to calculate the following (Round off calculation to the nearest Rand):
   1.1 Value of stock on hand on 29 February 2008.
   1.2 The number of cellphones stolen.
   1.3 Gross profit for the year ended 29 February 2008.

2. The owner, S. Sipho, is deciding to change the stock valuation method from the weighted average to FIFO. Calculate the gross profit using the FIFO method.

3. Calculate the value of closing stock using the FIFO method.

4. Which method of stock valuation provided above do you consider to be a better method for this business? Give one reason for your choice.

The foll. Information appeared in the records of GEMS for the year ended 29/02/08. The business uses a fixed selling price of R990 to remain competitive

	Units	Unit Price	Total Price
Cell phones on hand:1 March 2007	290	R540	R156 600
Purchases of Cell phones: -			
June 2007	300	R570	R171 000
September 2007	180	R600	R108 000
November 2007	950	R550	R522 000
January 2008	400	R610	R244 000
Cell phones per stock take:29/02/08	330	?	?
Sale of Cell phones	1750	R990	?

SUGGESTED ANSWERS TO ACTIVITY: INVENTORY VALUATION

1.1. A Calculation of the weighted average price

Opening stock of cellphones: 290 units x R540 = R156600
Purchases of cellphones:
June 2007: 300 units x R570=R171 000
September 2007: 180 units x R600=R108 000
November 2007: 950 units x R550=R522 500
January 2008: 400 units x R610=R244 000
212 R1045 500

Therefore:
R1045 500 / 2120 = R493
Weighted Average Price

B Value of stock on hand : 29 February 2008 330 units x R493 = R162690

1.2

Number of cellphones available for sale (290+300+180+950+400)	2120
Less: Number of cellphones sold	(1750)
Number of cellphones on hand	370
Cellphones per stock take: 29/02/2008	(330)
Number of cellphones stolen	40

OR

	Number of cellphones
Opening stock	290
Purchases(300+180+950+400)	1830
Available for sale	2120
Less:Closing stock	(330)
Number to be sold	1790
Number **actually** sold	(1750)
Therefore number stolen	40

1.3

Sales (1750 X R990)	1732500
Cost of Sales (1750 X R493)	862750
Gross profit	869750

2.

Sales (1750 x R990)	1732500
Less: Cost of Sales (FIFO)	(976400)
290 x R540 = 156600 300 x R570 = 171000 180 x R600 = 108000 950 x R550 = 522500 30 x R610 = 18300 976400	
Gross profit	**756100**

3. 330 cellphones x R610 = R201300
4. FIFO Control over stock is facilitated, especially over the quantities that should still be in stock.