Why RetailEdge Uses Average Cost for Inventory Valuation and Cost of Goods Sold

Inventory Management · https://retailedge.com/docs/why-retailedge-uses-average-cost-for-inventory-valuation-and-cost-of-goods-sold

How RetailEdge Calculates Inventory Cost

RetailEdge tracks inventory by average cost. So if have 8 items at $15.00 and buy 10 more at a discounted cost of $11.00. RetailEdge would calculate the cost of your inventory with average cost $12.78. RetailEdge uses this average cost for calculating your total inventory valuation:

Qty 8 * cost of $15 + Qty 10 * Cost of $11 = $230 total inventory cost / Total Qty 18 = $12.7778 Average Cost.

The average cost is then used when you sell something. Although this is an average, most businesses that we deal with can't guarantee that they are are selling the the First Item in. Take for instance a store that is selling Jackets and putting them on a rack. Can they guarantee that the customer pulls the first item they brought into inventory off the rack or the last one? Also think about how many times you reach for the Milk at the back of the cooler to get the item that has the longer expiration date.

Comparing FIFO (First In First Out) and LIFO (Last In First Out) to Average Cost.

If I use FIFO and the customer chooses the correct item that my system thinks I am selling, obviously my inventory valuation and cost of goods sold it 100% accurate.

If I use FIFO and the customer selects one of the newer "discounted" items to buy, then the FIFO system will think I am selling something that costs $15.00 but really I am selling something that is only $11.00, so my cost of goods sold will be off more that if I use an average cost of $12.78. In addition, my inventory will be off by more than if I use average cost.

Another inventory accounting method some people use is Last In First Out (LIFO) and Last Cost. These methods have the same limitations.

Why Does RetailEdge Use Average Cost?

Using the average cost does two things:

1. It accounts for the retail reality that the business owner has limited control over which item a customer chooses and minimizes the impact that choosing the "incorrect" item causes in inventory costs and cost of goods sold.
2. Matches what a number of accounting packages use for tracking inventory costs (QuickBooks being one of them).

Usually accountants are fine with using average cost as long as they know that you are doing it this way.