Why RetailEdge Uses Average Cost for Inventory Values

Inventory Management · https://retailedge.com/docs/why-retailedge-uses-average-cost-for-inventory-values

RetailEdge tracks inventory by average cost. For example, if you have 8 items at $15.00 and buy 10 more at a cost of $11.00. RetailEdge would calculate your inventory as having an average cost $12.78. RetailEdge uses this average cost for calculating your total inventory valuation $12.78 * 18 = 8 * $15 + 10 * $11 = $230.

The average cost is then used when you sell an item. Although this is an average, most businesses that we deal with can't guarantee that they are are selling the the First Item in (First In First Out or FIFO). 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 how many times do you reach for the Milk at the back of the cooler to get the item that has the longer expiration date.

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 than if I use an average cost of $12.78.

Other inventory accounting method some people want to use is Last In First Out (LIFO) and Last Cost. This methods have the same limitations as FIFO. **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.