Material Costing for Subsequent Valuation

Once inventory has been received into stock, it is subject to the lower of cost or market (LCM) rule. In essence, this rule states that the recorded cost of inventory should be at the lower of its recorded cost or the market rate. From a practical perspective, this rule is usually only applied to those inventory items having the largest extended costs. Its application to low-value items would not result in any material changes, and so is avoided from an efficiency perspective.

A cost layering concept must also be applied to inventory. Cost layering refers to the order in which inventory items are charged to the cost of goods sold when units are sold to customers. Several possible cost layering concepts that can be used are noted below.

Specific Identification Method

The *specific identification method* assigns costs to specific units of inventory, and charge these costs to expense when the specific units are sold. Usually only applies to expensive and unique inventory items.

First In, First Out Method

The *first in, first out method* assigns costs based on the assumption that the earliest goods acquired are the first ones sold. If prices are increasing, this tends to result in higher profits.

Last In, First Out Method

The *last in, first out method* assigns costs based on the assumption that the last goods acquired are the first ones sold. If prices are increasing, this tends to result in lower profits. This method is not allowed under international financial reporting standards.

Weighted Average Method

The *weighted average method* uses an average of the costs of all units in stock when charging costs to the cost of goods sold.