



Islamic University-Gaza

Faculty Of Commerce
Department Of Accounting

Methods of Inventory Valuation Application and Limitation

A Graduation Research Proposal
Presented to the
Faculty of Commerce
The Islamic University of Gaza

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Islamic University – Gaza
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الجامعة الإسلامية - غزة
كلية التجارة
قسم المحاسبة

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A Holy Qur'an Verse



﴿ وَقُلْ أَعْمَلُوا فَسَيَرَى اللَّهُ عَمَلَكُمْ وَرَسُولُهُ وَالْمُؤْمِنُونَ ﴾

سورة التوبة - الآية 105

صدق الله العظيم

Dedication

We dedicate this work to our lovely Palestine, to second home of Islamic university, and to our parents, who sacrificed everything in their life for us, and also we thank them for pushing us to success. For all of Those, Who are inspiring us and see us on our way.

Acknowledgement

In the beginning, we thank Allah for giving us the strength and health to let this work see the light and our parents for their help and support.

Our Prophet Mohammed said: “Who doesn’t thank people he doesn’t thank Allah”.

*We want to thank everyone help and participated in making this study starting from our honorable: **Mr. Salah Shubair.***

Who put a lot of faith in our capabilities and encouraged us to complete this study.

We thank all of our teachers in the faculty of commerce and our colleagues and friends for their support.

Abstract

The study aims to discuss and evaluate one of the accounting problems, which is choosing proper method for inventory evaluation, that play an important role in the evaluation of businesses financial position and net income.

There are many factors affecting the business decision while choosing any of these methods which depending on the environment and the nature of the business. This study aims to aware of the most methods used in the evaluation of the inventory and the limitations of adopting them.

Finally, we recommended the importance of the role of the vocational associations in setting course and workshops identifying advantages and disadvantages of these methods of inventory evaluation, and helping the facilities owners to acknowledge the optimal method suiting.

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Chapter one

Research Background

1.1 Introduction

In the present stores are represent an important role in the economies of all nations, whether developed or developing capital for its functions tasks and services to enterprises and economic sectors of production and service all alike (Ghanim,1986:3), and commodity stocks is one of the items traded in non-cash assets of interest to the majority of businesses and industry in While less attention in this service installations (Sebai,1998:86), because of its direct impact on business results and financial position and financial lists, one of the most important tools for supply and delivery of information on economic activities of the business and any change in a commodity stocks directly affect the significance of such lists and the value of their information for users, as well as to their suitability both followed the economic unity inventory system periodic or continuous (Sabban,1997:16).

A variation in inventory pricing method has a direct impact upon net income and current assets. Management personnel, stockholders and investors all need to be accurately aware of current financial position and earnings. The security and Exchange commission also has indicated the importance of proper inventory determination to income statements.

One of the most important ways to assess the commodity stocks all the way from first issued the first, the way the first and finally by the weighted average method.

1.2 Research problem

There are several methods of inventory valuation, which produces a different effect on income when prices are in a state of increase or decrease. Because price increases have been more common, the selection of one method or shifting from one method to another requires careful analysis. We discuss the different accounting methods and multiple consequent difference in business results and the list of income and financial position, which raises questions about the causes and factors affecting the decision established to determine the method used to assess Stocks to have.

1.3 Research objective

This research seeks to achieve the following aims:

1. Identify the reasons for not applying any of the methods in the evaluation of commodity stocks.
2. Analyzing the most commonly used methods "FIFO" and weighted average used for pricing inventories.
3. Defining the conditions under which specific methods should be used.
4. The most important reasons behind the selection method without the other.
5. Clarifying the importance of a way of accounting in evaluating commodity stocks.

1.4 Research importance

1. Contribute to the study analyzed one of the important problems in accounting thought a problem of the alternative between multiple alternatives.
2. This research is the source of information for all concerned in this issue of accountants, institutions and citizens would spell out the terms of the importance of choosing how to fit installations as active in evaluating commodity stocks.
3. This research may contribute to reducing the error when assessing the stock and access to real net profit, which reflects the fact that a treaty, which benefit all shareholders, creditors, management, the Government, was represented by income tax and other users of accounting data.

1.5 Research limitations

The research was limited by several various factors, some of which are stated as follows:

1. Books and periodicals were limited by availability of research material found in the University's library.
2. The researcher was unable to conduct other types of research due to financial restrictions.

1.6 Research Methodology

Research takes the theoretical study, which is obtained the necessary information of the topic of Inventory valuation through books, references. As for the reason for our choice for this research due to its importance

practical life, where the first goal of the establishing of the project, whether large or small is how to select the inventory evaluation method

1.7 Literature Review

Study Morse and Rachardson, "1983" entitled :

"First, the decision to use a first or contained finally I issued."

This study aimed to examine factors affecting the use of the first of a first or method contained finally I issued. This study has shown that the only factors affecting the choice of conversion resolution are differences between the two tax high in the early years of transition from the way the first issued to the first method contained finally issued first, the size of the company a major factor in the decision-making companies which are major shift from first, by the way the first to the method contained finally issued because the first provided by the tax outweigh the costs associated with the conversion process.

The study demonstrated that similar companies, which in the same industry always strives to choose the same routes such as accounting and similar relationship between the owners (shareholders) and creditors (bondholders) affect the decision when there is a written conditions in the contract of bonds and the company maintained.

Study Bohan and Robin, "1986" entitled:

"LIFO FIFO How Would it Work."

This study aimed to examine ways of accounting for inventory and assessment of each of the first method and manner by first contained finally issued first axis of the study.

The study pointed out that in the way the first issued first it will be calculated on the basis of the cost of stock chronology for the arrival of procurement of stores and the stock represents another period of such goods that were purchased recently, the basic objective of this method is the desire of the business in achieving rapprochement between the cost of the flow and flow physical inventory, especially if the disbursement of stores in accordance with this method in this case are similar to the way these roads discrimination specified in the calculation of the cost of stock last term and the main advantages of this method is that stocks are assessed another term on the basis of purchase prices this modern inventory list will be worth more financial position The most realistic and disadvantages failure to meet current revenue as the current cost of sales that this cost is the oldest purchase prices of materials.

One of the most important results of the study that set out how I finally give a better picture of where they entered the period offset the cost prices in recent years, with revenues rising prices. This method helps to prevent the acquisition of profits in return, but there is a substantial reduction in the value of stocks the end of term.

Study Dopuch and Pincus "1988" entitled:

"Evidence on the Choice of Inventory Accounting Methods: LIFO versus FIFO "

This study aimed to examine the reasons of tax and non-tax paying company to shift from the way to another when dealing inventory.

This study has shown that some companies prefer to use the first issued first for fear of some value stocks that could decrease as a result of lower profits in case the shift to the way the recently issued first, and there are

companies that seek to show greater value for the company's assets and profits for the Show Commitment to certain contract terms with creditors, and companies that use the first method is the first by large corporations or small companies how to best use the first issued first because that helps them raise the value of its assets and thus can obtain long-term loans, and tax considerations are very important in Some companies that wish to reduce their income to pay less tax and those using the method contained recently issued first.

It was one of the most important results of the study method that finally issued the first method is most appropriate for companies where the proportion of high inventory turnover.

Study Johnson and Dhaliwal, "1988" entitled:

"LIFO Abandonment"

This study aimed to examine the circumstances surrounding the companies that have nothing to do about the way the recently issued first in the assessment of stocks.

The study, the companies that suffer from a drop in profits and a decline in its stock price is that worked to abandon this method, despite the apparent increase in the tax burden to companies that have moved away from this method had suffered heavy losses compared with companies that continued to Application of this method, and a large number of companies have abandoned the method in an attempt to raise working capital so consistent with the requirements of contractors.

Study Lindahil, "1989" entitled:

"Analysis of a flexible choice of accounting for inventory"

This study aimed to examine factors affecting the choice of the method of valuation of inventory and analysis of these factors.

This study has shown that the higher the tax rate trends to shift from the way the first issued to the way I finally contained a first and companies that live in the same circumstances receives inflation, the usefulness of the largest tax whenever retained stocks higher .The degree of inventory turnover has an inverse relationship with the desire to apply the method recently issued I. The more the degree of turnover stock sold for about the cost of its value in the way the first case of a first.

This study has recommended that companies facing a large fluctuation in demand must move away from using the method recently issued first of what may cause these frequencies in demand from a drop in stock levels unwanted and that leads to profits is not real

And that the more debts and obligations of the company is unlikely to employ a method contained recently issued first to evaluate the stock, because the use of this method reduces profits and reduce stocks last term which may show the company in a difficult liquidity to its creditors.



Chapter Two

Introduction Of

Inventory

2.1 What Is Inventory?

Before defining the inventory, We have to discuss the need to the inventory; because, if the goods are immediately delivered to the customer, then there is no need to make an inventory, unless if we want it as insurance against the change in price ,“despite the high development of technology, transportation, and the management practices, the process of purchasing, manufacturing, and selling steel functioning in volume that doesn’t eliminate the need for keeping inventory” (Hajaj and others:523) ,The firms are keeping the inventory to meet the customer need fast to prevent the customer turnover, also the production process would not produce the needed flow of product if the firm did not keep a level of inventory that satisfies the needs. The need for inventory rise from its use as a tool for correcting the errors in planning, and the unexpected change in the supply and demand (Al-Rawi and HE, 2000:523).

In addition the are three main motives for establishing and maintaining the inventory:

1. **Transaction Motive:** focus on keeping inventory to insure the continuity of the production and seals processes.
2. **Precaution Motive:** keeping the inventory to protect the firm from the unexpected changes in the power of supply and demand, and other factors.
3. **Speculative Motive:** which affects the decision of increase of decrease the level of inventory in order to benefit from the changes in prices.

These three motives are concerned with reducing the production purchase cost; protect the firm form the lack of inventory threats.

Although the importance of the inventory the company may have financial losses by using bad policies in controlling the inventory (Kaabor, 1992:297).

There were many definitions contained in this field and displays many of the book to the definition of inventories.

The General American CPAs may be known as "set of items of tangible personal property that is acquired for the purpose of selling in the normal business cycle or at the production stage for the purpose of sale or that are currently expected to be used in the production of goods and services necessary to meet the needs of sales" (A.I.C.P.A, 1961:27).

The Abdullah Jafar has been known **inventory** that "the goods owned by the facility in the last financial period, whether they are in warehouses or outside these stores are different quality vocabulary of these goods according to the nature of the activity established", and intended nature of the activity that if the activity was established is to buy merchandise ready for resale shall be finished goods are representing inventory, If the established industrial the inventory is an raw materials, goods under operating and manufacturing finished goods ready for sale, the inventory is not just what is available in the stores of the entity only goods, but also outside the stores and is the (Jafar ,2003:497):

1. Goods sent for the purpose of selling agents commission and is not sold until the end of the financial period.
2. Purchased goods are still on the way to not enter the facility after the stores.
3. Goods sent to some customers under selling system or Reply.

And others definitions as "out of the held for sale in the ordinary course of business of the facility or keep it in a stage of production to become viable for sale or held in the form of raw materials or tasks used in the production process or in the provision of services" (Ali,2004:164).

2.2 Changing in accounting policy

According to IAS 8, a change in accounting estimate is an adjustment in the following that results from the assessment on the basis of present and expected future conditions:

1. The carrying amount of an asset or a liability, or
2. The amount of the periodic consumption of an asset, that results.

The reasons for changes in estimates can be any of the following:

1. Changes occurred in the circumstances on which the estimate was based.
2. New information gathered.
3. More experience gained.

However, IAS 8 has not defined specifically a change in accounting policy just like a change in accounting estimate has been defined specifically. However, we do know what is accounting policy, as this has been defined, and we can this definition to understand the change in accounting policy.

According to IAS 8 accounting policies are: the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

In simple words accounting policies are principles, bases, conventions, rules and practices applied by an entity to portray the financial effects of business transactions and other events. This requires selection of:

1. Recognition criteria.
2. Measurement basis.
3. Presentation format.

Every element of the financial statements requires rules for at least these three aspects and this is what accounting policies are. Accounting policies tell how an element will be recognized, measured and presented in the financial statement.

So, we can understand from this analysis that any change in any of the above three aspects will constitute a change in accounting policy.

Now is that change in inventory valuation method is a change in measurement base and it is not just an adjustment in the carrying amount of the inventory thus **it is a change in accounting policy.**

If company changes its inventory valuation method from FIFO to weighted average method then it is basically changing the principle of valuation as FIFO follows a particular cost flow assumption whereas weighted average method uses weighted average of the cost at which inventory was held at the beginning of the period and cost of the goods bought during the period. So, both methods use different basis to value the closing inventory.

2.3 The importance of the Inventory

The importance of the inventories can be summarized as follows (Ali, 2004:166).

1. Inventory is a part of the current assets, it affect the liquidity of the firm, and affect the working capital of it.
2. The ending balance of the goods inventory will affects the gross margin and the net profits of the period, cause high ending balance of inventory will produce a low level of gross margin and net profits, and vice versa.
3. The ending balance of inventory have an effect on the cost of goods sold specially in the periodic inventory system, its known that cost of goods sold is one of the cost element that use in the calculation of the operations income and the activities income.
4. Errors in the evaluation of the ending inventory will affect both the income statement and the statement of financial position, mainly in the gross margin, net profit, owner equity (retained earnings), and current assets (the inventory balance).
5. Errors in the evaluation of the cost of goods sold and ending inventory at the end of the period of leave a significant effect on the financial ratios and its effectiveness in evaluating the performance of the firm.
6. Effect on the taxes and the profit distribution and gives indicators if there is a liquidity dividend.

2.4 Risks rises from errors in the inventory valuation

Most important risk that rises from the errors in the inventory valuation is the increase in costs of inventory, which represented in (said, 1993:257):

1. Risk on the liquidity percent, and working capital.
2. Risk on the optimal use of the production power.
3. Risk on the career stability of the employees.
4. Risk on share price, creditability and granting credit.

The correct evaluation and effective reporting leads to saving the invested capital and solving the problems, which occurs, form the errors in evaluation, form that the problem of choosing the proper valuation method arises, so the firm should use the proper way of evaluation, which complies with its needs, and conditions (Srouf, 1993:274), And it remains important to evaluate and report inventory in comparison to the other items in the financial statements (Abu Hassan, 1997:7).

2.5 Types of the inventory

How a firm classifies its inventory depends on thy firm type of business, is it a merchandising or manufacturing firm. In the merchandising firms, they need only one type of the inventory classification (Obaidat, 1999:314):

Merchandise inventory: It consists of raw materials and parts that go into manufacturing a particular product of the company during the production process to him and includes spare parts for machinery and equipment used in the production.

From other point of view, in the manufacturing firms there are three common classifications of the inventory:

1. **Raw Material:** which is the input of the manufacturing process that manufacturer use to get their final product.
2. **Work in Process (WIP):** which is the portion of the manufactured inventory that has been placed into the production process but is not yet completed.
3. **Finished Goods Inventory:** which is the manufactured items that are completed and ready for sale.

2.6 Valuation of inventory

The accounting for inventory represent a high priority for the manufacturing and merchandising firm, and that because the value of the inventory and the cost of goods sold rises as the most important elements of the financial statements, and the ability to evaluate the inventory Accurately is the first step in the successful operation of maximizing the investment profit.

And the valuation of inventory is an important function that accountant pay a lot of their times performing it, especially the valuation at the end of the accounting period because of its significant effect on the profit and loss, owners' equity ,and tax payment(Jafar,2003:501).

2.7 Errors effects in the valuation of inventory

The main objective for accounting for inventory is the correct determination of the income by matching the revenues of specific period with is expenses, inventory is a current assets that have an effect on the income, gross profit and the financial position also inventory is important

assets from the view of his huge value in comparison with other assets, any errors occurs in calculating the value of inventory will lead to errors in current assets and owner equity, also it will affect cost of goods sold. The error in the valuation of a period inventory ending balance will affect the inventory valuation in the following periods cause the ending inventory of a period is the begging of the following period, and as result of this error the value of income in the period and the following periods will be over or under value with the amount of the error (Zaki, 1997:90).

So there should be an accuracy in valuation of inventory to avoid errors that affect the output of firms activities (Hayali,2002:212), cause it's important to improve the accuracy of the accounting measurement of the error. Any error have a significant effect on the results of the financial ratios that concern with liquidity, profitability, and meeting obligations (Matter, 2000:121).

2.8 Objectives of inventory valuation

The objectives of the inventory valuation in:

1. The main objective for the ending inventory accounting is the correct determination of income by comparing the revenues with expenses for specific period, and making a comparison between the revenues and costs related to those revenues, to determine the results of operation if its loss or gain during the period. The interest of inventory valuation rise from the accounting principles that record the revenue at the time of sales which requires the distribution of the cost between the sealing periods of the inventory go guarantee the correctness and the accuracy of the comparability processes, to accomplish the objective the inventory is evaluated at

the price of purchase in the merchandize firms and at the cost of production in the manufacturing in the manufacturing firms. And the goal is to divide the inventory held for sale into two parts, first part represent the cost of goods sold during the period, which will be deducted from the revenues, and the second part represent the ending balance of inventory which will be transfer to the next period as a begging inventory (Noor,1999:178).

2. To introduce information about the inventory to the investors ,and other users of financial statements to help them to prepare the future cash flows wither its inflows or outflows, thus available ending inventory represent cash inflow in the case of sales and the volume of inventory also affects the needed purchases thus the cash outflows (Shokeir,2000:72).

2.9 The accounting concepts related to the inventory

valuation:

1. **Objectivity:** objectivity in accounting refer to the lack of bias from the accountant when measure the financial data, this mean that these data did not affected by the judgment or the personal estimations of the accountant. To comply with this concept the accountant must rely on outside evidence insure the correctness of the inventory measurement, such as purchase invoices, purchase orders. Objectivity does not mean the existence of completely correct estimations, because many of estimations have the possibility for correctness and error (Defi, 1980:163).
2. **Consistency:** This implies consistent treatment of similar items and application of accounting policies, and this includes the application of the same inventory valuation method, measurements,

and procedures and policies for consequent periods (Hanan, 2003:205).

3. **Conservatism:** this implies that under the uncertainty and existence of two acceptable alternatives to measure the inventory, the accountant should choose the alternative that produce the lowest amount of inventory, and this directs the accountant to choose the alternative that will result in less net income or less asset amount. Conservatism evaluates current assets under cost or market values, which is lower (Defi, 1980:164).
4. **Materiality:** under this concept the financial data are treated as the materiality of its effect on the decision of the financial statement users, the choice of the inventory valuation method will affect the financial data the will be processed under the procedures and policies of the adopted method to generate the final information that use in the decision making (Hanan, 2004:120).

2.10 Inventory counts

Is the determination of the quantity of inventory according to the weight, number of unites, and other measurements for each item of the inventory, and determine the value and price for each (Noor,1999:177), in order to calculate the revenue and to give accurate presentation for the financial position of the firm.

To assurance about the existence and correctness of the presented inventory, ending balance came by (Jafar ,2003:497):

1. Insure about the firm ownership of the inventory, despite it is in the store or on the others stores.

2. Insure about the physical existence of the inventory by performing physical inventory. The physical inventory: is he actual count, determination of each and total value for the existed quantity of items after the determination of the quantity existed in the stores; the physical inventory is called the natural measure (Hayali,2002:231), Despite the different number of physical inventory performed by firms it's important to perform at least once in a fiscal year ,often at the end of the fiscal year ,and in all situations physical count of inventory must perform surprisingly by a committee that have the permission and the authority (Defi, 1980:161).

After the ending of the inventory check and count, we can evaluate the inventory by the following equation (Noor, 1999:181).

Inventory ending balance = Inventory begging balance + Purchased unites during the year – Sold unites during the year.

2.10.1 There is two systems to count the inventory:

1. Perpetual system: the system does not rely on the count of inventory in specific date, because under the perpetual system, purchases, purchase returns and allowances, purchase discounts, sales, and sales returns are immediately recognized in the inventory account, so the inventory account balance should always remain accurate. According to that, the firms can trace the profitability of each transaction (Sirefi, 2002:303), This system does not assume that all the changes in the inventory result from the sales transactions only, it can deal with malty of the accounting practices, it direct the cost(decrease in inventory) of the sales to its

accounts and the costs(decrease in inventory) that result of other transactions to its proper accounts, use this system in manual accounting system will cost more time and efforts in comparison with the periodic system.

2. Periodic system: Under the periodic system, merchandise purchases are recorded in the purchases account, and the inventory account balance is updated only at the end of each accounting period. Perpetual inventory systems have traditionally been associated with companies that sell small numbers of high-priced items, but the development of modern scanning and computer technology has enabled almost any type of merchandiser to consider using this system.

This system depend of those equations:

Gross profit	=	Net sales	-	Cost of goods sold
Cost of good available for sale	=	Beginning inventory	+	Cost of goods purchased
Cost of goods sold	=	Cost of good available for sale	-	Ending inventory

And that is recorded inventory in the first period calculates independent and closing at the end of the period with the expense of purchases in the income statement or a trading account with the aim of determining the cost of goods sold The balance inventory last term remains their account open until the beginning of the new year to be an inventory first period for the next period, and is used this system is mostly in facilities that deal with a variety of goods at low prices (Hayali,2002:216).

2.11 Accounting standards that related to inventory

International accounting standard No. 2

Objective

To prescribe the accounting treatment for inventories, including cost determination and expense recognition.

Summary

- ❖ Inventories are stated at the lower of cost and net realizable value (NRV).
- ❖ Costs include purchase cost, conversion cost (materials, labor and overheads), and other costs to bring inventory to its present location and condition, but not foreign exchange differences.
- ❖ For inventory, items that are not interchangeable, specific costs are attributed to the specific individual items of inventory.
- ❖ For interchangeable items, cost is determined on either a First in First out (FIFO) or weighted average basis. Last In First out (LIFO) is not permitted.
- ❖ When inventories are sold, the carrying amount is recognized as an expense in the period in which the related revenue is recognized.
- ❖ Write-downs to NRV are recognized as an expense in the period of the write-down. Reversals arising from an increase in NRV are recognized as a reduction of the inventory expense in the period in which they occur.



"First in? First out!"

Chapter Three

The FIFO Method

3.1 An analysis of the commonly used methods of inventory valuation according IFRS.

In the case when there are no actual changes in the price level during a given period, either the FIFO method or the weighted average method may be used with the same results. If the prices do indeed fluctuate significantly during the period, the method of inventory valuation which the company implements will have a direct effect upon the financial statement. The significant difference between the FIFO method and the weighted average method lies in the inclusion of inventory profit under weighted average.

During the inflationary price period, the FIFO inventory method results in the highest valuation of year-end inventory, gross profit margin and net income. The FIFO method also results in the lowest cost of goods sold. On the contrary, during a similar inflationary period the weighted average inventory method results in moderate year-end inventory, gross margin and net income and average cost of goods sold. During the price inflation is that this method results in a moderate value of current assets on the balance sheet.

3.2 An analysis of FIFO

FIFO has been the most popular method of inventory valuation. A shift from LIFO to FIFO and weighted average to become noticeable after 1970. The principle reason for this change is the tax advantage.

One of the objectives of using the FIFO method is to present figures of the ending inventory fairly and accurately FIFO assumes that the most recent costs, which will approximate current replacement cost, would

create a fair presentation of ending inventory. The approximation to current cost is closest when inventory turnover occurs rapidly. Furthermore, another objective of FIFO is to present fairly the cost of goods sold in the income statement. FIFO assumes that the oldest units are the first to be sold. The FIFO method has been subjected to considerable criticism because of the failure of the method to match current cost with the current revenue, thus overstating the income of this period. Another failure of FIFO is that this method does not report separately gains from inventory price changes, or inventory profits. The use of the FIFO system for cost determination of inventory at year-end is acceptable because the last goods are assumed to be those, which are in hand and appear in the balance sheet.

This method is based on the idea of pricing disbursements in accordance with the oldest material purchases, thus pricing quantities issued by the oldest of the purchase price of the materials are in inventory exchange moment, and so the balance of the remaining inventory is according to the latest purchase prices (Arab Society of Certified Accountants, 2001:94).

As the evaluation inventory will be the latest prices, such as the market price, it will reflect on the balance sheet to reflect the fact that the financial position at the date of preparation also affect the gross profit and net profit in the income statement at the end of the period (Jafar, 2003:513).

This method is to provide the raw material to production departments by the time of entry into the stores and in this case come out in the order of entry materials (Shara, 2002:60).

The following is a summary of the advantages and the disadvantages in the use of the FIFO method.

3.3 Advantages of using FIFO

1. Assume that the inventory moves in the factory in the form indicates the effective control materials oldest disposal first so as not to corrupt or become obsolete.
2. The commodity inventory flow logically and reasonably.
3. Ending inventory costs are latest period costs then they are near market value.
4. Cost flow is conformity with the material flow of inventory and this flow is not subject to the desire of consumers or managers.
5. Provide a firm basis for determining the cost of goods and the cost of inventory latest period, which can make comparisons between the results of sequence years.
6. preferred be used in the event mile rates are low, achieving tax savings because the goods Latest period will set the lowest prices and thus lower gross profit.
7. The FIFO method illustrates the inventory in the balance sheet at approximately market price.
8. The FIFO method approximates the physical flow of goods because the FIFO physical flow concept is based upon the assumption that the oldest units are the first, which are sold, and because of this FIFO is considered to be part of good management practice.
9. The FIFO method eliminates the possibility of directly manipulating income through the procedures of elimination, expansion or contraction of quantities.

10. During a recessionary period of declining prices, the FIFO results in a lower income figure.
11. The FIFO method will approximate replacement cost on the financial statements.
12. Assess the latest inventory prices, for the purposes of final accounts and balance sheet.
13. Provide a constant foundation for determining the cost of goods and the cost of inventory at the end of term, which can hold.

3.4 Disadvantages of using FIFO.

1. Does not agree matching principle to determine income, where will be match historical cost with current revenues.
2. Lack of separation between regular profits and losses of the facility and between profits and losses arising from changes in prices.
3. Prefer not to use them in case of rising prices because it would lead to an increase in profits and gross profit and therefore will have high taxes.
4. Non-application of the economic need for written procedures leading many to commit certain accounting errors or clerical.
5. The FIFO method brings about fluctuation in the income statements due to price level changes.
6. The FIFO method may provide inaccurate information about income and funds available.
7. The FIFO method causes income tax to be higher during the present inflationary trend.

According to this summary, the advantages and the disadvantages of using the FIFO method of inventory valuation may be evenly balanced,

and management personnel must be able to weigh the facts in making a decision.

3.5 Recommended in the following method.

1. The case of the magnitude or large of the cost of raw materials units.
2. The absence of repeat the exchange significantly times during one session.
3. The absence of fluctuate largely material prices during a single session.

3.6 Effects first in first out method "FIFO"

1. Income statement effects

The cost of goods sold account holds information detailing the cost for inventory items sold. FIFO generally results in a lower cost of goods sold number on the income statement. This increases gross profit and net operating profit as well. The reason behind this comes from inflation that often raises the cost of goods a company sells to consumers. This effect will usually occur as long as the company uses FIFO.

3.6.1 How the benefits and limitation of financial statement to use FIFO method?

❖ Benefits to Income Statement.

The benefits of FIFO on the income statement arise in inflationary environments when the cost of inventory increases. During times of rising prices, a company has a lower cost of goods sold (COGS) using FIFO than when using other inventory methods. This is because the first items

of inventory purchased at lower prices were the first items sold. This lower COGS results in lower total expenses and, in turn, a higher net income. A higher or inflated net income can make a business seem more profitable than it is in reality.

❖ **Limitations to Income Statement.**

While using FIFO offers benefits to the income statement when costs rise, the opposite holds true during periods of falling costs. When inventory costs fall, COGS is higher and net income is lower. Taking that into consideration when weighing the benefits of inventory methods can help to determine which method is correct for a company.

2. Balance sheet effects

A company's balance sheet also has FIFO affects. Ending inventory reported on the balance sheet will usually be higher under FIFO. This increases a company's net wealth and working capital, which are total assets less total liabilities and current assets less current liabilities, respectively. Higher asset dollar amounts usually make a company look financially stronger as the assets offset liabilities on the balance sheet.

3. Tax influence

In the case of inflation, (high general level of prices) including inventory in the company high and therefore net income will be high and therefore its impact on high taxes due to higher net income and lower cost of goods sold and higher stock last year, and vice versa in the case of a recession.

4. Financial ratio effects

❖ **Current Ratio** = Current assets / Current liabilities.

Usually, (inflation) higher in a rising price environment because reported inventories are more valuable and COGS is lower.

❖ **Inventory Turnover** = COGS/Avg. Inventory.

Usually lower in a rising price environment because the average cost of inventory will be higher.

❖ **Debt to Equity Ratio** = Total liabilities/Total shareholders' equity.

Usually lower in a rising price environment.

❖ **Return on Assets** = Net income/Total Assets and **Return on Equity** = Net income /total equity.

Usually higher in a rising price environment because net income is higher.

❖ **Net Profit Margin** = Net income /Sales.

Usually higher in a rising price environment.

Summary about effects of income statement, statement of financial position and taxes according of IFRS.

FIFO	Ending inventory	COGS	Net income	Taxes
Inflation	High	Low	High	High
Deflation	Low	High	Low	Low

3.6.2 How to calculate an inventory balance using FIFO?

Since the price of products continually changes due to inflation and consumer demand, valuing current inventory can be challenging. FIFO, or first in, first out, is an accounting method used to determine the value of unsold product inventory based on the latest purchase price regardless of when product units were originally purchased. Under FIFO, it is assumed that old inventory sells first. Remaining inventory should then be valued at current market prices.

Calculate inventory using First in first out by the following steps:

❖ Step 1

Review inventory purchase records to determine the number of products purchased during the year. Compile a list of products, quantity purchased, purchase amounts and dates of purchase.

❖ Step2

Review sales records to create a list of each product sold along with the quantity sold during the year.

❖ Step3

Tally the purchase prices of your inventory.

❖ Step4

Calculate ending inventory and cost of goods sold using FIFO.

For example illustrates the calculate first in first out method.

PALTEL Company has the following inventory, purchases and sales data for the month of March.

Inventory: March 1 200 units @ \$4.00 \$800

Purchases:

March 10 500 units @ \$4.50 \$2250

March 20 400 units @ \$4.75 \$1900

March 30 300 units @ \$5.00 \$1500

Sales: March 15 500 units

March 25 400 units

The physical inventory count on March 31 shows 500 units on hand.

Calculate ending inventory and cost of goods sold according first in first out "FIFO"?

Solution**Using FIFO method**

Ending inventory:

<u>Date</u>	<u>Units</u>	<u>Unit Cost</u>	<u>Total Cost</u>	
March 30	300	\$5.00	\$1500	
March 20	200	4.75	950	<u>\$2450</u>

Cost of goods available for sale = Beginning inventory + cost of good purchased.

$$= 200*4+500*4.5+400*4.75+300*5= \$6450.$$

Cost of goods sold = cost of goods available for sale – ending
inventory = \$6450 - \$2450 = \$4000.

Other method units sold *unit cost =

$$200 * 4 + 500 * 4.5 + 200 * 4.75 = \$4000.$$



Chapter Four

The Average Cost Method

4.1 An analysis of average cost method

The weighted average method assumes that the goods available for sale have the same average cost of unit (Kimmel, 2008:238). Generally, such goods are identical. Under this method, the cost of goods available for sale is allocated on the basis of the weighted average unit cost.

IFRS 2 states that under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending on the circumstances of the entity (paragraph 27).

Since the moving average cost changes whenever there is a new purchase, the method can only be used with a perpetual inventory tracking system; such a system keeps up-to-date records of inventory balances. You cannot use the moving average inventory method if you are only using a periodic inventory system, since such a system only accumulates information at the end of each accounting period, and does not maintain records at the individual unit level.

The moving average method tends to yield inventory valuations and cost of goods sold results that are in-between those derived under the first in, first out (FIFO) method and the last in, first out (LIFO) method. Also, when inventory valuations are derived using a computer system, the computer makes it relatively easy to continually adjust inventory valuations with this method. Conversely, it can be quite difficult to use the moving average method when inventory records are being maintained

manually, since the clerical staff would be overwhelmed by the volume of required calculations.

The following is a summary of the advantages and the disadvantages in the use of the average cost method.

4.2 Advantages of using average cost method

In periods of heavy fluctuations in the prices of materials, the weighted average cost method gives better results because it evens out fluctuations in price by taking the average of prices of various lots in stock.

1. **Best method even when prices fluctuate:** Weighted Average price method is considered to be the best method when prices fluctuate, considerably, because this method tends to smooth out fluctuation prices.
2. **Simple calculation:** Issue prices are not to be calculated each time issues are made. Issue prices are changed only when new lot of materials is received.
3. **Full recovery of cost:** This method recovers the cost of materials from production.
4. **Issue prices near to market prices:** This method maintains the issue prices as near to the market price as possible.
5. **No adjustments in stock ledger:** This method eliminates the necessity for adjustments in stock valuation.

4.3 Disadvantages of using average cost method

1. **New calculation with every receipt:** The greatest disadvantage of this method is that a fresh rate calculation has to be made as soon

as a new lot of materials is purchased which may involve tedious calculations. Thus, there are chances of clerical errors.

4.4 Recommended in the following method.

1. When the prices of purchasing inventory fluctuates up and down, so that, the use of average cost method reduces the effects of fluctuations on both sales costs and cost of inventory as well as the gross profit and net profit.
2. Should be used if the stocks in the storage consists of many goods and they are small units and have a low costs.

4.5 Which inventory valuation method should be selected?

Although there is no perfect way to evaluate the inventories that fits to all entities under all conditions , the accountant should choose the way that fits with the nature of the materials and conditions of the facility and he has to take into account the effects that will ensue all the way related to income and the value of inventory, taxes and must take into account the principle of consistency that is known in the accounting that is the entity should be committed to use the same way from year to year .

4.6 Valuing inventory at the lower of cost or market (LCM)

Inventory values sometimes fall due to changes in technology or in fashion .When the value of inventory is lower than its cost, the inventory should written down to its market value . This is done by valuing the inventory at the lower of cost or market (LCM) in the period in which the decline occurs. LCM is an example of the conservatism constraint: When choosing among alternatives, the best choice is the method that is least likely to overstate assets and net income.

Solution PALTEL Company at the top example on the average cost method.

Using Average Cost Method

Cost of goods available for sale = Beginning inventory + cost of good purchased.

$$= 200*4+500*4.5+400*4.75+300*5= \$6450.$$

Units cost =1400.

Average unit cost: $6450/1400=\$4.607$

Ending inventory: $500*\$4.607=\underline{\underline{\$2,303.50}}$

Cost of goods sold: $\$6,450-\$2,303.50=\underline{\underline{\$4,146.50}}$

Methodology



Chapter Five

Research

Methodology

5.1 Introduction

This chapter explains in details the procedures adapted by the three researchers in implementing the study, research methodology identification, defining the study population, the sample of the study, preparing the interview, and summarize the interview.

The three researchers will define these procedures as follows:

5.2 Research approach

The researchers used the descriptive analytical approach to complete the study which depends on describing and demonstrate the importance of using accounting information in decision-making process.

5.3 Research phases

1. Research proposal, which include generating research topic, identifying the research problem, establishing research objectives, defining the importance of the study, determine the scope and limitations of the research, and developing research plan.
2. Summary of literature review about accounting and accounting information, decision making, and the importance of using accounting information in decision making.
3. Write the interview questions and make the interview with the employees from Siksik company.
4. Summarize the questions and its answer after it has been answered by company employees.
5. Write the conclusions and recommendations.

5.4 Data collection

1. Primary data sources

This research would base on some sources of primary data, represented mainly in the books, Arabic and English references, researches, studies , specialized magazines and some related sites on the World Wide Web (Internet), which dealt with such research as well as brochures and periodicals that are related to the topic of the study.

2. secondary data sources

The secondary source concentrated in interview, which has been designed and prepared specially to meet the research purposes.

5.5 Society and sample of the study

1. Research community

It means all individuals that constitute the subject of study, or all the people the researcher want to know about.

The society of this study consists of Siksik company employees, in Gaza strip.

2. Research sample

It is impossible to make the interview with all individuals the three researchers want to know about. Instead of this, the three researchers select a sample that represent the original society and can generalize its results on the research.

Sample means a set of individuals or items selected from a population for analysis to yield estimates of, or to test hypotheses about, parameters of the whole population, and representative of all community.

The selected sample consists of siksik company, it was selected as one of the largest manufacturing and retailing companies , Where the interview was made with one of its employees.

5.6 Interview

An interview is a purposeful discussion between two or more people. To complete this research structured interview was made with (Mahmoud Al Hattab) The accountant in Siksik Company in Gaza strip.

5.6.1 Content of the interview

The interview includes a series of questions relating to the research hypotheses that have been developed, which aims to achieve the objectives of the research

5.6.2 Advantages and disadvantages of the interview

➤ Advantages of using an Interview

- ❖ It is a good way to find out the attitudes, thoughts, and behaviors of a large group of people.
- ❖ Always offer positive information.
- ❖ Get directly the information that you need.
- ❖ The respondent lacks reading skills to answer a question.
- ❖ Are useful for untangling complex topics.

➤ Disadvantages of using an Interview

- ❖ In some situations, it can take a long time.
- ❖ Unwillingness of respondent to provide Information.
- ❖ The interviewer can affect the data if he/she is not consistent.
- ❖ It is very time consuming.
- ❖ It is not used for a large number of people.
- ❖ The Interviewer may be biased and ask closed questions.

5.6.3 Summarized the interview

Coordinate the interview and summarized the answers of the questions that were obtain in the interview in a scientific and clear way and use clear and understandable terms so that everyone can understand it.



Chapter six

Case study and The Result and Recommendations

Bashir Al-Siksik Company

6.1 Introduction

It is a Palestinian private limited company, established in 1976 by Mr. Bashir Al-Siksik, and started its work as a supplier for plumbing and infrastructure materials.

Its supply plumbing and infrastructure materials for governmental, nongovernmental institutes and contracting companies in Palestine.

It has decided to establish the factory of Bashir Al-Siksik company for plastic pipes, with an approximate capital of \$3000, 000. This will be a credit for the national Palestinian industry, with following Palestinian and international standards. The factory is 2500m² area, and is designed to have three main production lines. Currently, the factory has started its production with one production line. It attached to the factory an updated laboratory for testing & ensuring the quality of our pipes. , in addition to special stored to accommodate the raw materials used in the industry, as well as to accommodate production.

6.2 Mission

our company signed a pioneering role in the sale and manufacture of plumbing and infrastructure locally, where the company has gained an excellent reputation through employing local and international expertise in order to develop human resources and productivity so that they can keep up with all the developments in the technology of the manufacture of plumbing and infrastructure around the world and enhance availability in the Palestinian products.

6.3 Vision

Be the first and leading Palestinians and the fastest growing in the field of trade and industry, which offers products and services in accordance with the international quality standards

6.4 Objectives

1. The development of the industrial production level by keeping up with the latest global technologies.
2. The development of the industrial production level by keeping up with the latest global technologies.
3. Provide enough new production lines for the manufacture of all products and sanitation infrastructure quality comparable to international quality.
4. Open new horizons for cooperation with international companies specialized in the production of infrastructure and sanitation.
5. Contribute to the development of the Palestinian economy through the support and development of all the elements necessary technical and administrative materials industry in the field of infrastructure and sanitation.
6. Rehabilitation and ongoing development of staff working in the company and the factory in line with business requirements and keep up with the latest developments in the field of manufacturing in the world.
7. Commitment to the highest levels of customer service in order to obtain full satisfaction for the company's products and services.
8. The adoption of social responsibility towards the Palestinian community through his work on the development.

6.5 Values

1. A deep understanding of our company believes that our customer is the most precious element has a deep and it is our understanding the requirements of customers will achieve success and continuity and win the loyalty of our customers.
2. Commitment to excellence 38 years of success due to the skills and expertise of employees in our company and their commitment to lasting quality standards of products and services offered to our customers.
3. To maintain the best possible performance by providing an integrated work environment include crew experienced staff, highly efficient and trained on the latest management practices and sales with the reliance on technology and information systems.
4. Creativity and innovation, the company believes that the innovation and development in the performance at all levels is the best way to reach the market leadership
5. High credibility through each transaction staff deals with any of the parties to the action.
6. Employee loyalty Company believes that providing the right environment for the employee in terms of rehabilitation and provide the reasons for its success, progress and satisfaction is the main reason for the success of the company and increase its production.

6.6 Company location

The company location was selected in Karni industries zone because it is Close to the markets, Easier for shipping materials to the stores and factory, Easiness of transportation, Provide electricity, water and

Networks, suitable environment for industrial manufacturing processes, Ease export.

6.7 Product and Production lines

Is controlled industrialization in the laboratory via computer and Engineers specialists collect samples and examination of internal pressure, density, intensity, power disruption, bear the blows and collisions are these tests essential in every manufacturing process to ensure quality as all the staff Madrbenaly means maintaining the highest quality of the tubes during production process.

Company supports its customers to provide transportation services at low prices and are also secured the lowest transportation costs in addition to the shortest delivery time.

About 10 years of dedication to quality and customer satisfaction. Pioneers in plastic pipe systems in the Palestinian territories.

➤ Raw material

1. Polyvinyl chloride.
2. PP polypropylene.

➤ Factory production

1. pipes U-PVC
 - ❖ Polyvinyl chloride pipe steel (UPVC) for the extensions of drinking water and agricultural irrigation
 - ❖ Polyvinyl chloride pipe steel (UPVC) for the extensions of underground drainage

- ❖ Polyvinyl chloride pipe steel (UPVC) for the packaging electricity and telephone cables and fiber optic cables underground.

2. polyethylene PE pipes

- ❖ Extensions of water.
- ❖ Extensions of drinking water (Pressure).
- ❖ Extensions of agriculture and irrigation water.
- ❖ Extensions of wastewater.
- ❖ Industrial uses.
- ❖ Extensions above the ground.
- ❖ Extensions of fuel (gas, diesel Special Features).

3. PP polypropylene tubes

- ❖ Indoor plumbing (wastewater hot and cold).
- ❖ Gutters and rainwater drainage.
- ❖ Vents.

4. Polyethylene pipes Bropalen random polymer (PP-R)

- ❖ Used in the extended networks of hot and cold water.
- ❖ Used in central heating installations.
- ❖ Used for extensions of production lines in the food and chemical industries, pharmaceutical and refrigeration units in hospitals and laboratories.

➤ **Retails Products**

Bashir Al-Siksik Company is the exclusive agent in Palestine for a number of well-known companies from UK, Italy, Germany, Turkey, India, Israel, France, Poland and China. Such a

- a. Refineries.
- b. Toilet.
- c. Washbasin.
- d. Toilet lid.
- e. Relationship shower - shower - shower pan.
- f. Nobility chair spring.
- g. Sink Basin.
- h. Bathroom Accessories.
- i. Siphon.
- j. Tub and shower.
- k. Hand mixer
- l. Shower pipes Stanlistil.
- m. Closer Laundry – Refineries.
- n. Bathrooms and house Ceramic.

6.8 Interview summary

We meet Mr. Mahmoud Al Hattab, accountant at Siksik Company and we ask him the following questions:

- ❖ Does your company concern itself in inventory valuation? Does the management pay attention for the inventory valuation?

Mr. Mahmoud says that their company gives a high attention for their inventory and they have many policies for this, the company established

its system for the stores to keep with its inventory, and to support the management and accounting of its inventory.

- ❖ What is the method of inventory valuation the company use? Why they use it? Why they don't use other valuation method?

Mr. Mahmoud answered that the use the FIFO method in the valuation of the inventory, and the management support the use of FIFO because it's easy to implement and it support the goals of the management, and the company accounting computer system support this method. He says that the company have a strict control over the flow of material and that make the use of the FIFO method much easier to implement. He says that they don't use the weighted average method because the staff does not have sufficient knowledge and its easier to use FIFO and the management does not support the W.A.

- ❖ Does the company have accountants to perform the physical inventory? And does they use a CPA. Supervise the physical inventory ?

He says that they have 6 accountants who perform the physical inventory with the sorts keepers, and the company does not use CPA to supervise the physical inventory, and the company have its own committee that supervise the physical inventory.

6.9 Results

6.9.1 General results from the theoretical review

- ❖ Reasons for not applying any of the methods in the evaluation of commodity stocks.

- ☒ Legal requirement (income tax cod).
 - ☒ Lack of knowledge about the advantages and application of the valuation method and lack of experience.
 - ☒ The attention of the owners is to the value of profits regardless of a sound road to reach the real outcome of the profit.
 - ☒ Management focus on the market price without paying attention to the correct way to calculate the cost.
 - ☒ Existence of competition promotes the use of the method to calculate the cost and establish a competitive price.
 - ☒ No external audit in the unlisted companies.
 - ☒ Accounting programs support on method of valuation.
 - ☒ Complexity of the implementation of the valuation method.
 - ☒ High cost of implementation of one of the valuation methods.
 - ☒ Existence of huge number of goods types or quantities in the stores.
- ❖ An analyzing the most commonly used methods “FIFO& Average Cost” used for pricing inventories.
- FIFO is the most common method of inventory valuation because of:
 - ☒ Easy to implement and exercise on all types of inventory (Raw Materials, Work In Process, Finished goods).
 - ☒ Supported by all the local accounting programs and some of the programs supports only the FIFO.
 - ☒ Organized and logical way to value inventory.

- ☒ Gives a clear vision about the inventory.
- ☒ Enhance the control over the inventory cost, sale price.
- ☒ Present the ending inventory in fair value.

- Weighted Average is not promoted in the market because of:
 - ☒ Lack of knowledge about the implementation of the WA.
 - ☒ Not supported by the local accounting software.

6.9.2 Result of case study

1. The company give attention to their stokes valuation and reporting.
2. The company have a costing system to valuate inventory.
3. The company use computer software to enhance the inventory valuation process.
4. The company have six accountants and financial manager.
5. The company apply the FIFO method in valuation of inventory, for taxation and control purposes.
 - a. Easy to implement and perform.
 - b. Supported by the company accounting software “Al-asseal for accounting and management”.
 - c. Promoted by the management of the company.
6. The company have committee to supervise the inventory, and employee to perform physical inventory without external supervision of CPA.

6.10 Recommendations

- ❖ Businesses must try to get rid of subordination to Israeli sources and encourage local sources for materials needed for manufacturing.
- ❖ Provide the necessary facilities for the import of materials that are not available locally from the Rafah crossing.
- ❖ Publications to owners of clarifying the importance of the application of any of the accounting methods when evaluating Inventory by professional associations.
- ❖ Importance of the role of professional associations in holding courses and workshops to explain the advantages and disadvantages of each inventory valuation method and help the owners of enterprises to adopt the best way which suited their type of business and fit the economic situation.
- ❖ Requiring businesses to apply one of accounting methods when evaluating the inventory.
- ❖ The need for the relevant regulatory authorities to look after the inventory and its valuation to assert the veracity of installations and the disclosure of inventory to make sure about the correctness of disclosure.
- ❖ Formation of special committees to carry out inventory with the participation of external auditor.
- ❖ Impose financial penalties on those that found they change the fact of the stock.

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