

Average Cost vs. Latest Cost

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 Attention

 Tip

 Hot Tip

 Warning!

Smarties          

Bright Sparks         

1. What is Cost Price and when do I use Average and When Latest?

The term “Cost Price” refers to the actual price that was paid for an item that is kept in stock. If you purchased a Widget at R 10.00, the cost price of the item is R 10.00. This is simple. If I had to ask what the monetary **value** of the stock is that you currently hold, you will tell me it is worth R 10.00 (at Cost) We are not interested in the selling price value of the item at this time, as it is only a *potential* value that only becomes a reality when the item actually gets sold. In accounting selling potential is never considered when determining value.

Now, when you buy stock on different times and at different cost prices, things seem to get a bit more complicated. You have two problems to solve. The first problem is to calculate the **value** of the stock that you hold. The second problem is to calculate a **new selling price** for the stock that you hold. To solve these problems, the industry came up with two calculation concepts, Average and Latest Cost.

Latest Cost is usually only used as a **tool** to work out what the **new selling price** should be for an item that was just bought. The understanding is that the more you pay for an item, the more the client should be paying for the item. The assumption is that you will usually pay more rather than less for items every time new stock is purchased.

A further assumption is that if the Latest cost of the item is in actual fact less than the previous times, the Latest cost should still be used to calculate the new selling price; otherwise your business will no longer be competitive. The difference in the cost prices of items bought at different cost's, should be to your benefit, not the clients. If you bought a Widget last year at R 5.00 and now buy another Widget at R20.00, you would like to charge the Client the same price for both widgets (Let's say R 40.00). On the older widget, you will make R35.00 Profit, on the new widget, R 20.00. The higher profit on the one widget should in theory cover your cost for carrying the item in stock for an extended period.

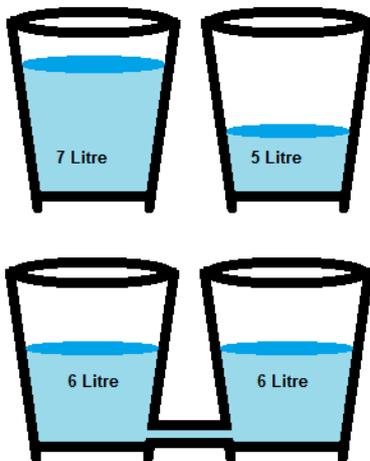
Average Cost is used to solve the second problem; how to tell what the value in terms of equity you are holding on the books. Another name for the term Average Cost is “On-hand Stock Value”, (at the actual price you paid for stock). The word “Average” is a bit misleading as it points to the calculation method used to work out the value of multiple units, rather than what it represents.

The definition of the word **Average** is to calculate or Balance out.

“The result obtained by adding several quantities together and then dividing this total by the number of quantities; the mean.”

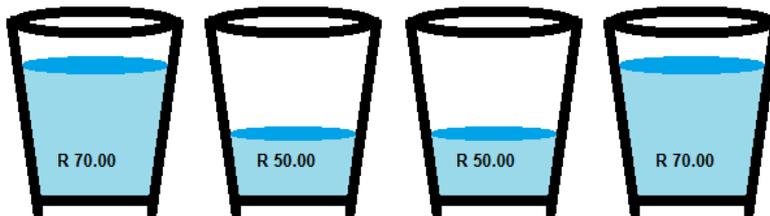
To work out what the average value (what you paid for it) of two items of the same stock code is, you simply average them out. How do you do this, well, by adding both items cost prices (what you paid for each) together, and then by dividing them with the quantity on-hand. If you want to work out the average age of a group of people, you would use exactly the same calculation. You are 35 years old. You wife is 33.

Add the two ages together and then divide them by two. $(35 + 33 = 68. 68 / 2 = 34)$. Your combined average age is then 34.

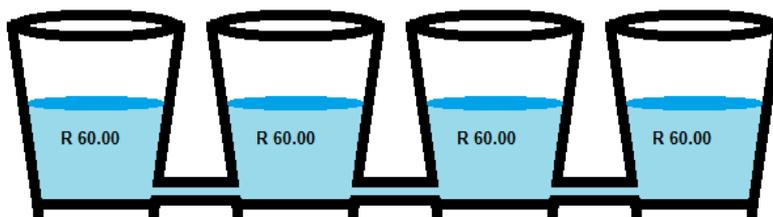


The same principle is applies when you have two buckets of Water, the one 5 Litres and the other 7 Litres. The minute you add a pipe to connect them (GRN), one Litre of water will run from the 7 Litre bucket to the 5 Litre Bucket in order to average out the 5 Litre bucket (due to gravity). The result is that both the buckets will contain 6 Litres. Now this is the secret to working with average cost pricing. BOTH buckets BECOME 6 Litres. They both loose their original volumes by the averaging process.

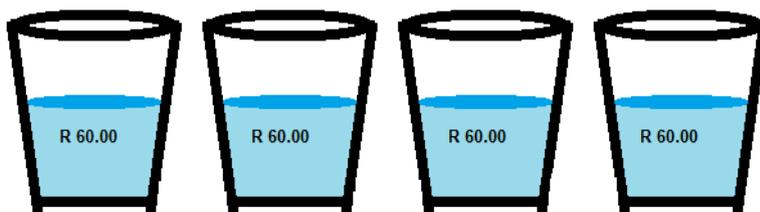
Stock works in exactly the same way. When two stock items are placed together on an accounting platform, they both loose their original cost price by applying the same average costing engine. This holds true even when you place more than two items are bought at different prices. The principle remains.



The new cost price of all the stock now becomes equal via the Average calculation.



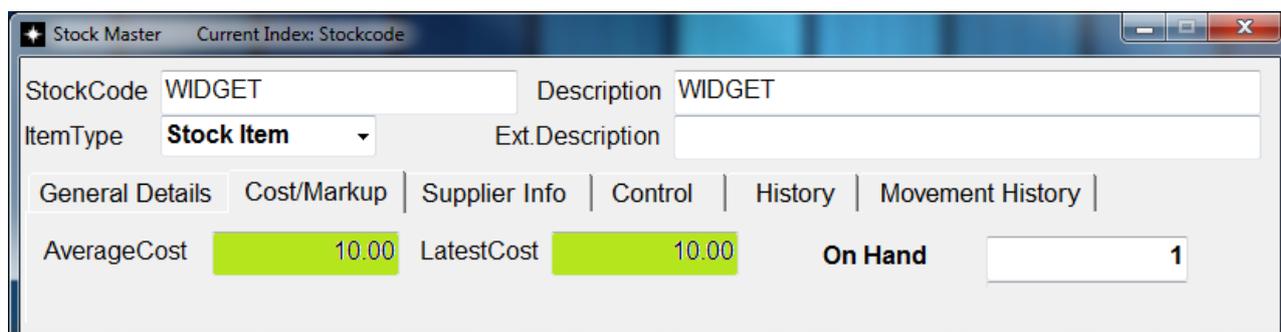
Assuming the holes are sealed instantaneously, once the pipes are disconnected, the buckets remain at the same (equal) level.



2. How is Cost price calculated in Revelation? Average, Latest

There is a lot of confusion over how average cost price is calculated in Accounting packages. Some users are under the *INCORRECT* impression that this is calculated over a period of time. In other words, how much did an item cost from March 2011 to February 2012. Nothing could be further from the truth. Average cost is calculated based purely on the amount of stock items CURRENTLY in stock. Each time new stock is purchased, a new average price is calculated, based on the existing stock and the new stock that is being added. No calculation is done when stock is sold. To calculate average cost, the system takes the existing stock quantity and then adds it to the new quantity. This results in a new On-hand quantity. It then takes the existing stock value and adds it to the new stock value. The resulting total is then simply divided by the quantity on-hand. This is why, when stock is sold to Zero, when new stock is then bought, the average and latest cost then become the same. This is also the reason you should avoid selling stock into minus, as you are no longer able to calculate the cost price. All the system can do is remembering the old cost price before the stock became zero. If the new stock does not arrive at the same price as what the negative stock was sold at, profit losses and gains result.

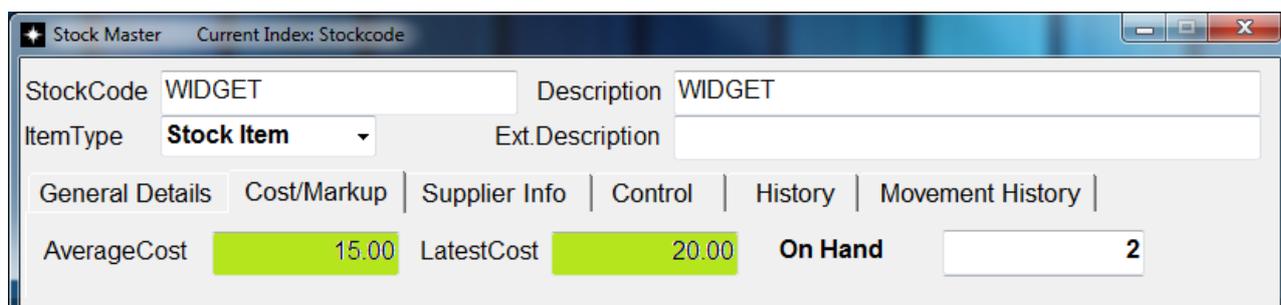
Let's look at an example: You have 1 Widget in stock that was purchased at R 10.00. At this stage the Average and Latest Cost is exactly the same, R 10.00.



The screenshot shows the 'Stock Master' window for a 'Widget' item. The 'AverageCost' and 'LatestCost' fields are both highlighted in green and set to 10.00. The 'On Hand' quantity is 1. The window title is 'Stock Master Current Index: Stockcode'.

StockCode	WIDGET	Description	WIDGET
ItemType	Stock Item	Ext.Description	
General Details	Cost/Markup	Supplier Info	Control
History	Movement History		
AverageCost	10.00	LatestCost	10.00
On Hand			1

Now you purchase (GRN) another Widget from a different supplier at R 20.00. Your new on-hand quantity is 2. You then add the two cost prices (R 10.00 + R 20.00 = R 30.00). Now divide the result (R30.00) by the quantity on-hand. (R 30.00 / 2 = R 15.00) Your new Average Cost for both items is then R 15.00. The R15.00 then becomes the items NEW COST PRICE PER ITEM.



The screenshot shows the 'Stock Master' window for a 'Widget' item after a second purchase. The 'AverageCost' field is highlighted in green and set to 15.00. The 'LatestCost' field is highlighted in green and set to 20.00. The 'On Hand' quantity is 2. The window title is 'Stock Master Current Index: Stockcode'.

StockCode	WIDGET	Description	WIDGET
ItemType	Stock Item	Ext.Description	
General Details	Cost/Markup	Supplier Info	Control
History	Movement History		
AverageCost	15.00	LatestCost	20.00
On Hand			2

3. Which price to use in Calculating new Selling Prices? Average or Latest

Again, this should be a “No Brainer”; however people still struggle with this concept. In the current economic climate, it is safe to assume that prices go up all the time. The logical thinking should then be that the more you pay for goods, the more clients should pay for them. But what about your old stock? Well, the fact that you have stock that was purchased at a lower cost price than the stock that just arrived yesterday should be to your advantage. Surely you will have to replace the stock once it is sold. Both old and new stock will have to be replaced by new stock at the (we assume) latest cost price. Therefore logic dictates that the client should pay the same price for the old and new stock.

For this reason we should always use the Latest Cost Price to calculate Selling Prices. The extra profit on the older stock should be seen as your reward for keeping stock (as the money could have been in the bank earning interest instead of laying in stock).

Stock Master Current Index: Stockcode

StockCode: WIDGET Description: WIDGET

ItemType: Stock Item Ext.Description:

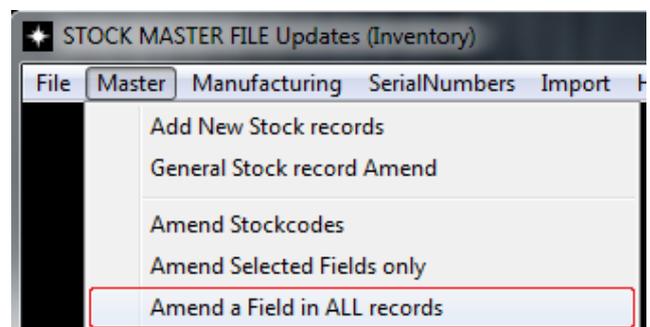
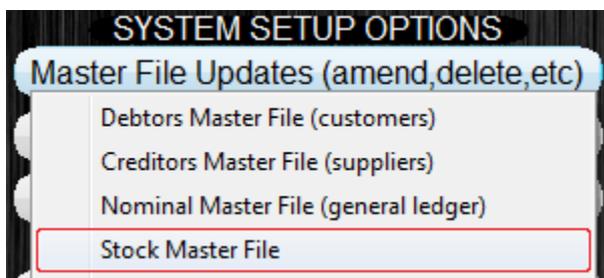
General Details | Cost/Markup | Supplier Info | Control | History | Movement History

AverageCost: 15.00 LatestCost: 20.00

Markup%: 100.00 On Latest/Average: A

To change the stock from average markup to Latest markup, simply click on the Edit button. Under the Cost/Markup section, change the On Latest/Average from “A” to “L”.

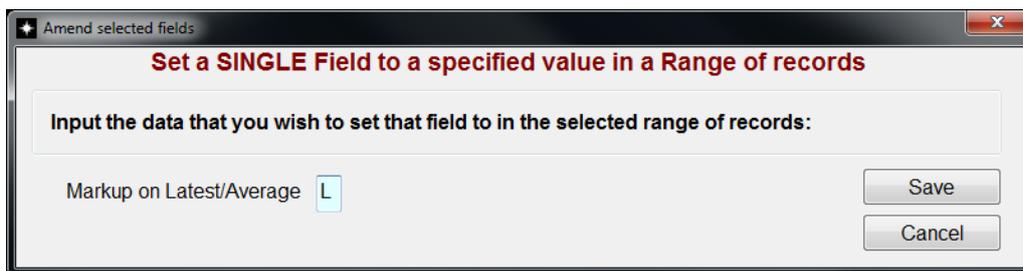
If you would like to change all of the stock codes in one go, go to the Master File Updates button. Now select [Stock Master File]. And then >> [Amend a Field in ALL records].



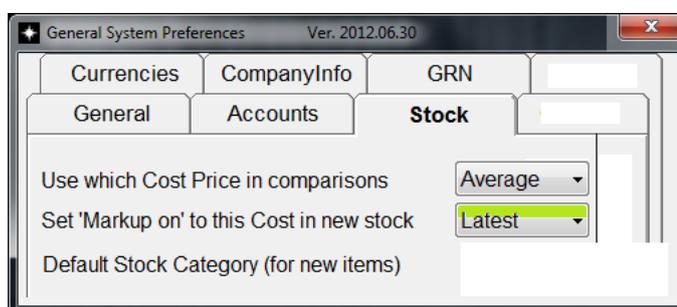
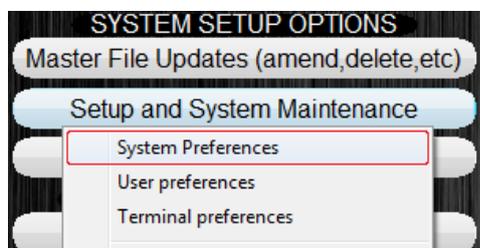
You may now look for and select the option to amend the “Markup on Latest/Average” and move it to the Right (Active) column.



Now Type in "L" for Latest and then press the Save button and....Presto, it is done.

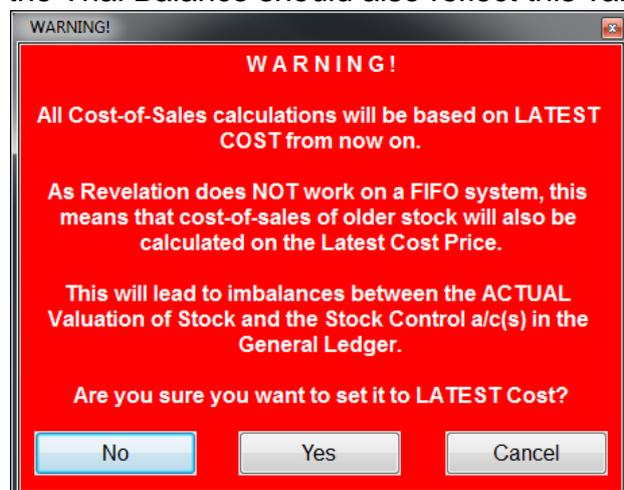


You may now also set the system so that all new stock items will, by default, be set to "Latest". To setup this option select the System Preferences button. Under stock, change the "Set 'Markup on' to this Cost in new stock" to [Latest].



4. Use which Cost Price in comparisons

Again, I am amazed on how the users get confused on this issue. When you want to compare your stock value to the value in the Trial Balance, it is important that you use the correct cost price on both. We have already stated that when new stock is purchased; it is added to your existing stock. The cost prices are then added together and divided into the on-hand quantity. This in effect means that the stock on the Trial Balance should also reflect this value. In order for this to happen, you really



don't have a choice, the Cost Price being used for comparisons (Actual valuation via the Stock Report vs. the Value on the TB) MUST be set to Average. If not, every time you buy stock, the existing stock will automatically be re-valued to the latest cost. Your Trial Balance and Stock Valuation will then always be out by the difference in Average to Latest Cost. If you do attempt to change this setting, the system gives you a nice big red warning – DON'T DO IT.