

Average Costing Method

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Average costing is a method of calculating part cost by warehouse based on the cumulative journal activity for a given part. All receipts, issues, physicals and adjustments are cumulated as of the date of the costing to determine the average cost of a given part.

How is the Average Cost Determined?

The unit cost of an item is the average value of all receipts, issues, physicals, and adjustments of that part to inventory, on a per unit basis. Issues from inventory use the current average cost as of the date of the issue to calculate the unit cost.

The inventory is valued at an average cost, weighted by quantity (inventory cost = average unit cost * quantity).

Each warehouse may have a different average cost based on the complete journal activity of the part in the warehouse.

Perpetual Recalculation of Unit Cost

For the transactions listed below, the transaction unit cost may be different from the current unit cost for an item. In such cases, after the transaction has been processed, the item's unit average cost is automatically recalculated. As a result, at any time, inventory is valued at a current, up-to-date average unit cost.

- Purchase order receipt
- Return to vendor
- Transfer between warehouses

Purchase Order Receipts

The receipt of parts on a Purchase Order affects the Average Cost when a part is ordered at a cost that is lower or higher than the current average cost in the warehouse. When the Purchase Order is received, the part unit cost is used to debit the inventory. If the part cost on the Purchase Order is lower or higher than the current average cost in the warehouse at the time of the receipt, the average cost will be recalculated and decreased or increased to a new average cost.

For example, a Purchase Order was created for a part with the amount of \$.80/ea. At the time the Purchase Order was created, the current average cost of the part in the warehouse was \$1.00. After the part on the Purchase Order was received, the new average cost of the part in the warehouse is calculated as \$.90.

Issuing Parts to a Job or Service Ticket

When parts are issued from a warehouse, the cost applied to the Job or Service Ticket is the current average cost at the time of the transaction.

If parts for a Job or Service Ticket are ordered on a Purchase Order, received in and issued immediately (option on the Parts Receipt), the cost applied to the Job or Service Ticket is the Purchase Order receipt cost. If those same parts are received into a warehouse then issued as a separate transaction, the issue transaction will be calculated at the current average part cost in the warehouse.

Returning Parts to Stock

When parts are returned to stock from a Job or a Service Ticket, the original issue cost is used for the return

transaction, provided the Job or Service Ticket number is referenced on the return transaction. If parts are returned to stock not referencing a Job or Service Ticket number, the current average cost in the warehouse is used for the transaction.

Returning Parts to a Vendor

Part returns may affect the average cost of the parts in a warehouse. If a part is returned to a Vendor at a lower or higher cost than the current average cost in the warehouse, your inventory could possibly have a positive or negative value with no quantity on hand.

For example, 1 part is on hand in the warehouse with a current average cost of \$.90. The original purchase cost was \$.80. The Vendor part return transaction was created for 1 @ \$.80. The end result is 0 on hand with a value of \$.10.

Part Transfers

Transferring parts from one warehouse to another may affect the average costing in the warehouse receiving the part transfer. When a part is transferred from one warehouse to another the cost from the originating warehouse will be transferred to the destination warehouse. A transfer could result in increasing or decreasing the average cost in the destination warehouse if the average cost in each warehouse is different.

For example, a transfer was made from a warehouse where the average cost was \$.90/part. The average cost in the "transfer to" warehouse was \$1.00/part prior to the transfer. After the transfer, the new average cost in the "transfer to" warehouse is \$.95/part.

Correcting Inventory Balances

In situations where the part value in the warehouse is no longer realistic, you have two choices for making inventory valuation corrections. You may make a manual stock adjustment or wait until the next physical inventory where the adjustment will be made automatically when the inventory is released and variances are posted.

Dealing with High Fluctuation in Part Costs – Direct Expensing

If parts are being ordered at a much lower cost than your current average cost, you may use the direct expense option on the Purchase Order. This way the warehouse average cost will not be affected by the favorable pricing from the vendor. The direct expense option is typically used when parts are being ordered for a particular Job when your company is receiving special pricing from the vendor.

If parts are ordered for stock and the vendor is offering a special sale price of which you want to take advantage, you may direct expense the parts then perform a stock adjustment to put the parts into stock.

If excess parts are returned to stock from a Job where the parts were direct expensed, the cost of the part from the original Purchase Order receipt will be used for the transaction, which may affect the average cost in the warehouse.