FIFO

In FIFO (i.e. first in first out) accounting, the inventory purchased first is assumed to be sold first. This contrasts with LIFO (i.e. last in first out) accounting in which the inventory purchased most recently (i.e. last) is assumed to be sold first.

When any firm has inventory in its possession and then eventually sells that inventory, that firm must determine how to account for that inventory. It must determine what cost amount to assign to that inventory to calculate the cost-of-goods-sold number that is necessary in determining that firm's profit. This seems like a straightforward task; whatever the firm paid for that inventory is its cost.

However, it is not quite that simple. If the firm built its inventory over time, and paid different prices each time, then determining how to account for the inventory becomes a little more difficult; and the method chosen can have a significant effect on reported profits.

There are two basic ways a firm can account for its inventory, LIFO and FIFO. Under LIFO accounting (LIFO is an acronym that stands for **L**ast **I**n **F**irst **O**ut), the most recent (i.e. the last) inventory is assumed to be sold first; and the inventory purchased earliest is assumed to be sold last. Under FIFO accounting (FIFO is an acronym that stands for **F**irst **I**n **F**irst **O**ut), the inventory purchased earliest (i.e. first) is assumed to be sold first.

In periods of rising prices, FIFO accounting usually leads to greater profits than LIFO accounting. If prices are rising, then recent prices are going to be higher than earlier prices. Since FIFO accounting assigns the cost to inventory based on the earlier prices, cost of goods sold will be lower than it would be under LIFO accounting, and profits will be higher.

However, it is important to understand that these profits are "phantom" profits. They are entirely the result of inflation and nothing else. In an inflationary environment, FIFO accounting is generally considered a more aggressive form of accounting. Investors should be slightly wary of firms that use FIFO instead of LIFO, and investors should be wary of firms that switch from LIFO to FIFO for no apparent reason.