Marudhar Kesari Jain College for Women (Autonomous)
Vaniyambadi

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SYLLABUS
UNIT-V

Reconciliation of Cost and Financial Accounts.

Introduction

Reconciliation of Cost and Financial Accounts is the process to find all the reasons behind disagreement in profit which is calculated as per cost accounts and as per financial accounts. There are lots of items which are shown in the profit and loss account only when we make it as per financial accounting rules. There are lots of items which are shown in costing profit and loss account only when we calculate profit as per cost accounting.

Suppose, we have taken the profit or loss as per financial accounts, we adjust it as per cost accounts. In the end of adjustments, we see same profit as per cost accounts. If we have taken profit as per cost account, we must adjust items as per financial accounts. For this purpose, we make reconciliation statement.

A reconciliation statement is a statement which is prepared to reconcile the profit as per cost accounts with the profit as per financial accounts by suitably treating the causes for the difference between the cost and financial profit.

Reconciliation of Cost and Financial Accounts – Need and Objectives

(i) To find out the difference existing in cost accounts and financial accounts.

(ii) To ensure the mathematical accuracy and to have a check on both the cost and financial books.

(iii) To adhere to the convention of consistency where all the policies should be kept constant with regard to valuation of inventory or depreciation etc.

(iv) To help the management in taking decisions with regard to profitability of the concern.

(v) To help the management to take people internal control.

(vi) To promote coordination between the two departments namely the costing departments and financial department.

(vii) To identify and detect the variation in profit caused by the difference in the books of cost and financial system.

(viii) To detect if any mistakes are made in recording the translations in both the books namely the cost or financial books of accounts.

Profit reconciliation is necessary to achieve the following two objectives:

1. To ascertain the reasons for the difference in the profits or losses in cost and financial books.

2. To check the arithmetic accuracy and reliability of cost and financial data.

Reconciliation of Cost and Financial Accounts – Preparation of Reconciliation Statement of Cost and Financial Books

When a manufacturing company opt integrated accounting system, there is no separate cost and financial accounts maintained. But where this accounting system is not followed, the need for reconciliation of cost book and financial book occurs there. Because the financial statement and costs statement shows different profit, it creates problem. This problem can be solved by preparing a Reconciliation statement of Cost and Financial books.

So, reconciliation between two sets of books is necessary due to the following reasons:

(a) To find out the reason of differences of profit or loss in both the books.

(b) To make sure that the calculation, accuracy and reliability of cost and financial accounts in order to have a correct cost control.

(c) To standardised the policies regarding valuation of stock, depreciation of assets and overheads.

(d) To increase the internal control system over cost by comparing the cost allocation according to finance and cost.

(e) To coordinate in a better manner in activities of financial and cost department.

(f) To identify the reasons for different result of accounts.

1. Following are some of the important items the costs of which may be different in financial books and costing books:

(a) Direct Materials:

The estimated or standard cost of the direct materials purchased or consumed in the production process may be different from the actual costs. This difference will be due to change in price or quantity or both.

(b) Direct Labour:

The estimated or standard cost of direct labour may be different from the actual costs because of differences in wage rates or hours of work or both. Sometimes, workers might have to be paid more due to increased dearness allowance, pay revision, bonus etc. This will cause difference between the profits shown by the two sets of books.

(c) Overheads:

In cost accounts the recovery of overheads is generally based on estimates while in financial accounts the actual expenses incurred are recorded. This results in under-or over-recovery of overheads.

The under-recovery or over-recovery of overheads may be carried forward to the next period or may be charged by a supplementary rate (positive or negative) or transferred to costing Profit and Loss Account. In case the under-recovery or over-recovery of overheads has been carried forward to the next period, the profit as shown by the costing books will be different from the profit as shown by the financial books. Such variation may be due to over-or-under charging of factory, office or selling and distribution overheads.

(d) Depreciation:

Different methods of charging depreciation may be adopted in cost and financial books. In financial books depreciation may be charged according to fixed installment method or diminishing balance method etc. while in cost accounts machine hour rate or any other method may be used. This is also an item of overheads and may be one of the reasons of difference between the overheads charged in financial accounts and overheads charged in cost accounts.

2. Valuation of Stocks:

(a) Raw materials – In financial accounts stock of raw materials is valued at cost or market price, whichever is less, while in cost accounts stock can be valued on the basis of FIFO or LIFO or any other method. Thus, the figure of stock may be inflated in cost or financial accounts.

(b) Work-in-progress – Difference may also exist regarding mode of valuation of work-in-progress. It may be valued at prime cost or factory cost or cost of production. The most appropriate mode of valuation is at factory cost in cost accounts. In financial accounts work-in-progress may be valued after considering a part of administrative expenses also.

(c) Finished goods – Under financial accounts, stock of finished goods is valued at cost or market price whichever is lower. In cost accounts, finished stock is generally valued at total cost of production. If the circumstances warrant, prime cost or factory cost may also be taken as the basis for valuing the stock of finished goods.

Thus, mode of valuation of stocks gives rise to different results in the two sets of books. Greater valuation of opening stocks in cost accounts means less profit as per cost accounts and vice versa. Greater valuation of closing stocks in cost accounts means more profit as per cost accounts and vice versa.

3. Items Included in Financial Accounts Only:

There are certain items which are included in the Financial Accounts but not in the Cost Accounts.

These include the following:

(a) Appropriation of profits e.g., provision for taxation, transfer to reserves, goodwill, preliminary expenses written off.

(b) Purely financial charges e.g., losses on sale of investments; penalties and fines, expenses on transfer of company's office.

(c) Purely financial incomes e.g., interest received on bank deposits, profits made on the sale of investments, fixed assets, transfer fees received etc.

4. Items Included in Cost Accounts Only:

There are certain notional items which are excluded from the financial accounts but are charged in the cost accounts:

(i) Charge in lieu of rent where premises are owned.

(ii) Depreciation on an asset even when the book value of the asset is reduced to a negligible figure.

(iii) Interest on capital employed in production but upon which no interest is actually paid (this will be the case when the firm decides to include interest in the overheads).

The above items will reduce the profits in Cost Accounts as compared to that in Financial Accounts.

5. Abnormal Gains and Losses:

Abnormal gains or losses may completely be excluded from cost accounts or may be taken to costing profit and loss account. In financial accounts such gains and losses are taken to profit and loss account. As such, in the former case costing profit/loss will differ from financial profit/loss and adjustment will be required. In the latter case, there will be no difference on this account between costing profit or loss and financial profit or loss.

Therefore, no adjustment will be required on this account. Examples of such abnormal gains and losses are abnormal wastage of materials e.g., by theft or fire etc., cost of abnormal idle time, cost of abnormal idle facilities, exceptional bad debts, abnormal gain in manufacturing through processes (when actual production exceeds normal production).

The need for reconciliation will not arise in case of a business where Integral or Integrated Accounting System is in use as there will be only one set of books both for financial and costing records. But where there are separate sets of books, reconciliation is imperative.

Preparation of Reconciliation Statement or Memorandum Reconciliation Account:

A Reconciliation Statement or a Memorandum Reconciliation Account should be drawn up for reconciling profits shown by the two sets of books. Results shown by any sets of books may be taken as the base and necessary adjustment should be made to arrive at the results shown by the other set of books.

The technique of preparing a Reconciliation Statement as well as a Memorandum Reconciliation account is discussed below:

The preparation of reconciliation statement involves the following steps:

(1) Profit as per any set of books (cost or financial) may be taken as the base. This is as a matter of fact the starting point for determining the profit as shown by the other set of books after making suitable adjustments taking into consideration the causes of difference.

(2) The effect of the particular cause of difference should be studied on the profits shown by the other set of books.

(3) In case, the cause has resulted in an increase in the profit shown by other set of books, the amount of such increase should be added to the profit as per the former set of books which has been taken as the base.

(4) In case, the cause has resulted in a decrease in the profit shown by other set of books, the amount of such decrease should be subtracted from the profit as per the former set of book which has been taken as the base.

Reconciliation Procedure:

The cost and financial accounts are reconciled by preparing a Reconciliation Statement or a Memorandum Reconciliation Account.

(a) Reconciliation Statement:

The same principles of bank reconciliation will apply here. One may start with the profit shown by one set of accounts (usually cost accounts) as base profit and items which do not tally are either added to it or deducted from it to get the profit shown by other set of accounts (i.e., financial accounts).

The treatment of items will be reversed if the starting point in the reconciliation statement is the profit as per financial accounts.

Proforma of Reconciliation Statement

			Rs.	Rs.
		Profit as per Cost Accounts		******
Add :	(1)	Over-absorption of overheads in cost accounts	******	
	(2)	Financial incomes not recorded in cost accounts	******	
	(3)	Under-valuation of Closing Stock in cost accounts	******	
	(4)	Over-valuation of Opening Stock in cost accounts	******	
	(5)	Items charged only in cost accounts (i.e., Notional rent and interest on capital etc.)	******	******
Less :	(1)	Under-absorption of overheads in cost accounts	******	******
	(2)	Financial charges not considered in cost accounts (e.g. Bad debts written off, preliminary expenses, goodwill and discount on issue of shares written off)	******	
	(3)	Under-valuation of Opening Stock in cost accounts	******	
	(4)	Over-valuation of Closing Stock in cost accounts	******	******
		Profit as per Financial Accounts		******

Note: In case of Loss, the amount shall appear as a minus item.

(b) Memorandum Reconciliation Account:

Here the reconciliation procedure is in the form of an account. The profit as per cost accounts is the starting point and is shown on the credit side of this account. All items which are added to costing profit for reconciliation are also shown on credit side.

The items to be deducted from costing profit for reconciliation are shown on the debit side. The balancing figure gives the profit as per financial accounts. It is only a memorandum account and does not form part of double entry system of book-keeping.

Proforma of Memorandum Reconciliation Account:

Dr. **Memorandum Reconciliation Account** *Cr.*

Particulars		Rs.	Particulars		Rs.
To Financial Expenses debited in financial accounts :			By Profit as per Cost Accounts		***
Discount	***		„ Financial Incomes not recorded in Cost Accounts		
Fines and Penalties	***		Rent received	***	
Loss on Sale of Assets	***		Interest received	***	***
Bank Interest	***		„ Dividend/Profit on Sale of Assets		***
Donations	***		„ Items charged only in cost accounts		***
Preliminary expenses &			„ Over-absorption of overheads		***
Goodwill written off	***	***	„ Over-valuation of opening stock (in cost)		***

Particulars	Rs.	Particulars	Rs.
To Under-absorption of overheads	***	By Under-valuation of closing stock (in cost)	***
„ Under-valuation of opening stock in cost accounts	***	„ Depreciation over charged in Cost Accounts	***
„ Over-valuation of closing stock in cost accounts	***		
„ Net profit as per Financial Accounts	***		
	***		***

PROBLEMS

1. From the following particulars ascertain the amount of profit shown in profit and loss account by preparing necessary reconciliation account:

	Rs.
(a) Profit shown as per cost books	140000
(b) Depreciation shown excess in cost books	2000
(c) Interest on investment received	1000
(d) Provision made for Income Tax	40000
(e) Income received for share transfer	150
(f) Factory overhead under recovered in cost books	3000
(g) Office expenses under recorded in financial books	1000

SOLUTION:

RECONCILIATION STATEMENT

PARTICULARS	RS	RS
Profit as per cost A/C		140000
(+) Depreciation excess in cost A/C	2000	
Interest on investment	1000	
Income received from share transfer	150	
Office expenses under recorded in financial a/c	1000	4150
		144150
(-) Provision made for Income Tax	40000	
Factory overhead under recovered in cost books	3000	43000
Profit as per financial a/c		**101150**

2. Profit disclosed by a company's cost accounts for the year 2006 was Rs.50,000. The following information is available:

(a) Overheads as per cost accounts were Rs.8,500 while Rs.7,000 was recorded as recorded as overheads in financial accounts.

(b) Directors' fees shown only in financial accounts Rs.2,000

(c) The company allocated Rs.5,000 as provision for doubtful debts.

(d) Depreciation was shown as Rs.750 in financial accounts whereas in cost accounts it was shown as Rs.1,500.

(e) Share transfer fees received during the year Rs.2,000

(f) Provision for income tax was Rs.15,000.

Prepare cost and financial reconciliation statement.

SOLUTION:

RECONCILIATION STATEMENT

PARTICULARS	Rs.	Rs.
Profit as per cost a/c		50000
(+) Overheads as per cost a/c (8500-7000)	1500	
Depreciation in financial a/c (1500-750)	750	
Share transfer fees received	2000	4250
		54250
(-)Directors' fees shown in financial accounts	2000	
Provision for doubtful debts	5000	
Provision for income tax	15000	22000
Profit as per financial a/c		**32250**

3. Prepare a statement of reconciliation from the following:

	Rs.
Net loss as per cost accounts	34500
Net loss as per financial accounts	40950
Works overhead under recovered in costing	6240
Administrative overhead recovered in excess	3400
Depreciation recovered in costing	11200
Depreciation charged in financial accounts	12500
Interest on investments not included in costing	6000
Goodwill written off	5000
Provision for doubtful debts in financial accounts	1260
Store's adjustment credit in financial accounts	950
Loss of stock charged in financial accounts	3000

SOLUTION:

RECONCILIATION STATEMENT

PARTICULARS	Rs.	Rs.
Net loss as per cost accounts		34500
(+) Works overhead under recovered in costing	6240	
Depreciation charged in financial accounts (12500-11200)	1300	
Goodwill written off	5000	
Provision for doubtful debts in financial accounts	1260	
Loss of stock charged in financial accounts	3000	16800
		51300
(-) Administrative overhead recovered in excess	3400	
Interest on investments not included in costing	6000	
Store's adjustment credit in financial accounts	950	10350
Loss as per financial a/c		**40950**

4. The profit as per cost accounts is Rs. 1,50,000. The following details are ascertained on a comparison of the cost and financial accounts:

	Cost Accounts	Financial a/c
(a)Opening Stock:		
Materials	10000	15000
Finished goods	18000	16000
(b)Closing Stock:		
Materials	12000	13000

Finished goods	20000	17000
(c) Interest charged	10000	-
Preliminary expenses written off	-	500
Goodwill written off	-	1500
(e) Dividend received	-	1000
(f) Indirect expenses	75000	80000

SOLUTION: (I) Profit as per cost a/c:

RECONCILIATION STATEMENT

PARTICULARS	Rs.	Rs.
Profit as per cost accounts		150000
(+) Over absorption of finished goods (18000-16000)	2000	
Interest charged in cost a/c	10000	
Under absorption of closing stock (13000-12000)	1000	
Dividend received in Financial a/c	1000	14000
		164000
(-) Opening stock material under absorption (15000-10000)	5000	
Over absorption stock finished goods (20000-17000)	3000	
Preliminary expenses written off	500	
Goodwill written off	1500	
Under absorption of overhead (80000-75000)	5000	15000
Profit as per financial a/c		**149000**

(ii) Profit as per financial a/c:

RECONCILIATION STATEMENT

PARTICULARS	Rs.	Rs.
Profit as per financial a/c		149000
(-) Opening stock material under absorption (15000-10000)	5000	
Over absorption stock finished goods (20000-17000)	3000	
Preliminary expenses written off	500	
Goodwill written off	1500	
Under absorption of overhead (80000-75000)	5000	15000
		134000
(-) Over absorption of finished goods (18000-16000)	2000	
Interest charged in cost a/c	10000	
Under absorption of closing stock (13000-12000)	1000	
Dividend received in Financial a/c	1000	14000
Profit as per cost a/c		**120000**

5. The following is the profit and loss account of ‘X’ Ltd.

PARTICULARS	Rs.	PARTICULARS	Rs.
To Materials	30000	By Sales	100000
To Wages	14000	By Closing stock	8000
To Factory expenses	10000	By Profit on sale of machinery	2000
To Administration expenses	8000	By Discount received	5000
To Selling expenses	6000		
To Depreciation	2000		
To Net profit	45000		
	115000		115000

The profit as per cost accounts was Rs.37000

You are required to prepare reconciliation statement of the cost and financial profits using the following additional data:

(1) Factory overhead in cost accounts is absorbed at 100% on wages

(2) Closing stock is valued at Rs. 10000 in costing

(3) Administration and selling overheads were recovered at 5% and 7% on sales respectively

(4) Depreciation was charged in costing at Rs. 3000

SOLUTION:

Calculation of overhead as per cost a/c:

a) Factory Overheads:

Factory overhead-100% on wages

= 14000*100%

= Rs. 14000

b) Closing stock:10000

c) Administrative overhead- 5% on sales:

=100000*5%

= rs.5000

d) Selling overhead- 7% on sales:

= 100000*7%

= rs.7000

e) Depreciation in cost: Rs.3000

(I) Profit as per Cost a/c:

RECONCILIATION STATEMENT

PARTICULARS	Rs.	Rs.
Profit as per cost a/c		37000
(+) Over absorption of factory overheads (14000-10000)	4000	
Over absorption of selling overheads (7000-6000)	1000	
Profit on sale of machinery	2000	
Over absorption of depreciation (3000-2000)	1000	
Discount received	5000	13000
		50000
(-) Over valuation of closing stock (10000-8000)	2000	
Under absorption of administrative overheads (8000-5000)	3000	5000
Profit as per financial a/c		**45000**

(ii) Profit as per financial a/c:

RECONCILIATION STATEMENT

PARTICULARS	Rs.	Rs.
Profit as per financial a/c		45000
(+) Over valuation of closing stock (10000-8000)	2000	
Under absorption of administrative overheads (8000-5000)	3000	5000
		50000
(-) Over absorption of factory overheads (14000-10000)	4000	
Over absorption of selling overheads (7000-6000)	1000	
Profit on sale of machinery	2000	
Over absorption of depreciation (3000-2000)	1000	
Discount received	5000	13000
Profit as per cost a/c		**37000**