Reconciliation of cost and financial accounts

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COST ACCOUNTING

Cost accounting is a process of recording, classifying, analyzing, summarizing, allocating and evaluating various alternative courses of action and control of costs. Its goal is to advise the management on the most appropriate course of action based on the cost efficiency and capability. Cost accounting provides the detailed cost information that management needs to control current operations and plan for the future.

FINANCIAL ACCOUNTING

Financial accounting is the process of recording, summarizing and reporting the transactions resulting from business operations over a period of time. These transactions are summarized in the preparation of financial statements, including the balance sheet, income statement and cash flow statement.

Meaning of reconciliation

- Where cost accounts and financial accounts are separately maintained in two different sets of books, the profit or loss shown by one may not agree with that shown by other. Therefore, it becomes necessary that periodically the profit or loss shown by the two sets of accounts is reconciled.
- A memorandum of reconciliation is prepared showing the reasons for difference between the results disclosed by each system. It is done to check the arithmetical accuracy of both sets of accounts as well as to detect mistakes committed in the accounts.

NEED FOR RECONCILIATON

(a) It reveals the reasons for difference in profit or loss between cost and financial accounts.

(b) It ensures that no income or expenditure item has been omitted to record and there is no under- or over-recovery of overheads.

(c) It helps in checking the arithmetical accuracy of both the sets of accounts.

(d) It ensures the reliability of cost accounts in order to correct ascertainment of cost of production.

(e) It facilities internal control by highlighting the variations causing increase or decrease in profit.

(f) It promotes co-ordination and co-operation between cost and financial accounting departments in order to generate correct and reliable accounting data.

(g) It enables management to formulate policies regarding overheads, depreciation and stock valuation.

(h) It ensures managerial decision-making.

REASONS FOR DISAGREEMENT IN PROFIT

The disagreement between the costing and financial profit is caused by the following:

1. Items Shown Only in Financial Accounts:

These may be items of expenditure or appropriation of profit or items of income. The former reduce the profit while the latter have the reverse effect.

The items may be classified as under:

(a) Purely Financial Charges:

(i) Loss arising from the sale of fixed assets,
(ii) Loss on investments,
(iii) Discount on debentures,
(iv) Interest on bank loan, mortgages and debentures,
(v) Penalties and fines,

(b) Appropriations of Profit:

(i) Donations and Charities,

(ii) Taxes on income and profits,

(iii) Dividend paid,

(iv) Transfers to reserves and sinking funds,

(v) Additional provision for depreciation on fixed assets and for bad debts,

(c) Writing off Intangible and Fictitious Assets:

Goodwill, Patents and Copyrights, Advertisement, Preliminary Expenses, Underwriting Commission, Discount on Issue of Shares/Debentures etc.

(d) Purely Financial Incomes:

(i) Rent receivable,

(ii) Profits on the sale of fixed assets,

(iii) Transfer fees received,

(iv) Interest received on bank deposits,

(v) Dividend received,

(vi) Brokerage received,

(vii) Discount, commission received etc.

2. Items Shown Only in Cost Accounts:

There are certain items which are included in cost accounts but not in financial accounts. These items are very few and usually are notional charges. For example, interest may be calculated on capital employed in production to show the **nominal cost of employing the capital** though, in fact, no interest has been paid. Similarly production may be charged with a **nominal rent** for premises owned to enable the concern to compare its cost of production with that of a rented factory.

3. Over or Under-absorption of Overheads:

Overheads absorbed in cost accounts on the basis of estimation like percentage on direct materials, percentage on direct wages, etc. may be more or less than the actual amount incurred. If overheads are not fully absorbed i.e. the amount in cost accounts is less than the actual amount, the shortfall is called under-absorption. On the other hand, if overhead expenses in cost accounts are more than the actual, it is called over- absorption.

4. Different Bases of Stock Valuation:
The valuation of all stocks in financial accounts is done on the basic principle of cost or realisable value whichever is less. The valuation of stock in cost accounts is dependent on whether FIFO or LIFO or Average method is adopted.

5. Different Methods of Charging Depreciation:
The methods of charging depreciation may differ in financial accounts and cost accounts and may cause disagreement in profits of the two books of accounts. For example, Straight Line or Diminishing Balance Method

6. Abnormal Gains and Losses:
Abnormal items as **abnormal wastage of material by theft, wages of abnormal idle time, cost of abnormal idle facilities, exceptional bad debts, abnormal gain on manufacturing** may be shown in financial accounts but are excluded from the cost accounts and are taken directly to the costing and profit and loss account. This causes difference in profits as per two books of accounts.

METHODS OF RECONCILIATION

RECONCILIATION STATEMENT

- 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.

A proforma of reconciliation statement is shown below:

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		******

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.

A proforma of memorandum reconciliation account is shown below:

Dr. *Memorandum Reconciliation Account* Cr.

Dr.		Rs.	Cr.		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)		***
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		***			
		***			***

EXAMPLE:

Prepare a reconciliation statement from data as shown below:

	Rs.
Profit as per Cost Accounts	1,45,500
Works Overhead under-recovered	9,500
Administration Overheads under-recovered	22,750
Selling Overheads over-recovered	19,500

	Rs.
Over-valuation of Opening Stock in Cost Accounts	15,000
Over-valuation of Closing Stock in Cost Accounts	7,500
Interest earned during the year	3,750
Rent received during the year	27,000
Bad debts written off during the year	9,000
Preliminary expenses written off during the year	18,000

SOLUTION:

Reconciliation Statement

		Rs.	Rs.
	Profit as per Cost Accounts		1,45,500
Add :	Over-recovery of selling overheads in Cost Accounts	19,500	
	Over-valuation of Opening Stock in Cost Accounts	15,000	
	Interest earned excluded in Cost Accounts	3,750	
	Rent received excluded in Cost Accounts	27,000	65,250
			2,10,750
Less :	Under-recovery of Works Overheads in Cost Accounts	9,500	
	Under recovery of Administration Overheads	22,750	
	Over-valuation of Closing Stock in Cost Accounts	7,500	
	Items not charged in Cost Accounts		
	— Bad debts written off	9,000	
	— Preliminary expenses written off	18,000	66,750
	Profit as per Financial Accounts		1,44,000

THANK YOU