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Reconciliation of cost and financial accounts

- Introduction
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- Procedure of reconciliation

[1] INTRODUCTION :

It is common in business to keep separate set of books for financial accounts as well as for cost accounts . There is always some difference in the trading results shown by both sets of books , as they are written for different purpose However , the results of both must be capable of being reconciled . An interesting simile would make the point clear . There is generally some difference in the bank balance as shown by bank pass - book and that shown by our cash book However , by preparing bank reconciliation statement one is able to reconcile the two balances . The same logic applies to the reconciliation of profit as shown by two sets of books for which a reconciliation statement is prepared .

[2] REASONS FOR DISAGREEMENT IN PROFITS :

Financial acccounts and cost accounts are prepared with different objects The main object of financial accounts is to record day - to - day monetary transactions and to prepare final (or annual) accounts at the end of the financial year to ascertain the trading result of the year and to show the state of affairs of the business at the end of the financial year . The main object of cost accounts is to analyse the expenditure in a greater detail and to ascertain the cost per unit of goods produced or services rendered .

The disagreement in profit or loss disclosed by cost and financial accounts arises mainly due to the following four reasons :

(a) Some items are shown only in financial accounts .

(b) Some items are shown only in cost accounts .

(c) Under or over absorption of overheads .

(d) Different bases of stock valuation .

(A) Items shown only in Financial Accounts :

There are certain items which are shown in the financial accounts and not in the cost accounts . Such items of expenditure will reduce the financial profit for the year , whereas any such item of income will increase the profit in financial accounts .

The main items included only in financial accounts are as follows :

(1) Appropriation of profits :

(a) Provision for taxation

(b) Transfer to general reserves and other reserves

(c) Transfer to sinking fund

(d) Dividend on share capital

(2) Non - trading and non - recurring expenditure and income :

(a) Rent received or receivable

(b) Profit or loss on sale of investments or fixed assets .

(c) Share transfer fees .

(d) Fines and penalties .

(3) Items of purely financial nature :

(a) Interest on investments or on bank deposits

(b) Interest on debentures or on bank loan (if interest on capital is not taken into consideration in cost accounts) .

(4) Intangible and fictitious assets written off :

(a) Goodwill written off

(b) Preliminary expenses , discount on issue of shares or debentures , underwriting commission and brokerage etc. written off .

(B) Items shown only in Cost Accounts : There are very few items which are shown in cost accounts only but not in the financial accounts . All expenditure , whether paid or not , are recorded in financial accounts . Thus the type of expenditure which would appear in the cost accounts only is a notional charge . The following two items are examples of items included in cost accounts only : accounts , even though it is not to be paid , to show the normal cost of employing

(i) Interest on capital : Sometimes , interest on capital is charged in cost capital rather than investing it outside the business . by the proprietors , sometimes a notional amount for rent of premises is charged

(ii) Charge in the lieu of rent : When the business uses premises owned so that the cost of production in a factory owned by a company can be compared with similar costs in a rented factory .

(C) Under or Over - absorption of Overheads :

In financial accounts , the actual overheads incurred are shown . However , in case of cost accounts , overhead is recovered on some pre - determined basis . e.g. percentage on direct wages , percentage on sales etc. Thus the amount of different . If these differences are written off to Costing Profit and Loss overhead recovered and amount actually incurred will be invariably different. If these differences are written off to costing profit and loss Account , then the profit as shown by two sets of books will agree , and the over - absorption or under absorption will not be shown in Reconciliation Statement . As Wheldon has put it , " Instead , if it has been carried forward as a balance to next year , this amount must be shown in Reconciliation Statement . " *

As in all textbooks published in India at all India level have shown under absorption or over - absorption in the Reconciliation Statement , we have followed the same practice in this book . It has been assumed in all cases that difference in Overheads Accounts has not been transferred to Costing Profit and Loss Account , so that adjustment in respect of overheads becomes necessary , while reconciling cost and financial accounts .

(D) Different Bases of Stock Valuation :

As a matter of financial prudence , the stock in financial accounts , is always valued on the basis of cost or market price whichever is less . The basis for valuing stock in cost accounts is always the actual cost . Thus in cost accounts , raw - materials will be valued on FIFO or LIFO or other accepted methods of pricing issues ; work - in - progress may be valued at prime cost only or at work cost ; finished goods is generally valued on the basis of its cost of production .

The finished stock is valued on the basis of its work cost or factory cost in financial accounts , i.e. office overhead is excluded , whereas in cost accounts stock is always valued on the basis of cost of production , i.e. prime cost plus factory overheads plus administration overhead . Thus the stock figures in the two sets of accounts will be different to the extent of office overheads chargeable to closing stock . Hence , an adjustment becomes necessary for such difference while reconciling the profit of two sets of books .

PROCEDURE OF RECONCILIATION :

Reconciliation of profit (or loss) of cost accounts with that of financial accounts is done by preparing a Reconciliation Statement or by means of a Memorandum Reconciliation Statement . The following procedure may be adopted for reconciling the profit shown by the two sets of books of accounts .

Firstly , the reasons of disagreement between the profits as shown by two sets of accounts must be ascertained . Various items in the Trading and Profit and Loss Accounts of Financial Accounts must be compared with the costing Profit and Loss Account in order to find out the following :

(I) Expenses shown in financial accounts but not in cost accounts .

(ii)Incomes shown in financial accounts only .

(iii) Expenses shown in cost accounts only but not in financial accounts .

(iv) The difference between overhead charges shown in financial accounts and overhead charges recovered in cost accounts .

(v) The bases of valuation of stock in both sets of accounts and the difference between the values of stock shown in both sets of accounts .

Now we are in a position to prepare a statement of reconciliation of profit . In order to reconcile the profit , we may start with the figure of profit as per any set of books and arrive at the figure of profit as per the other set of books .

For example , while comparing the Financial Profit and Loss Account with that of Costing Profit and Loss Account , it is observed that Works overhead charges shown in Financial Profit and Loss Account is Rs . 9,000 whereas Works overhead recovered in Costing Profit and Loss Account is Rs . 10,000 , i.e. it is over - recovered or charged more by Rs . 1,000 in Cost Accounts . Thus the profit as shown by Cost Accounts will be less by Rs . 1,000 as compared to profit shown by Financial Accounts . Now if we prepare a statement of reconciliation and start with the profit as per cost accounts , then we have to add Rs . 1,000 so that profit becomes equal to that of financial accounts .

While preparing reconciliation statement the following rule should be applied :

" DO WHAT THE OTHER HAS DONE "

i.e. " See the position of Profit in the opposite set of books and make changes accordingly . "

In order to understand this rule , if we start with the profit as per cost accounts , then the opposite set of books will be the financial accounts . It means that we should make necessary changes in cost accounts only so that its profit or loss becomes equal to financial profit or loss . Suppose , in Financial Profit and Loss Account an item of loss on sale of investment Rs . 100 is shown which does not appear in cost accounts .

(1) We start with profit as per cost books . The apposite set is financial accounts .

(2) Looking to the position of profit in opposite set of books (financial accounts) , we find that the profit is less .

So , Rs . 100 must be deducted from profit shown by cost accounts .

Another method of preparing this statement is that **" If expenses in our books are more , add the difference . "**

" If expenses in our books are less , then deduct the difference .

" If we start reconciliation statement with profit as per cost books , then our books are cost books .

If income in our books is more , deduct the difference .

If income in our books is less , add the difference .

PROFORMA OF A RECONCILIATION STATEMENT

Particulars	Rs	Rs.
Profit as per cost accounting Add ; i. items not credited in cost accounts share transfer fees interest on investments ii. items shown in cost accounting only notional rent charges of premises owned by a company iii. overhead over-absorbed or over-recovered in cost accounts iv. over- valuation of opening stock of finished goods in cost accounts Deduct ; I. items not charged in cost accounts : income tax loss on sale of investments preliminary expenses written of ii. overhead under recovered in cost account iii. over valuation of closing stock of finished goods in cost accounts		
Profit as per financial accounts		