Reconciliation of Cost Accounts and Financial Accounts?

Reconciliation of Cost and Financial Accounts is 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 have to adjust items as per financial accounts. For this purpose, we make reconciliation Statement.

(a) Items included only in financial accounts

There are number of items which appear only in financial accounts, and not in cost accounts, since they neither do nor relate to the manufacturing activities, such as,Purely financial charges, reducing financial profit
Losses on capital assets
Stamp duty and expenses on issue and transfer of stock, shares and bonds
Loss on investments.
Discount on debentures, bonds, etc.
Fines and penalties,
Interest on bank loans.
Purely financial income, increasing financial profit
Rent received
Profit on sale of assets
Share transfer fee
Share premium
Interest on investment, bank deposits.
Dividends received.
Appropriation of profit – donations and charities.
(b) Items included only in the cost accounts

There are very few items which appear in cost accounts, but not in financial accounts. Because, all expenditure incurred, whether for cash or credit, passes though the financial accounts, and only relevant expenses are incorporated in cost accounts. Hence, only item which can appear in cost accounts but not in financial accounts is a notional charge, such as, (i) interest on capital, which is not paid but included in cost accounts to show the notional cost of employing capital, or (ii) rent i.e. charging a notional rent of premises owned by the proprietor.

(c) Items accounted for differently in cost accounting and financial accounting

Overhead – In cost accounts, overheads are applied to cost units at predetermined rates based on estimates, and the amount recovered may differ from actual expenses incurred. If

such under-or over-recovery of overheads are not charged off to costing profit and loss account, the profits on two sets of books will differ.
Stock valuation – In financial accounts, stock is valued at lower of cost or market value. In cost accounts, stock is valued at cost adoption one of the methods, such as FIFO, LIFO, average etc., which is suitable to the unit. Thus, there may be difference in stock valuation, which will reflect difference in profit between the two sets of books.
Depreciation – If different basis is adopted for charging depreciation in cost accounts as compared to financial accounts, the profits will vary.

Need for Reconciliation:
In those concerns where there are no separate cost and financial accounts, the problem of reconciliation does not arise. But where cost and financial accounts are maintained independent of each other, it is imperative that periodically two accounts are reconciled. Though both sets of books are concerned with the same basic transactions but the figure of profit disclosed by the former does not agree with that disclosed by the latter.

Thus, reconciliation between the results of the two sets of books is necessary due to the following reasons:
1. To find out the reasons for the difference in the profit or loss in cost and financial accounts and to indicate the position clearly and to be sure that no mistakes pertaining to accounts have been committed.

2. To ensure the mathematical accuracy and reliability of cost accounts in order to have cost ascertainment, cost control and to have a check on the financial accounts.

3. To contribute to the standardisation of policies regarding stock valuation, depreciation and overheads.

4. To facilitate coordination and promote better cooperation between the activities of financial and cost sections of the accounting department.

5. To place management in better position to acquaint itself with the reasons for the variation in profits paving the way to more effective internal control.
Methods of Reconciliation:
Reconciliation of costing and financial profits can be attempted either:

(a) By preparing a Reconciliation Statement or

(b) By preparation a Memorandum Reconciliation Account.

Reconciliation Statement:When reconciliation is attempted by preparing a reconciliation statement, profit shown by one set of accounts is taken as base profit and items of difference are either added to it or deducted from it to arrive at the figure of profit shown by other set of accounts.

Procedure of Reconciliation:
When there is a difference between the profits disclosed by cost accounts and financial accounts, the following steps shall be taken to prepare a Reconciliation Statement:

(I) Ascertain the various reasons of disagreement (as discussed above) between the profits disclosed by two sets of books of accounts.

(II) If profit as per cost account (or loss as per financial accounts) is taken as the base:
Add:

(i) Items of income included in financial accounts but not in cost accounts.

(ii) Items of expenditure (as interest on capital, rent on owned premises etc.) included in cost accounts but not in financial accounts.

(iii) Amounts by which items of expenditure have been shown in excess in cost accounts as compared to the corresponding entries in financial accounts.
(iv) Amounts by which items of income have been shown in excess in financial accounts as compared to the corresponding entries in cost accounts.

(v) Over-absorption of overheads in cost accounts.

(vi) The amount by which closing stock of inventory is undervalued in cost accounts.

(vii) The amount by which the opening stock of inventory is overvalued in cost accounts.

(viii) Over charge of depreciation in cost accounts.

Deduct:

(i) Items of income included in cost accounts but not in financial accounts.

(ii) Items of expenditure included in financial accounts but not in cost accounts.

(iii) Amounts by which items of income have been shown in excess in cost accounts over the corresponding entries in financial accounts.

(iv) Amounts by which items of expenditure have been shown in excess in financial accounts over the corresponding entries in cost accounts.

(v) Under-absorption of overheads in cost accounts.

(vi) The amount by which closing stock of inventory is overvalued in cost accounts.

(vii) The amount by which the opening stock of inventory is undervalued in cost accounts.

(viii) Under charge of depreciation in cost accounts.

(III) After making all the above additions and deductions, the resulting figure will be profit as per financial accounts (or loss as per cash accounts).

Note:

If profit as per financial accounts (or loss as per cost accounts) is taken as the base, then items added shall be deducted and items to be deducted shall be added i.e. the procedure shall be reversed.

Memorandum Reconciliation Account:
Reconciliation can also be done by preparing a Memorandum Reconciliation Account. This account is a memorandum account only and does not form part of the double entry. When reconciliation is attempted through Memorandum Reconciliation Account, profit to be taken as “base profit” is shown like opening balance of this Account. All items of differences required to be deducted are debited and those to be added are credited to this Account, the balancing figure of this Account is the profit shown by other set of Accounts.

Reasons for disagreement between Profits as per financial accounting and Profits as per cost accounting
The difference in the profitability of cost and financial records may be due to the following reasons.

1. Items included in the financial accounts but not in cost accounts.
• Purely financial income: such as interest received on bank deposits, interest and dividend on investments, rent receivables, transfer fee received, profit on the sale of assets etc.

• Purely financial charges: such as losses due to scraping of machinery, losses on the sale of investments and assets, interest paid on the bank loans, mortgages, debentures etc., expenses of company’s transfer office, damages payable at law etc.

• Appropriation of profit: the appropriation of profit is again a matter which concerns only financial accounts. Items like payment of income tax and dividends transfer to reserve, heavy donations, writing off of preliminary expenses, goodwill and patents appear only in profit and loss appropriation account and the costing profit and loss a/c is not affected.

2. Items included in cost accounts only: There are certain items which are included in cost accounts but not in financial accounts. They are: Charges in lieu of rent where premises are owned, interest on capital employed in production but upon which no interest is actually paid.

3. Under/Over absorption of overhead expenses: In cost accounts, overheads are absorbed at predetermined rates which are based on past data. In the financial accounts the actual amount incurred is taken into account. There arise a difference between the actual expenses and the predetermined overheads charged to product or job.

If overheads are not fully recovered, which means that the amount of overheads absorbed in cost accounts is less than the actual amount, the shortfall is called as under recovery or under absorption. If overhead expenses recovered in cost accounts are more than that of the actually incurred, it is called over absorption. Thus, both the over and under recovery may cause the difference in the profits of both the records.

4. Different basis of stock valuation: In cost accounts, the stock of finished goods is valued at cost by FIFO, LIFO, average rate, etc. But, in financial accounts stocks are valued either at cost or market price, whichever is less.
The valuation of work-in-progress may also lead to variation. In financial books only prime cost may be taken into account for this purpose whereas in cost accounts, it may be valued at prime cost plus factory overhead.

5. Different basis of depreciation adopted: The rates and methods of charging depreciation may be different in two sets of accounts.