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RECONCILIATION OF COST AND FINANCIAL ACCOUNTS

In manufacturing concerns where the system of cost accounting is introduced, it usually functions independently of financial accounts. When financial accounts aim at ascertainment of total profit of an enterprise, cost accounting aims mainly at cost ascertainment, cost reporting, cost control and cost reduction. Hence, the approach of both the systems differs and the profit/ loss disclosed by cost accounts usually disagrees with that shown by the financial accounts. It is mainly due to difference in the basis of valuation of stock, under or over absorption of overhead charges and items of expenses or incomes taken in one set of accounts only.

In order to check the correctness of accounts prepared by cost and financial accountants and to explain the causes for difference in profits, a statement is prepared at the end of the period either by cost accountant or by financial accountant. Such a statement is called Profit Reconciliation Statement. A Profit Reconciliation Statement is defined as "*a statement prepared at the end of an accounting period either by the cost accountant or by the financial accountant in order to verify the correctness of cost and financial accounts as well as to explain the causes for disagreement in profits.”*

Need for Reconciliation of cost and financial profits

a. Reconciliation helps in checking the arithmetical accuracy of both the sets of accounts.

b. It enables the management to know the reasons for disagreement in profits.

c. It helps in formulating uniform policies regarding valuation of stock, methods and basis of depreciation, overhead absorption etc.

d. It helps in facilitating internal control.

e. It promotes co-ordination and co-operation between cost and financial sectioms of the accounting department.

f. The cost data becomes more reliable.

Reasons for disagreement in profits

The reasons for difference in profit or loss between cost and financial accounts may be broadly classified into the following:

I. Items appearing only in financial accounts.
Il. Items appearing only in cost accounts.
Ill. Adoption of different basis of stock valuation.
IV. Under or over absorption of overheads.
V. Difference in methods and rates of depreciation.
VI. Abnormal losses and gains taken only in one set of books.

I. Items Appearing only in Financial Accounts

Some items of expenses and incomes are taken only in financial accounts. They are not taken in cost accounts on the ground that they are non-cost items and their inclusion in cost accounts might lead to wrong inferences and unwise managerial decision. Items are:

i. Purely financial charges:

a. Loss, on sale of investments and other assets.

b. Preliminary expenses written off.

c. Goodwill written off.

d. Discount on issue of debentures and shares.

e. Loss due to destruction and scrapping of assets.

f. Interest on mortgages and loans.

g. Fines, penalties and damages payable.

h. Charitable donations.

i. Share transfer office expenses.

j. Remuneration to proprietor in excess of a fair reward for services rendered.

k. Bad debts written off, discount allowed etc.

Purely Financial Incomes:

a. Profit on sale of assets.

b. Interest and dividend received.

c. Discount, commission, brokerage etc. received.

d. Bad debts recovered.

e. Transfer fees received.

f. Rent receivable.

g. Discount allowed to customers, but later on disallowed.

iii. Appropriation of Profits:

a. Dividend paid.
b. Transfer to reserves.
c. Taxes on profit.
d. Additional provision for depreciation.
e. Capital expenditure specifically charged to revenue.

II Items appearing only in Cost Accounts

These are some notional charges made by cost accountant. These are charges made in cost accounts though not payable by the concern. If such charges are not made in the cost accounts, the cost per unit of the concern will be comparatively lower than those concerns where such payments are to be made. Such items of charges are:

a. Notional interest on capital. i.e., interest charged in the Profit and Loss Account, though there is sufficient amount of owned fund and no interest is payable on it.
b. Notional rent on owned premises.
c. Salary for the proprietor where he works in the business but does not have to pay.

III Adoption of Different Basis of Stock Valuation

There need not necessarily be uniformity in the basis and method of stock valuation. Cost accountant may follow one system where as the financial accountant may follow some other systems.

Cost accountant may value finished goods at cost of production or works cost, whereas, the financial accountant values it at total cost or market value whichever is lower. Value of raw material depends on whether FIFO or LIFO or Average method is adopted Work-in-progress may be valued at prime-cost or works cost level. Thus, due to difference in valuation of stock, the profits of the two sets of books vary.

IV. Under or Over-absorption of Overheads

In cost accounting, the recovery of overheads is always based on estimates or predetermined ratios. It may usually be certain percentage on prime-cost, works cost, sales etc. In financial accounts actual expenses of overheads are recorded with the result that there is either under recovery or over recovery of overheads in cost accounts. *If the overhead recovered in cost accounts is less than the actual amount of overhead charged in financial accounts, it is called under absorption. On the other hand, if the amount recovered in cost books is more, it is called over absorption*. The under recovery or over recovery of overheads may be transferred to costing Profit and Loss Account or may be carried to the next period. If these differences are written off to costing Profit and Loss Account, the profit will agree, otherwise, adjustment will have to be made on this account. In some concerns, administrative and selling distribution over heads are ignored leading to greater profit in cost accounts.

V. Difference in Methods and Rates of Depreciation

The amount of depreciation charge may be different in the two sets of books because of the difference in methods and rates adopted. The Financial Accountant may charge depreciation under fixed Instalment Method or Reducing Balance Method to meet the requirement of Income Tax rules, while the cost Accountant may charge it under machine hour rate or production hour rate. Rate of depreciation may also be different in certain cases.

VI. **Abnormal losses and gains taken only in one set of books**

Abnormal items such as, loss of materials by fire or theft, cost of abnormal idle facilities, abnormal gain in units of production etc. might have recorded only in one set of books leading to disagreement between profits.

Effects on Profits due to the items causing difference

The different items discussed above cause either to increase or decrease the profit of one set of books. If financial profit is more due to the effect of an item, the costing profit will be less by the same amount than the financial profit. The effects of different items on costing profit are discussed below:

1. **Purely financial charges**: These are the expenses taken only in financial accounts. As these expenses are not taken in cost books, the costing profit will be more than the financial profit.

2. **Purely financial Incomes**: These are the incomes taken only in financial books. As these incomes do not appear in the cost books, the costing profit will be less than the financial profit.

3. **Appropriation of profits:** Appropriations are made in financial accounts only after preparing the Profit and Loss Account. In order to study the effect, we should see whether the financial profit available is one before or after the appropriations. If the profit given is that before the appropriations, such items had no effect in the given financial profit. If the profit given is after appropriations the profit of cost account would be more by the amounts of appropriations.

4. **Items appearing in Cost Accounts only**: These being the notional charges made only in cost accounts, the costing profit would be less than the financial profit.

5. **Difference in stock valuation**: More value on closing stock will lead to more profit and more value on opening stock will lead to lesser amount of profit and vice-versa. If value of closing stock is more in cost accounts, the costing profit will be more than the financial profits. If the value of opening stock in cost accounts is more, the profit of cost accounts will be less than the financial accounts.

6. **Under or over absorption of overheads**: Under or over absorption takes place in cost accounts. If an overhead absorbed in cost accounts is less, the costing profit will be more. If the absorbed amount is more, the costing profit will be less.

7. **Difference in depreciation**: Depreciation is an expense item. If depreciation charged in one set of books is less the profit of that set will be more.

8. **Abnormal losses and gains**: Profit of the book in which abnormal loss is charged will be less than that of the other book. If abnormal gain is credited in one book only, the profit of that book will be more than the other set.

Procedure of Reconciliation

Reconciliation of cost and financial profits is made by preparing a Reconciliation Statement or Memorandum Reconciliation Account. Reconciliation Statement may be prepared:

I. Starting with profit as per Cost Accounts.

II. Starting with profit as per Financial Accounts

III. Starting with loss as per Cost Accounts.

IV. Starting with loss as per Financial Accounts.

The statement is prepared by starting with profit or loss of cost or financial books as the case may be. To the 'starting' or 'base' profit or loss, adjustments are made by adding or deducting amounts on the basis of reasons to arrive at the amount of profit or loss of the other set of books. If costing profit is chosen os the base profit, the profit to be found out would be that of financial accounts and vice versa.

If a given reason had led to increase in base profit the amount should be deducted on the contrary if a given item has led to, a reduction in base profit it should be added. The following steps shall be taken to prepare a reconciliation statement.

1.*Ascertain the various items and amounts caused for disagreement in profits.*

2.*If costing profit is taken as the base:*

Add:

i. Income credited to financial accounts only.

ii. Notional charges in cost account only.

iii. Value of closing stock taken more financial accounts.

iv. Value of opening stock taken less in financial accounts.

v. Overheads charged more in cost accounts.

vi. Depreciation charged less in financial accounts.

vii. Abnormal gains taken only in financial accounts.

Deduct:

i. Items of expenses charged only in financial account.

ii. Under absorption of overhead in cost accounts

iii. Excess depreciation in financial accounts.

Iv .Closing stock valued less in financial books.

v Opening stock valued more in financial books.

vi Any abnormal loss recorded in financial accounts only

vii Appropriation made in financial books.

Proforma of a Profit/Loss Reconciliation Statement

	₹	₹
Profit/Loss as per Cost Accounts/Financial Accounts		XXXX
Add: 1.	XXX	
2.	XXX	
3.	XXX	XXXX
		XXXX
Less: 1.	XXX	
2.	XXX	
3.	XXX	XXXX
Profit/Loss as per Financial Accounts/Cost Accounts		XXXX

MEMORANDAM RECOCILIATION ACCOUNT

A Memorandum Reconciliation Account is an account prepared to reconcile the profit as per cost books with that of the financial books. For the purpose of reconciliation, the profit as per cost books as well as the items to be added are credited in the memorandum reconciliation account and the items to be deducted are debited in it. The difference between the two sides gives the profit as per financial books.

Format of Memorandum Reconciliation Account

To Financial expenses Under-absorption of overheads „ Under-valuation of opening stock in cost accounts Over-valuation of closing stock in cost accounts **Profit as per Financial Accounts**	By Profit as per Cost accounts „ Financial income „ Imputed charges of rent and interest Over-absorption of overheads Over-valuation of opening stock in cost accounts Under-valuation of closing stock in cost accounts

I. **Preparation of Profit Reconciliation Statement starting with Profit as per Cost Accounts**.

Example

On 31st March 2018 Cost Accounts of a manufacturing concern show a profit of? 1 40,000 for the year 2018. The Financial Accounts reveal a net profit of 1,53,200 for the year.

Bad debts written off	3,000
Loss due to obsolescence charged in financial accounts	4,000
Interest and dividend credited in financial books	12,000
Profit on sale of investments credited in financial books	6,000
Depreciation charged more in financial accounts	3,200
Factory overhead charged more in financial books	1,600
Office overheads charged less in financial books Selling overhead charged	2,800
less in financial books	1,800
(over absorbed in cost books)	

Distribution overhead charged more in financial books (under absorbed in cost books)	600
Rent charged only in cost books	3000

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Prepare a profit Reconciliation statement also prepare a memorandum reconciliation

Profit as per cost books		140000
Add: Interest and dividend credited in financial books	12000	
Profit on sale of investments credited in financial books	6000	
Office overheads charged less in financial books	2800	
books Selling overhead over absorbed in cost	1800	
books Rent charged only in cost books	3000	25600
		165600

less:-Bad debts written off	3000	
Loss due to obsolescence charged in financial accounts	4000	
Depreciation charged more in financial accounts	3200	
Factory overhead charged more in financial books	1600	
Distribution overhead under absorbed in cost books	600	
		12400
		153200

Memorandum reconciliation account

particulars	amount	particulars	amount
To Bad debts written off	3000	By profit as per cost books	140000
Loss due to obsolescence	4000	Interest and dividend	12000
Depreciation charged	3200	credited	6000
Factory overhead charged more	1600	Profit on sale of investments	2800
Distribution overhead	600	Office overheads	1800
		Selling overhead	3000
		Rent charged	
Profit as per Financial books	**153200**		
	165600		165600