UNIT V

RECONCILIATION OF COST AND FINANCIAL ACCOUNTING

Where the cost accounts and financial accounts are maintained separately, the profit or loss shown by the two sets of accounts differ. The difference arises due to differences in the valuation of stock, over or under absorption of overheads and non-inclusion of some items of expenses in cost and financial accounts. Such difference must be reconciled. In order to reconcile the differences and ensure arithmetical accuracy, a reconciliation statement is prepared.

REASONS FOR DIFFERENCE IN PROFIT

The reasons for difference in profit or loss shown by cost accounts and financial accounts are as follows:

1. Items included in financial accounts only: There are certain items of income and expenditure, which are recorded in financial accounts only. That is, they are not recorded in cost accounts. These items are as follows:

3. Purely financial incomes like rent received, transfer fees received, interest on bank deposits and other investments, dividend income, profit on sale of assets.,

4. Purely financial charges like interest on bank loans, mortgages, debentures etc, discount on debentures, damages payable by law, expenses on transfer of company's office, loss on sale of assets, penalties and fines.

5. Appropriation of Profit is concerned with financial accounts only. It includes income tax, dividend paid, transfer to reserves, amounts written off, donations and charities.

1. ITEMS INCLUDED IN COST ACCOUNTS ONLY

Certain notional charges are included in cost accounts only. That is they are not recorded in financial accounts. These items are:

1. Notional Rent:

When the premises are owned, no rent is payable. However, the rental value called notional rent may be included in the cost accounts for cost ascertainment.

2. Notional Interest:

Interest on capital employed (though not actually paid) may be included in cost accounts for cost ascertainment.

2. UNDER OR OVER ABSORPTION OF OVERHEADS

In cost accounts, overheads are absorbed based on pre-determined rates. In financial accounts, actual amount of expenditure is taken into account. As a result, there is a difference in the absorption of overheads. It may be either under absorption or over absorption.

If overheads absorbed in cost accounts are less than the actual amount, it is known as under absorption.

If the overheads absorbed in cost accounts are higher than the actual amount, it is known as over absorption.

3. DIFFERENT METHODS OF DEPRECIATION

Adoption of different methods of depreciation in cost accounts and financial accounts may lead to difference in profit or loss. For example, use of straight-line method in financial accounts and machine hour in cost accounts will result in difference in profit or loss.

4. DIFFERENT BASES OF STOCK VALUATION

In financial accounts, stocks are valued at cost price or market price whichever is less. In cost accounts, stocks are valued at cost by adopting FIFO, LIFO, Simple Average price etc. The adoption of different bases of stock valuation leads to differences in profit or loss.

PROCEDURE TO RECONCILE COST AND FINANCIAL ACCOUNTS AT THE END OF AN ACCOUNTING PERIOD

The profit and loss shown by cost accounting differs from the profit or loss shown by financial accounting. The reconciliation statement is prepared to reconcile the differences between these two sets of accounts.

Profit as per financial accounts or cost accounts are taken as the starting point for reconciliation. Items included in one set of accounts and not in the other set are added or deducted, depending upon their effect on the profit to be found. For example, rent received is an item of income. It is included in financial accounts only. As a result, profit as per financial accounts is high. If the reconciliation statement starts with costing profit, rent received is added to arrive at profit as per financial accounts.

If the given profit is less, then the profit to be found will be more. Hence, the difference is added. If the given profit is more, then the profit to be found will be less. Hence, the difference is deducted.

STEPS IN PREPARATION OF RECONCILIATION STATEMENT

1. Ascertain the reasons for the difference between the profits shown by the two sets of accounts.

2. If profit as per cost accounts (or loss as per financial accounts) are taken as the starting point:

ADD THE FOLLOWING

1. Items of income included in financial accounts only.
2. Items of expenditure included in cost accounts only.
3. Amount by which incomes are over stated in financial accounts.
4. Amount by which expenses are over stated in cost accounts.
5. Amount by which opening stock is over stated in cost accounts.
6. Amount by which closing stock is over stated in financial accounts.
7. Over absorption of overheads in cost accounts.

DEDUCT THE FOLLOWING

1. Items of income included in cost accounts only.
2. Items of expenditure included in financial accounts only.
3. Amount by which incomes are overstated in cost accounts.
4. Amount by which expenses are overstated in financial accounts.
5. Amount by which opening stock is overstated in financial accounts.
6. Amount by which closing stock is over stated in cost accounts.
7. Under absorption of overheads in cost accounts.

8. The figure obtained after additions and deductions will be profit as per financial accounts.

If the profit as per financial accounts (or loss as per cost accounts) is taken as the starting point, the procedure shall be reversed. That is, items added shall be deducted and items deducted shall be added.

The following table will help to prepare the reconciliation of cost and financial accounts :

Treatment of Causes for Differences

S.No.	Reasons For Differences	Base is Costing Profit or Financial Loss (+) or (-)	Base is Financial Profit or Costing Loss (+) or (-)
1.	Over absorption of overhead in Cost Account	Add (+)	Less (-)
2.	Over valuation of closing stock in Financial Account	Add (+)	Less (-)
3.		Add (+)	Less (-)
4.	Over valuation of opening stock in Cost Account	Add (+)	Less (-)
5.	Excess provision for depreciation of building plant & machinery etc., charged in Cost Account	Add (+)	Less (-)
6.	Items of expenses charged in Cost Account but} not in Financial Accounts (Example Notional interest on Capital, Notional rent on Premises)	Add (+)	Less (-)
7.	Items of income recorded in Financial Account } but not in Cost Account	Less (-)	Add (+)

8. 9. 10.	Under absorption of overhead in Financial Account Over valuation of opening stock in Financial Account Over valuation of closing stock in Cost Account Item of income tax, dividend paid, preliminary expenses written off, goodwill written off, under writing commission and debenture discount written off and any appropriation of profit included in Financial Account only.	Less (-) Less (-) Less (-)	Add (+) Add (+) Add (+)

Illustration: 1

The financial books of a company show a net profit of Rs.l,27,560 for the year ending 31st Dec. 2003. The Cost Account shows a net profit of Rs.I,33,520 for the same corresponding period. The following facts are brought to light:

	Rs.
Factory overhead under recovered in costing *Alc*	1l,400
Administration overhead over recovered in costing *Alc*	8,500
Depreciation charged in financial accounts	7,320
Depreciation recovered in cost *Alc*	7,900
Interest received but not included in cost *Alc*	900
Income Tax debited in financial *Alc*	1,200
Bank interest credited financial *Alc*	460
Stores adjustment credited in financial *Alc*	840
Rent charged in financial Alc	1,720
Dividend paid recorded in financial *Alc*	2,400
Loss of obsolescence charged in financial *Alc*	520

Solution:

Reconciliation Statement

Particulars	*Rs.*	*Rs.*
Profits as per Cost Accounts		1,33,520
Add:		
Administration overhead over recovered in Cost Account	8,500	
Depreciation over recovered in Cost Account (7900 - 7320)	580	
Interest received but not included in Cost Alc	900	
Bank interest credited in Financial *Alc*	460	
Stores adjustments credited in Financial *Alc*	840	
		11,280
Less :		
		1,44,800
Factory overhead under recovered in Cost Alc	1l,400	
Income Tax received but not included in Cost *Alc*	1,200	
Rent charged in Financial *Alc*	1,720	
Dividend paid charged in Financial Alc	2,400	
Loss of obsolesce charged in Financial *Alc*	520	

		17,240
Profit as per Financial Accounts		1,27,560

Illustration: 2

AVS Ltd., made a Net Profit of Rs. 5,71,000 during the year 2003 as per the their financial system. Whereas their cost accounts disclosed a profit of Rs. 7,77,200. On reconciliation, the following differences were noticed :
(1) Directors fees charged in financial account, but not in cost account Rs. 13,000.
(2) Bank interest credited in financial account, but not in cost account Rs. 600.
(3) Income Tax charged in financial account, but not in cost account Rs. 1,66,000.
(4) Bad and doubtful debts written off Rs. ll,4oo in financial accounts.
(5) Overheads charged in costing books Rs. 1,70,000 but actual were Rs. 1,66,400.
(6) Loss on sale of old machinery Rs.20,000 charged in financial accounts.

Solution:

Reconciliation Statement

Particulars	Rs.	Rs.
Profits as per Financial Account		5,71,000
Add: Director fees charged in financial account but not in Cost a/c	13,000	
Income Tax charged in financial account but not in Cost Account	1,66,000	
Bad and doubtful debts written off	11,400	
Loss on sale of old machinery	20,000	2,10,400
		7,81,400
Less: Bank interest credited in financial account but not in Costa/c	600	
Overheads over absorbed in Cost *Nc* (170000 - 166400	3,600	4200
Profit as per Cost Accounts		7,77,200

Illustration: 3

Harish Ltd., has furnished you the following informations from the financial books for the year
ended 30th June, 2003 :

Profit and Loss Account (ended 30th June)

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Purchases	1,26,050	By Sales (25000 units at Rs. 15)	3,75,000
Direct wages	52,500		
Factory Overheads	60,650	Rent Received	1,300
Office & AdministratiVe Overheads	26,700	Profit on sale of investment	ll,7oo
		Closing Stock 20,400	
Depreciation	5,500		
Selling Expenses	35,500		
Net Profit	1,01,500		
	4,08,400		4,08,400

The cost sheet shows the costing profit of Rs. 98.850 and closing stock of Rs. 21,400. The factory overheads are absorbed at 100% of direct wages and Office and Administrative overheads are charged at Re. 1 per unit. Selling expenses are charged at 10% of Gross of sales. Depreciation in cost account absorbed was Rs. 4,000. You are required to prepare:

(1) A statement showing as per cost account for the year ended 30th June, 2003.

(2) Statement showing the reconciliation of profit disclosed in cost accounts with the profit shown in the financial accounts.

Solution:

Profit as per Cost Accounts

Particulars	*Amount*
Purchases	1,26,050
Add: Direct Wages	52,500
Prime Cost	1,78,550
Add: Factory overhead at 100% on direct wages	52,500
	2,31,050
Add: Depreciation	4,000
Factory cost or Works cost	2,35,050
Add: Office & Administrative overhead at Re. 1 Per unit (25,000 units at Re. 1)	25,000
Cost of Production	2,60,050
Less: Closing stock of finished goods	21,400
Cost of goods sold	2,38,650
Add: Selling expenses at 10% of Rs. 3,75,000	37,500
Cost of Sales	2,76,150
Costing Profit	98,850
Sales	3,75,000

Reconciliation Statement

Particulars	*Amount Rs.*	*Amount Rs.*
Profits as Financial Account		1,01,500
Add: Over valuation of closing stock in Cost a/c	1,000	
Under absorption of Factory overhead in Cost a/c	8,150	
Under absorption of Office & Admi. Overhead in Cost a/c	1,700	
Depreciation under absorbed in Cost a/c	1,500	12,350
		1,13,850
Less: Over absorption of selling expenses in Cost a/c	2,000	
Rent received charged in Financial a/c	1,300	
Profit on sale of investment charged in Financial a/c	11,700	15,000

Profit as per Cost a/c	98,850

Illustration 4

The profit as per cost accounts is Rs. 150000. The following details are ascertained on comparison of cost and financial accounts.

		Rs.	Rs.
a.	Opening Stock: Materials Finished goods	 10000 18000	 15000 16000
b.	Closing Stock: Materials Finished goods	 12000 20000	 13000 17000
c.	Interest charged but not paid Rs. 10000		
d.	Write of preliminary expenses Rs. 500; Goodwill Rs. 1500		
e.	Dividend on UTI received Rs. 1000		
f.	Indirect expenses charged in financial accounts Rs. 80000 but Rs. 75500 recovered in Cost Accounts.		
	Find out the profit as per financial accounts by drawing up a Reconciliation statement.		

Solution: **Reconciliation Statement**

	Rs.	Rs.
Profit as per Cost accounts		150000
Add : Opening stock of finished goods over valued in cost accounts	2000	
Closing stock of materials under recovered in cost accounts	1000	
Interest charged only on cost accounts	10000	
Dividend on UTI not included in cost accounts	1000	14000
		164000
Less : Opening stock of material under valued in cost accounts	5000	
Closing stock of finished goods over valued in cost accounts	3000	
Preliminary expenses written off in financial accounts	500	
Goodwill written off in Final accounts	1500	
Indirect expenses under recovered in cost accounts	4500	14500
Profit as per financial accounts		149500

Illustration 5

From the following particulars, prepare

(a) A statement of cost of manufacture for the year.
(b) A statement of profit as per cost accounts and
(c) Profit and loss account in the financial books and a reconciliation of the difference in the profits as shown by (b) and (c) above:

	Rs.
Opening stock of raw materials	100000
Closing stock of raw materials	150000
Opening stock of finished product	200000
Closing stock of finished product	50000
Purchase of raw materials	600000
Wages	250000

Calculate factory overhead at 25 percent on prime cost. Office overhead will be levied at 75 percent on factory overhead. Actual works expenditure amounted to Rs. 193750 and actual office expenses amounted to Rs. 152500. The selling price was fixed at 25% above cost price.

COST LEDGER ACCOUNTING

Cost of manufacture	Rs.	Rs.
a) Raw materials Opening stock Add purchases Less closing stock	 100000 600000 150000	 550000
Wages		250000
Factory overhead (25% on Prime cost)		200000
Office overhead (75% on Fy. Overhead)		150000
Cost of manufacture		115000
Statement of Profit (Cost Accounts)		
		Rs.
b) Opening Stock of Finished goods		200000
Cost of manufacture		1150000
Less Closing Stock of Finished goods		50000
Cost of sales		1300000
Profit (25% of cost)		325000
Sales		1625000

Profit and Loss Account

		Rs.		Rs.
To opening Stock		200000	By sales	1625000
To Raw materials:			By Closing Stock	50000
To Opening Stock	100000			
To Purchase	600000			
Less Closing Stock	150000	550000		

To Wages		250000		
To Factory overhead		193750		
To office overhead		152500		
To Profit		328750		
		1675000		**1675000**

Reconciliation Statement

Profit as per Cost Accounts		325000
Add Over-absorption of F.Y. overhead	200000 -193750	6250
Less under-absorption of office overhead	152500 -150000	2500
Profit as per Financial Accounts		328750

Illustration 6

A company's net profit as per the cost books was RS. 23063 whereas the audited final accounts showed a profit of Rs. 16624. With the help of the following data, you are required to prepare a reconciliation statement, and explain the reason for the difference between the two figures.

Profit and Loss Account

Year ended 31st March, 19….

		Rs.			Rs.
Opening Stock	247179		Sales		346500
Purchase	82154				
	329333				
Closing Stock	75121	254212			
Direct Wages		23133			
Factory Overhead		20826			
Gross profit c/d		48329			
Total		346500			346500
Administration expenses		9845	Gross profit b/d		48329
Selling expenses		22176	Miscellaneous income		316
Net Profit		16624			
Total		48,645			48645

The costing records show:

(a) Stock balance of Rs. 78179

(b) Direct wages absorbed during the year – Rs. 24876

(c) Factory overhead absorbed – Rs. 19714
(d) Administration expenses charged @ 3 per cent of selling prices.
(e) Selling expenses charged @ 5 per cent of value of sales
(f) No mention of miscellaneous income

Solution

	Rs.	Rs.
Profit as per Cost Accounts		23063
Less : Difference in valuation of closing stock	78197 75121	(-) 3076
Factory overhead under absorbed	20826 19714	(-) 1112
Selling expenses under-absorbed	22176 17325	(-) 4851
Add: Wages over-absorbed	24867 23133	1734
Administration overhead over-absorbed	10395 9845	550
Sundry income not shown in Costing Profit		316

Profit as per financial accounts 16624.