11

RECONCILATION OF PROFIT AS PER COST AND FINANCIAL ACCOUNTS

STRUCTURE :

11.0 OBJECTIVES :

Study of this unit will enable you to :

1. Ascertain the difference between Profit as shown by Financial Profit and Loss Account and Profit appearing in Costing Profit & Loss Account.

2. Identify and quantify the cost components, which contribute to the difference in profit figures.

4. Prepare a statement reconciling the two profit figures reported by financial and cost records.

11.1 INTRODUCTION

It is normally assumed that the profit of a business for a given period is given by the Profit & Loss account made out for that period.

Imagine your surprise, when Profit and Loss Account prepared by the financial accountant of X Ltd. shows a profit of Rs.4,56,000 for the year ended 31.03.2009. While the cost accountant has prepared a cost sheet for the same period and arrived at a profit of Rs.5,12,000. You feel that one of the figures reported should be wrong, otherwise how could there be a difference.

However, there is a logical explanation for the difference in the profit figures and both may be right.

This is because the fundamental assumptions made by the two accountants for preparing the profit and loss account vary. For example, Interest on loan will be debited in financial Profit & Loss Account but the cost accountant will ignore this item as he does not consider this interest expense as an item of cost. Naturally, in this case, the cost accountant will report a higher profit than the financial account.

In the following sections we shall see the types of differences and the items which give rise to these differences.

11.2 NEED FOR RECONCILIATION

The need for reconciliation arises due to the following reasons :

a) To ensure that no income or expenditure item has been omitted and that there is no under or over recovery of overheads.

b) To check the arithmetical accuracy, as well as for the determination of reason for disagreement between the two results.

c) To know the reason for variation of profit or loss as internal control.

d) To take administrative decisions such as depreciation, stock valuation and direct expenses.

e) To test the reliability of cost accounts.

REASONS FOR DISAGREEMENT BETWEEN COST AND FINANCIAL RESULT:-

It is very essential to know the causes, which generally give rise to disagreement between Cost and Financial Accounts. These are briefly summarised below:-

Expenses that are not taken into account. The under mentioned expenses are usually not included in overheads or, for that matter in cost.

(a) Expenses or income of purely financial nature like dividends received, rent received, cash discount allowed, etc.

(b) Expenses or profits of capital nature like profit or loss on sale of investments, plant and equipment, etc.

(c) Items not representing actual costs but dependent on arbitrary decisions of management e.g. an unreasonably high salary to the managing director, providing for depreciation at a rate exceeding the economic rate.

(d) Appropriation of profits for dividends, payment of income tax and transfer to reserves.

I) Items recorded in financial books only and not in cost books:

a) Interest received/ paid on Debentures,
b) Interest received and paid on Investment and Bank loan or overdraft respectively.
c) Interest charged/ paid to debtors /creditors
d) Discount allowed/ received.
e) Provision for discount on debtors/ creditors
f) Bad Debts written off/ bad debts recovered.
g) Discount on issue of shares and debentures.
h) Income tax paid /refund
i) Penalty and fines paid / received
j) Rent received/ paid
k) Loss by fire, natural calamities or theft /damage recovered.
l) Loss/ profit on sale of fixed assets, investment
m) Cost of share transfer /share transfer fees received.
n) Donation given/received
o) Deferred revenue expenses written off. Such as write off of :
   i. Preliminary Expenses
   ii. Discount on Shares/ Debentures

II) Items recorded in cost book only and not in financial books:-

a) Notional rent charges of owned premises
b) Salary of proprietor
c) Interest on proprietors fund

III) Items recorded in both books with different amounts:-

In Cost book and Financial book some item of expenses and incomes which are treated differently such as -

a) Method of charging depreciation:

In Financial Books depreciation may have been provided, on Straight Line Method or Written down Value Method whereas in Costing Book depreciation may have been charged on the basis of Machine Hour Rate Method. Amounts of depreciation charge in both books are bound to be different.

b) Under and Over recovered expenses:

The expenses in costing books are recorded on the basis of pre-determined rates but in financial books they are recorded on actual basis hence the amount recorded in these two set of books differ.

c) Method of Valuing Stocks:-

It is well known that in Cost Book Stocks are only valued at cost. But in Financial Books stock are valued either at cost or market price, whichever is lower.

PROCEDURE FOR RECONCILIATION :-

When there is a difference between the profit/loss shown by cost accounts and financial accounts the procedure for reconciliation is similar to that of Bank Reconciliation Statement. For reconciliation following steps should be considered.

1. Prepare a cost sheet for a particular period and find out costing profit or loss if it is not given.

2. If financial profit or loss is not given then find out the same by preparing Trading and Profit and loss account for a period which corresponds to the cost sheet.

3. Ascertain items which are shown in financial account and not in cost account.

4. Ascertain items which are shown in cost account only.

5. Calculate difference between expenses recorded in financial books and the amount of expenses recorded in cost accounts.

6. Reconciliation Statement is to be prepared as on a particular date. Hence one can start with the figure of profit / loss as per cost account and arrive at the figure of profit/ loss as per financial accounts or vice –versa.

[Entries which are at variance with each other will appear in Reconciliation Statement and also entries appearing in only one set of book (non - common items)

PROFORMA STATEMENT OF RECONCILIATION

1. Starting with financial profit Statement of Reconciliation

Between Financial Profit and Cost Profit For the Year ended

Particulars	Rs	Rs
		xxx
Financial Profit (as per the financial books)		
Add Expenses, losses and appropriation debited in financial books only		
	xxx	
Closing stock under valued in Financial Books		
Opening Stock over valued in Financial books		
	xxx	
Excess depreciation charged in Financial Books		
Expenses under recovered in Cost Books	xxx	
Income credited only in Cost Books		
	xxx	
Less		
Income credited only in Financial Books	xxx	
Closing stock over valued in Financial Books	xxx	xxx
Opening Stock under valued in Financial books		xxx
Short depreciation charged in Financial Books		
Expenses over recovered in Cost Books	xxx	

Costing Profit (as per Costing books)		
	xxx	
	xxx	
	xxx	
	xxx	xxx
		xxx

Statement of Reconciliation Between Financial Profit and Cost Profit For the Year ended…..

Particulars	Rs	Rs
Costing Profit (as per the Costing books)		xxx
Add Income credited only in Financial Books	xxx	
Closing stock over valued in Financial Books	xxx	
Opening Stock under valued in Financial Books	xxx	
Short depreciation charged in Financial Books	xxx	
Expenses over recovered in Cost Books	xxx	
Expenses debited only in Cost Books	xxx	xxx
Less		xxx
Expenses, losses and appropriation debited in		
financial books only	xxx	
Closing stock under valued in Financial Books	xxx	
Opening Stock over valued in Financial Books	xxx	
Excess depreciation charged in Financial Books	xxx	
Expenses under recovered in Cost Books	xxx	
Income credited only in Cost Books	xxx	xxx
Financial Profit (as per the financial books)		xxx

Illustration 1 : From the following particulars prepare a reconciliation statement:-

	Rs.
Net Profit as per financial records	154506
Net Profit as per costing records	206880
Works overheads under recovered in costing	3744
Administrative Overheads recovered in excess in costing	2040
Deprecation charged in financial accounts	13440
Depreciation recovered in Cost Accounts	15000
Interest received but not included in Cost Accounting	9600
Obsolescence loss charged in financial records	6840
Income tax provided in financial books	48360
Bank interest credited in financial books	900
Stores adjustment credited in financial books	570
Depreciation of stock charged in financial books	8100

Solution

RECONCILIATION STATEMENT		**Rs.**	**Rs.**
Net Profit as per costing records			206880
Add:			
1. Administrative Overheads over absorbed		2040	
2. Depreciation excess charged		1560	
3. Income not credited in costing -			
Interest received	15000		
Bank interest	900		
Stores adjustment	570	16470	
			20070
Total			226950
Less		3744	
1. Works overheads under recovered			
2. Expenses not charged in costing books	9600		
3. Income tax provided in Financial Book	48360		
4. Depreciation of Stock charged in Financial Book	8100	66060	69804
Net Profit as per financial books			157146

Illustration 2 : Following is the Trading and Profit and loss account of a factory producing a particular unit of a product of which the actual output is 100000 units.

Trading & Profit and Loss A/c for the year ended 31/12/09

	Rs		**Rs.**
To Material	200000	By Sales	400000
To Wages	100000		
To Works Exp.	60000		
To Office rent	18000		
To Selling & Dist. Exit	12000		
To Net Profit	10000		
	400000		400000

The normal output of the factory is 1,50,000 units. Works expenses are fixed to the extent of Rs.36,000. Office expenses for all practical purposes are constant, Selling and distribution expenses are variable to the extent of Rs.6000/- Prepare a cost sheet and reconciliation statement.

Solution :

(a) COST SHEET

Actual output 1,00,000 units   Normal output 1,50,000 units

	Per Unit (Rs.)	Total (Rs.)
Material	2.00	2,00,000

Wages		1.00	1,00,000
	PRIME COST	3.00	3,00,000
Works expenses			
Fixed (2/3 of 36000) = 24000			
Variable	= 24000	0.48	48,000
	WORKS COST	3.48	348000

*Actual output/ Normal output = 2/3

Proportionate fixed cost are considered

Office Expenses (2/3 * 36000)		0.12	12,000
	COST OF PRODUCTION	3.60	3,60,000
Selling and Distribution Expenses			
Fixed (2/3)	= 4000		
Variable	= 6000	0.1	10,000
	COST OF SALES	3.7	3,70,000
Profit		0.3	30,000
Sales		4.00	4,00,000

b) Reconciliation Statement

Profit shown by Cost Accounts			30,000
Less : 1. Under recovery of Work Expenses	12000		
2. Under recovery of Office Expenses	6000		
3. Under recovery of Selling Expenses		2000	20000

Profits shown by Financial Accounts			10,000

Illustration 3 : The Trading & Profit & Loss account of "A' Ltd. is as follows:-

Trading & Profit & Loss Account

To Purchases	25120	By Sales (50000 units	75000
		@ of Rs Rs.1.50 each)	
Less : Closing Stock	4050		
To Gross Profit	53870		---------
	------------		75000
To Net Profit	75000		
			43870
To Direct Wages	10500	By Gross Profit	260

To Works Expenses	12130	By Discount received	2340
To Selling Expenses	7100	By Profit on sale of land	
To Administrative Expenses	5340		---------
To Depreciation	1100		56470
To Net Profit	20300		

	56470		

The profit as per cost accounts was only Rs.19,770. Reconcile the financial and costing profits using the following information :

a) Cost accounts valued closing stock at Rs. 4280

b) The work expenses in the cost accounts were taken at 100% of direct wages.

c) Selling & administration expenses were charged in the cost accounts at 10% of sales and 0.10 per unit respectively.

d) Depreciation in the cost accounts was Rs.800

Solution :

RECONCILIATION STATEMENT	**Rs.**	**Rs.**
Profit as per Cost Accounts		19770
Add: 1. Over absorption of selling expenses	400	
2. Discount received	260	
3. Profit on sale of land	2340	3000
	-----------	------------
		22770
Less 1. Difference in valuation of closing	200	

2. Under absorption of Administrative Exp.	340	
3. Under absorption of Works Exps.	1630	
4. Depreciation under changed	300	2470
Profit as per Financial Accounts	-----------	-----------
		20300

Illustration 4 : From the following Profit & loss account draw up a Memorandum Reconciliation account showing the Profit as per Cost Accounts:-

To Office Salaries	11282	By Gross Profit	54648
To Office Expenses	6514	By Dividend received	400
To Salary to Salesmen	4922	By Interest on Bank FD	150
To Sales Expenses	9304		
To Distribution Exp.	2990		
To Loss on Sale of Machinery	1950		
To Fines	200		
To Discount	100		
To Net Profit c/d	17936		
To Income Tax	55198		55198
To Transfer to Reserves	8000	By Net Profit b/d	17936
To Dividend	1000		
To Balance c/d	4800		
	4136		
	17936		17936

The cost accountant has ascertained a Profit of Rs.19636 as per his books.

Solution :

Memorandum Reconciliation Account :

Dr Cr.

	Rs		Rs.
To Expenses not debited to Cost accounts:		By Profit as per cost account	19636
Fines	200	By Income not credited in	
Discount	100	Cost accounts:	400
Loss on sale of Care	1950	Dividend Received	150
Income Tax	8000	Interest on Bank FD	
Tr. to Reserves	1000		
Dividend	4800		
To Net Profit c/d	4136		
	20186		20186

Illustration : 5

M/s ESVEE Ltd. has furnished you the following information from the financial books for the year ended 31^{st} December, 2009.

Particulars	**Rs.**
Materials consumed	260000
Wages	150000
Factory overheads	94750
Administration Overheads	106000
Selling and Distribution overheads	55000
Bad Debts	4000
Preliminary expenses	5000
Opening Stock (500 units at Rs.35/- each)	17500
Closing stock (250 units at Rs.50/- each)	12500
Sales (10250 units)	717500
Interest Received	250
Rent Received	10000

The cost sheet shows the following :

Cost of materials	Rs. 26 per unit.
Labour cost	Rs. 15 per unit
Factory overheads	60% of Labour cost
Administration overheads	20% of Factory cost
Selling expenses	Rs, 6 per unit
Opening Stock	Rs. 45 per unit

You are required to prepare :

1. Financial Profit & Loss Account
2. Costing Profit & Loss Account
3. Statement of Reconciliation

Solution

A) Financial Books

Profit and Loss Account for the year ended 31-12-2009

	Rs		Rs.
To Opening Stock (500 Units at Rs.35 each)	17,500	By Sales (10250 units)	7,17,500
To Materials consumed (10000 units)	2,60,000	By Closing stock (250 units at Rs.50 each)	12,500
To Wages	1,50,000		
To Gross Profit c/d	3,02,500		
	--------------		--------------
	7,30,000		7,30,000
To Factory overheads	94,750	By Gross Profit b/d	3,02,500
To Administration c/d	1,06,000	By Interest received	250
To Selling Expenses	55,000	By Rent Provided	10,000
To Bad Debts	4,000		

To Preliminary Expenses	5,000		
To Net Profit	48,000		
	--------------		-------------
	3,12,750		3,12,750

B) COST SHEET FOR THE YEAR ENDED 31.12.2009

Prod. 10000 units

Particulars	Total Cost Rs.	Cost per Unit Rs.
Material Consumed	260000	26
Labour	150000	15
	--------------	-------------
PRIME COST	410000	41
Factory Overheads (60% of Labour cost)	90000	9
	---------------	------------
WORKS COST	500000	50
Administration overheads		
(20% of work cost)	100000	10
COST OF PRODUCTION	600000	60.
Add : Opening Stock of finished goods		
(500 units at (Rs.45/- each)	22500	

	622500	
Less : Closing stock of finished goods (250 units)	15000	
	---------------	-------------
Selling Expenses	607500	
	61500	6

	---------------	------------
COST OF SALES	669000	66
PROFIT	48500	4
	---------------	-------------
SALES	717500	70

C) STATEMENT OF RECONCILIATION AS ON 31.12.2002

Starting Point (Cost Accountant)	Rs.	Rs.
Profit as per Cost Accounts		48500
Add: 1. Over recovery of overheads :		
Selling expenses	6500	
2. Over valuation of stock :		
Opening stock	5000	
3. Purely financial income:		
Interest	250	
Rent	10000	31750
	-----------	------------
		70250
Less : Under recovery of overheads-		
4. Factory overheads	4750	
5. Administrative overheads	6000	
6. Over valuation of stock :	2500	
Closing Stock		
7. Purely financial expenses:	4000	
Bad Debts		
Preliminary expenses	5000	22250
	-----------	------------

Project as be Financial Accounts		48000

Books Recommended

1. Principles & Practice of Cost Accounting – N.K. Prasad
2. Cost Accounting - Jawaharlal

EXERCISES:

1. What is the need for reconciliation of cost and financial accounts?
2. Discuss the main sources of difference between Profit shown by cost accounts and that as per financial accounts.
3. The following transaction have been extracted from the financial books of a company.

	Rs.	Units
Sales	250000.00	20000.00
Materials	100000.00	
Wages	50000.00	
Factory overheads	45000.00	
Office & Administrative overheads	26000.00	
Selling & Distribution overheads	18000.00	
Closing stock:		
Finished goods	15000.00	
Work in progress	1230.00	
Materials	3000.00	
Wages	2000.00	
Factory overheads	2000.00	
	7000.00	
Goodwill written off	20000.00	
Interest on capital	2000.00	

In costing books factory overheads were charged at 100% of wages, administration over heads were charged at 10% of factory cost and selling and distribution overheads at the rate of Re.1 per unit sold. Prepare a statement reconciling the Profit as per cost and financial accounts.

4. The financial Profit and loss Account of a manufacturing company for the year ended 31st March, 2009 is as follows:-

	Rs		Rs.
To Materials consumed	50000.00	By Sales	124000.00
To Carriage inwards	1000.00		
To Direct wages	34000.00		
To Works Expenses	12000.00		
To Administration Expenses.	4500.00		
To Selling an Distribution Expenses	6500.00		
To Debenture Interest	1000.00		
To Net Profit d	15000.00		
	124000.00		124000.00

The net profit shown by the cost accounts for the year is Rs.16.270 Upon a detailed comparison of the two sets of accounts it is found that (a) The amounts charged in the cost account in respect of overheads charges are as follows:- Works overhead charges Rs.11,500; Office overhead charges Rs.4590, Selling and Distribution Expenses Rs.6,640 (b) No charge has been made in the cost account in respect of debenture interest. You are requested to reconcile the profits shown by the two sets of accounts.

5. During the year a company's profit have been estimated from the costing system to be Rs.23,063 whereas the financial accounts prepared by the auditors disclose a profit of Rs.16,624. Given the following information you are required to prepare a Reconciliation statement showing clearly the reason for the difference.

Profit and Loss Account for the year ended March 3, 2009

	Rs.	Rs.		Rs.
Opening			Sales	3,46,500
Stock	2,47,179			
Purchases	82,154			

	3,29,333			
Closing stock	75,121	2,54,212		

Direct wages		23,133		
Factory overheads		20,826		
Gross Profit		48,329		
		-----------		-----------
		3,46,500		3,46,500
Administration expenses		9,845	Gross profit b/d	48,329
Selling expenses		22,176	Sundry Income	316
Net Profit		16,624		
		-----------		-----------
		48,645		48,645

The costing record shows:

a. a stock ledger closing balance of Rs.78,197

b. a direct wages absorption account of Rs.24,867

c. a factory overhead absorption account of Rs.19,714

d. administration expenses calculated at 3% of the selling price

e. selling expenses are five percent on selling price

f. no mention of sundry income.

Question 6 :

A company's Trading and Profit and Loss Account was as follows:-

	Rs.	Rs.		Rs.
Opening			Sales	175000.00
Stock	100000.00			
Purchases	80000.00			

	180000.00			
Less:				
Closing stock	80000.00			

		100000.00		
To Direct wages		20000.00		
To Factory Wages		15000.00		
To Gross Profit C/f.		40000.00		

		-------------		-------------
Total Rs.		175000.00	Total Rs.	175000.00
		-------------		-------------
To Administration expenses		10000.00	By Gross profit	40000.00
To Selling expenses		15000.00		
To Net Profit		15000.00		
		-------------		-------------
		40000.00		40000.00

Costing records show the following :-

a. Stock Ledger closing balance Rs.89,000

b. Direct labour Rs.23,000

c. Factory overheads Rs.13,000

d. Administrative overheads and selling expenses each are calculated at 8 per cent of the selling price.

Prepare costing profit and loss account and the statement of reconciliation between the profit or loss as per the two accounts.

Question 7:

From the following information you are required to prepare a statement reconciling the result of Cost Book with Financial Books

	Rs.
Net profit as per Financial Books	51,052
Works overhead under recovered in Cost Book	1,001

Depreciation charged in Financial Book	13,000
Depreciation charged in Cost Book	14,326
Obsolescence loss charged in Financial Books only	2,021
Income tax provided in Financial Books only	2,626
Interest received but not recorded in Cost Book	3,031
Bank interest debited in Financial Book only	292

Question 8 ;

The following is the Financial Profit and Loss Account of a company for the year ending 31st March, 2009.

Profit and Loss Account

	Rs		Rs.
To Purchases	2,53,000	By Sales (50000 (units at Rs. 16 each)	8,00,000
" Wages	1,03,000	By Closing stock	43,000
" Works Expenses	1,16,000	By Interest on Investments	3,000
" Administration Expenses	55,000	By Profit on Sale of building	24,000
" Selling Expenses	68,000		------------
" Depreciation	12,000		8,70,000
" Net Profit	2,63,000		

	8,70,000		

The cost accounts disclosed the following information :-

1. Value of closing stock was Rs.45,000/-
2. Works expenses in cost accounts have been taken at 100% of wages
3. Selling Expenses in cost accounts have been charged at 10% on sales.
4. Administration Expenses in cost accounts have been taken at Rs.1 per unit sold.
5. Depreciation shown in cost accounts was Rs.10,000

Prepare a reconciliation statement to reconcile the profit shown as per cost accounts with the profit shown as per financial accounts.

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