AGURCHAND MANMULL JAIN COLLEGE

DEPARTMENT OF CORPORATE SECRETARYSHIP – SHIFT – II

STUDY MATERIAL

COST AND MANAGEMENT ACCOUNTING - II

UNIT 1 – RECONCILIATION OF COST AND FINANCIAL ACCOUNTS

Reconciliation of Cost and Financial Accounts

Meaning

Reconciliation of cost and financial accounts refers to the process of identifying and eliminating differences between the cost accounting records and financial accounting records. Cost accounting focuses on tracking expenses related to production, while financial accounting provides an overall picture of the financial health of a business. Since both systems have different objectives and record transactions differently, discrepancies may arise, requiring reconciliation to ensure consistency and accuracy in reporting.

Importance of Reconciliation Statement

1. **Ensures Accuracy in Financial Reporting**: Reconciliation helps verify that both cost and financial accounts accurately reflect the company's financial status by identifying any errors or misstatements.

2. **Identifies Discrepancies:** Differences in valuation, recording methods, and timing issues between cost and financial accounts can create mismatches, which reconciliation helps to identify and resolve.

3. **Enhances Decision-Making:** By providing a clear picture of costs and financial performance, reconciliation helps management make informed decisions regarding pricing, cost control, and profitability.

4. **Compliance with Legal Requirements:** Financial statements must adhere to statutory regulations, and reconciliation ensures that discrepancies are addressed to meet legal and regulatory standards.

5. **Prevents Manipulation of Accounts:** Reconciliation reduces the chances of fraud, misstatements, or intentional manipulation of financial figures by providing cross-verification between two independent sets of accounts.

6. **Improves Cost Control and Budgeting:** By analyzing differences, businesses can adjust their costing methods, control expenses, and create more accurate budgets.

7. **Facilitates Audit and Internal Control:** External auditors often require reconciliation statements to verify the authenticity of records, ensuring smooth audit procedures and strong internal control mechanisms.

Reconciliation of Cost and Financial Accounts

The differences between cost and financial accounts arise due to various factors, including different accounting principles, treatment of certain expenses, and timing of recording transactions. Reconciliation is done systematically to ensure both sets of accounts align.

Steps in Reconciliation

1. **Prepare Cost and Financial Profit Statements Separately:** The first step is to compute profit as per cost accounts and profit as per financial accounts separately.

2. **Identify the Causes of Differences:** The major reasons for differences could be variations in stock valuation, treatment of overheads, depreciation methods, and inclusion/exclusion of certain incomes or expenses.

3. **Prepare a Reconciliation Statement:** A reconciliation statement is drafted by adjusting items that cause the difference between cost and financial profits. It is prepared by either:

    - Starting with profit as per cost accounts and adjusting it to arrive at profit as per financial accounts, or

    - Starting with profit as per financial accounts and adjusting it to match profit as per cost accounts.

4. **Adjusting Expenses and Incomes:** The reconciliation statement lists various items that need adjustments, such as:

    - **Items recorded only in Financial Accounts** (e.g., abnormal losses, interest on capital, income from investments).

    - **Items recorded only in Cost Accounts** (e.g., notional rent, standard cost variances).

    - **Different methods of recording certain items** (e.g., depreciation methods, treatment of reserves).

5. **Ensure Agreement of Both Accounts:** After making necessary adjustments, the profit/loss figure in the cost accounts should match with the profit/loss figure in financial accounts, ensuring accuracy and consistency.

Causes of Differences Between Cost and Financial Accounts

1. **Items Charged in Financial Accounts but Not in Cost Accounts**
   - Interest on loans, debentures, and bank overdrafts
   - Donations and fines
   - Losses on sale of assets
   - Income tax and legal charges
2. **Items Charged in Cost Accounts but Not in Financial Accounts**
   - Notional rent for using own buildings
   - Imputed interest on capital
   - Standard cost variances
3. **Difference in Stock Valuation**
   - Cost accounts may value stock based on cost price, whereas financial accounts may follow the lower of cost or market price.
   - Different valuation methods (FIFO, LIFO, weighted average) can cause discrepancies.
4. **Treatment of Overheads**
   - Cost accounts classify and distribute overheads based on pre-determined rates, while financial accounts charge actual expenses incurred.
   - Under- or over-absorption of overheads can create differences.
5. **Depreciation Methods**
   - Financial accounts may use the straight-line method, whereas cost accounts might follow the reducing balance method, leading to different depreciation charges.
6. **Recording of Abnormal Gains and Losses**
   - Financial accounts include abnormal losses (e.g., theft, fire losses), whereas cost accounts exclude such losses from product costs.
   - Similarly, financial accounts may record abnormal gains, but cost accounts exclude them from cost calculations.
7. **Allocation of Income**

- Interest received, dividends, and rent received are recorded in financial accounts but may not be considered in cost accounts.

Question 1: Calculation of Profit as per Financial Accounts

The profit as per cost accounts is Rs. 1,20,000. The following differences exist between cost and financial accounts:

1. Rent paid but not considered in cost accounts: Rs. 10,000
2. Interest on loan included only in financial accounts: Rs. 5,000
3. Over-absorbed factory overhead in cost accounts: Rs. 8,000
4. Income from investments recorded only in financial accounts: Rs. 6,000

Find the profit as per financial accounts.

Solution:

1. **Start with profit as per cost accounts**
   Profit as per cost accounts = Rs. 1,20,000
2. **Add expenses recorded only in financial accounts**
   - Rent paid = Rs. 10,000
   - Interest on loan = Rs. 5,000
     Total additional expenses = Rs. 10,000 + Rs. 5,000 = Rs. 15,000
3. **Deduct over-absorbed expenses in cost accounts**
   - Over-absorbed factory overhead = Rs. 8,000
4. **Add incomes recorded only in financial accounts**
   - Income from investments = Rs. 6,000
5. **Compute profit as per financial accounts**
   Profit as per financial accounts = Rs. 1,20,000 + Rs. 15,000 - Rs. 8,000 + Rs. 6,000 **= Rs. 1,33,000**

Final Answer: Profit as per Financial Accounts = Rs. 1,33,000

Question 2: Preparing a Reconciliation Statement

The profit as per cost accounts is Rs. 75,000. The following adjustments are needed:

1. Factory overhead under-absorbed in cost accounts: Rs. 5,000
2. Interest on capital recorded only in financial accounts: Rs. 4,000
3. Depreciation charged higher in financial accounts by Rs. 6,000
4. Dividend received recorded only in financial accounts: Rs. 3,000

Prepare a reconciliation statement.

SOLUTION:

Particulars	Amount (Rs.)	Amount (Rs.)
Profit as per Cost Accounts		75,000
Add: Under-absorbed factory overhead (added back)	5,000	
Add: Dividend received (income in financial accounts)	3,000	
Less: Interest on capital (expense in financial accounts)	4,000	
Less: Additional depreciation charged in financial accounts	6,000	
Profit as per Financial Accounts		**73,000**

Question 3: Finding Profit as per Cost Accounts

The profit as per financial accounts is Rs. 2,00,000. The following adjustments are given:

1. Rent paid included only in financial accounts: Rs. 12,000
2. Notional rent recorded only in cost accounts: Rs. 8,000
3. Financial accounts include abnormal loss of Rs. 10,000
4. Interest on debentures recorded only in financial accounts: Rs. 5,000

Calculate profit as per cost accounts.

Solution:

1. **Start with profit as per financial accounts**
   Profit as per financial accounts = Rs. 2,00,000
2. **Add expenses recorded only in financial accounts**
   - Rent paid = Rs. 12,000
   - Interest on debentures = Rs. 5,000
     Total additional expenses = Rs. 12,000 + Rs. 5,000 = Rs. 17,000
3. **Deduct notional rent included in cost accounts**
   - Notional rent = Rs. 8,000
4. **Add back abnormal loss (not included in cost accounts)**
   - Abnormal loss = Rs. 10,000
5. **Compute profit as per cost accounts**
   Profit as per cost accounts = Rs. 2,00,000 + Rs. 17,000 - Rs. 8,000 + Rs. 10,000 **= Rs. 2,19,000**

Final Answer: Profit as per Cost Accounts = Rs. 2,19,000

Question 4: Adjustment for Over-Absorbed Overheads

The profit as per cost accounts is Rs. 90,000. The following details are given:

1. Over-absorbed administration overhead in cost accounts: Rs. 4,000
2. Donation recorded only in financial accounts: Rs. 3,000
3. Interest received included only in financial accounts: Rs. 6,000
4. Factory overhead under-absorbed in cost accounts: Rs. 5,000

Find the profit as per financial accounts.

Particulars	Amount (Rs.)	Amount (Rs.)
Profit as per Cost Accounts		90,000
Less: Over-absorbed administration overhead	4,000	
Less: Donation recorded only in financial accounts	3,000	
Add: Interest received (income in financial accounts)	6,000	
Add: Under-absorbed factory overhead (added back)	5,000	
Profit as per Financial Accounts		**94,000**