RECONCILIATION OF 
COST AND FINANCIAL ACCOUNTS

Need for Reconciliation:
In an enterprise where two sets of accounting systems namely, financial accounting and cost accounting are being maintained, the profit shown by the two sets of accounts will not generally agree with each other. When, therefore, the two profit figures differ, they need reconciliation in as much as management would like to know the causes of difference. Besides, reconciliation will also help in checking the arithmetical accuracy of both set of accounts and thus will facilitate internal control by highlighting the variations causing increase or decrease in profits. As for instance, if he profit shown by financial accounts is less than that shown by cost accounts and the figures cannot be properly reconciled, there must be either fraud or an error in one set of books or the other. In another situation, even though the two profit figures agree with each other due to compensating errors and errors of principle, omission and commission, reconciliation is also a must to put the matter to order.

Reasons for variation:
The reasons for which there may be variation in profit shown by two set of books, may be shown under four broad groups. They are as follows:
1] Under/over-absorption of overheads;
2] Adoption of different bases of stock valuation;
3] Items included in one set of accounts but not included in other set;

1] Under/over-absorption of overheads:
In cost accounts, pre-determined rate are charged in respect of overheads in order to ascertain unit cost of products. The bases which are in frequent use for this purpose are; rate per labour/machine hour, percentage on prime cost, direct labour wage, sales etc. Therefore, overheads so charged or ‘recovered’ may not exactly agree with the amount of overheads actually incurred during a period. The difference between overheads ‘recovered’ and overheads ‘incurred’ is known as over/under-absorbed overheads.
Such difference may be due to volume variance, expenditure variance or both. In case of under-absorption of overheads, costing profits will be higher than financial profit and in case of over-absorption, costing profit will be lower than financial profit. Now if one wants to find out costing profit from financial profit:

1] In case of under absorption, the amount by which overheads are under-absorbed is to be added back to financial profit, in that financial profit has already been reduced by that amount as compared to costing profit.

2] In case of over-absorption, the amount by which overheads are over-absorbed will have to be deducted from financial profit in as much as costing profit is already reduced by the amount of overheads over-absorbed.

On the other hand, if one wants to find out financial profit taking costing profit as base, the procedure for reconciliation in this context will be just the reverse.

It may not be out of place to mention, in this connection, that if the over/under-absorbed balances are ultimately transferred to Costing Profit and Loss Account during the period under consideration, profits shown by the two sets of accounts will mutually agree, provide there are no other reasons which may lead to variation.

In many concerns, selling and distribution overheads are ignored from cost, the result being that costing profit will be higher or loss will be smaller than that shown by the financial books where these costs are included.

**Adoption of Different Bases of Stock Valuation:**

The valuation of stock in the two sets of books will generally be different according to the base used in each book. For the purpose of valuation, stocks may be grouped as follows:

- Materials;
- Work-in-Progress, and
- Finished Goods

In Financial Accounts, the traditional method of stock valuation is ‘cost or market price whichever is lower’. Both the terms, cost and market price have different meanings.

According to Accounting Standard 2, Valuation of inventories, stock should be valued at cost or, if lower, at net realizable value.

The financial accountant will generally follow the above rules. On the other hand, the cost accountant will value stocks on the basis of cost only. Again, even if the cost method of valuation is used by the two accountants, there still remains the scope for difference.
So far as the term ‘cost’ is concerned, the question arises: ‘which cost should be the true cost for the purpose’. Because, in case of materials, it may mean the cost of latest purchase price or earlier purchase price or the average price, which may again be simple, periodic or weighted. For work-in-progress, the cost may mean prime cost only or prime cost plus variable factory overheads or prime cost plus total factory overheads. Again, for finished goods, it may mean factory cost of production or factory cost of production plus administrative overheads, or prime cost plus variable factory and administrative overheads only. For Financial Accounting, AS-2, however specifies the composition of ‘cost of inventories’.

For the purpose of reconciliation, if the closing stock figures are more in the costing books as compared to those in financial books, the difference due to stock valuation as revealed by cost and financial books will have to be deducted from costing profit to arrive at financial profit. On the other hand, if opening stock is more, difference in stock value will have to be added to costing profit to arrive at financial profit and vice versa. It should always be kept in mind the general principle that ‘Lower the opening stocks, the higher is the profit’ and ‘the larger the closing stock, the larger is the profit’ and vice versa.

Items included in one Set of Accounts but not in another Set:

1] **Financial Accounts**: In the financial accounts will be included a number of items having no counterpart in cost accounts. This will lead to difference in profit. That is, items of expenses reduce financial profit and items of income inflate it. Common items of financial expenses of this nature are as follows:

- Loss on sale of fixed assets or investments;
- Cost of issue of shares, debentures or bonds;
- Fines and penalties;
- Interest on mortgages and loans;
- Preliminary expenses or goodwill written off, etc.

On the other hand items of financial income will include the following:

- Profit on sale of fixed assets or investments;
- Fees or commission received on issue of shares, debentures etc;
- Interest on bank deposits or loans granted;
- Dividend receivable, rent receivable, etc.

In respect of matters of purely financial charge, the financial profit is to be increased to arrive at the costing profit and vice versa.
On the other hand, in respect of matters of purely financial income, financial profit is to be reduced to arrive at the costing profit and vice versa.

Of course, there will be many items appearing in the Profit and Loss Appropriation Account. The possible items of appropriations of profit are:

- Income tax and super tax;
- Dividends;
- Transfer to general reserve or any other fund of accumulated profits;
- Excess provisions for depreciation of buildings, plant etc;
- Amount written off in respect of goodwill, preliminary expenses, underwriting commission, debenture discount etc;
- Capital expenditure specifically charged to revenue. Etc

The above items will not generally affect the net profit as per financial books, thus obviating the necessity of reconciliation. If, however, financial profit after appropriation is taken, adjustment in respect of appropriation items should be made in line with financial items of expenses.

2] Cost Accounts: Items which appear only in these books of accounts are very few. These will include notional charges only such as interest on capital owned and rent on premises owned. These notional items will not affect the costing profit or loss as they are only in the nature of transfer entries and hence should be ignored in reconciling profits. For instance, if a notional rent for factory building is included in cost accounts, it will not affect costing profit, as a corresponding credit will be given to the Costing Profit and Loss Account with the amount of notional rent as follows:

Production Overheads Account…………Dr.
To Costing Profit and Loss Account

In carrying out the reconciliation, care should be taken to see whether or not the profit as per Cost Accounts is inclusive of this adjustment.

Other Items:
Any other items which may lead to difference in profit between the two set of books should be taken into consideration in carrying out the reconciliation.