
Unit 5 □ Cost Control Accounts, Cost Reconciliation and Integrated Accounts

Structure

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5.1 Introduction

The purposes of cost accounting being different from that of financial accounting, cost accounting requires maintenance of cost accounting records. Since source documents for cost accounting transactions may in majority of the cases be common to financial accounting there are chances for duplication of recording. Again recording of same transaction in two separate sets of books following different sets of principles usually gives different results. It requires reconciliation. To avoid duplication of records integration between the two systems of accounting is made. To cover the above aspects this unit is designed to deal with those issues in the following sequences : Non-integrated Cost Accounting System, Reconciliation of Cost and Financial Accounts, Integrated Cost Accounting System. In any case, it may be mentioned that double entry principle is followed in cost books also.

5.2 Non-integrated Cost Accounting System

Under this system separate books of accounts are maintained for cost transactions. The basic ledgers maintained in the Cost Department are :

- a) *Cost Ledger* : This is the main ledger in which all the nominal accounts (representing incomes, expenses, gains and losses) and a few real accounts are maintained. This is also called Nominal Ledger.
- b) *Stores Ledger* : This ledger is maintained for recording all transactions related to stores like receipts, issues, wastages, etc. Separate accounts are opened for each item of stores.

c) *Work-in-progress Ledger* : This ledger is meant for recording transactions relating to incomplete productions. Separate accounts are maintained for each job, process, or batch in process.

d) *Finished Goods Ledger* : It maintains accounts separately for each job, batch or process completed.

The last three ledgers are subsidiary ledgers. Under self-balancing system, the Cost Ledger, i.e., the Principal Ledger, should maintain a control account entitled Cost Ledger Control Account. Similarly, for all the above subsidiary ledgers, it should also maintain separate control accounts so that cost ledger can be self-balanced. Thus, the principal accounts to be maintained in different ledgers under cost books are :

i) *Cost Ledger Control Account* : As mentioned above, it is maintained in the Cost Ledger. This is also termed as General Ledger Adjustment Account, Financial Ledger Control Account or Nominal Ledger Control Account. Since only nominal accounts and a few real accounts are maintained in the Cost Ledger, recording of transactions involving personal accounts and some real accounts remain incomplete. To complete the recording of that aspect this account is used. For example, Wages A/c is maintained to record wages paid but the other account i.e., Cash or Bank A/c, is not maintained to record the payment. To complete the double entry, Cash or Bank A/c is replaced by Cost Ledger Control A/c in cost books. This account will in effect reflect all the personal accounts maintained in financial books of accounts.

ii) *Stores Ledger Control Account* : While stores ledger maintains accounts of individual items of stores, Stores Ledger Control Account records the aggregate amount of all such transactions entered in individual accounts under Stores Ledger. The balance of this account will, therefore, represent the total balance of all individual stores accounts.

iii) *Work-in-Progress Control Account* : This account records all transactions related to cost of production (direct and indirect expenses) of goods completely produced and in process. The account is credited with the value of goods transferred. The balance of this account will represent the cost of all jobs or products which are in process.

iv) *Finished Goods Control Account* : This account is debited with the value of goods transferred to Finished Goods Store. Administration overhead is also debited to this account. It is credited for the value of goods sold by debit to Cost of Sales Account. The balance of this account shows the value of closing stock of finished goods.

v) *Wages Control Account* : This account is debited with the total amount of wages paid, both direct and indirect. It is credited with the amount of direct wages by debit to Work-in-Progress Account and with indirect wages by debit to respective overhead accounts (e.g., Production Overhead, Administration Overhead and Selling and Distribution Overhead). Wages for abnormal idle time is entered in the credit side by corresponding debit to Costing Profit & Loss Account.

vi) *Different Overhead Control Accounts* : Separate control accounts are maintained for each type of overhead (like Production Overhead Control Account). Respective overhead control accounts is debited with the amount of related indirect costs (e.g., Administration Overhead Control Accounts is debited with the amount of administration expenses). The amount of overhead recovered or absorbed is credited to the respective Overhead Control Account. The balance of each overhead control account is transferred to Overhead Adjustment Account or directly to Profit & Loss A/c.

vii) *Overhead Adjustment Account* : As a result of the transfers of the balances of Overhead Control Accounts, this account is debited for under-recovery of overhead and credited for over-recovery. The balance of this account is transferred to Costing Profit & Loss A/c.

viii) *Cost of Sales Account* : As stated in (iv) above, this account is debited for transfer from Finished Goods Control Account. It is also debited with the amount of selling and distribution, or marketing overhead recovered. Balance of this account is transferred to Costing Profit & Loss A/c.

ix) *Costing Profit & Loss Account* : A close look into the above accounts reveal that this account is debited with the cost of sales, under-recovered overheads and abnormal losses and credited with the amount of sales, over-recovered overhead and abnormal gains, if any. Balance of this account representing net profit or loss as per cost books is transferred to Cost Ledger Control Account.

Journal Entries for Some Specimen Transactions :

a) Materials

i) *For Purchases* :

Debit Stores Ledger Control A/c

Credit Cost Ledger Control A/c

ii) *For returns* :

Debit Cost Ledger Control A/c

Credit Stores Ledger Control A/c

- iii) *For Issues for Production :*
 - Debit WIP Control A/c (for direct materials)
 - Debit Production OH Control A/c (for indirect materials)
 - Credit Stores Ledger Control A/c
 - iv) *For Returns from factory to store :*
 - Debit Stores Ledger Control A/c
 - Credit WIP Control A/c
- b) Wages**
- i) *For payment (both direct and indirect) :*
 - Debit Wages Control A/c
 - Credit Cost Ledger Control A/c
 - ii) *For allocation of Direct Wages to Production :*
 - Debit WIP Control A/c
 - Credit Wages Control A/c
 - iii) *For Indirect Wages attributed to different functions :*
 - Debit Production OH Control A/c
 - Debit Administration OH Control A/c
 - Debit S&D OH Control A/c
 - Credit Wages Control A/c
- c) Direct Expenses incurred**
- Debit WIP Control A/c
 - Credit Cost Ledger Control A/c
- d) Overheads (Different types)**
- i) *Expenses incurred*
 - Debit Production OH Control A/c
 - Debit Administration OH Control A/c
 - Debit S&D OH Control A/c
 - Credit Cost Ledger Control A/c
 - ii) *For Overheads absorbed or recovered*
 - Debit WIP Control A/c (for Production OH)
 - Debit FG Ledger Control A/c (for Admn. OH)
 - Debit Cost of Sales A/c (for S&D OH)
 - Credit Production OH Control A/c (for Prodn. OH)
 - Credit Admn. OH Control A/c (for Admn. OH)
 - Credit S&D OH Control A/c (for S&D OH)

- iii) *For under-recovery of Overhead*
 Debit Overhead Adjustment A/c
 Credit Production OH Control A/c (for Prodn. OH)
 Credit Administration OH Control A/c (for Admn. OH)
 Credit S&D OH Control A/c (for S&D OH)
 - iv) *For over-recovery of Overhead* (e.g., Production Overhead)
 Debit Production OH Control A/c
 Credit Overhead Adjustment A/c
 - v) *For transferring net balance of Overhead Adjustment Account*
 Debit Overhead Adjustment A/c (for net credit balance)
 Credit Costing Profit & Loss A/c
 Reverse entry for transfer of net debit balance
- e) **Sales**
 Debit Cost Ledger Control A/c
 Credit Costing Profit & Loss A/c
- f) **Profit/Loss**
- i) *For Profit transfer*
 Debit Costing Profit & Loss A/c
 Credit Cost Ledger Control A/c
 - ii) *For Loss transfer*
 Debit Cost Ledger Control A/c
 Credit Costing Profit & Loss A/c

5.3 Reconciliation of Cost and Financial Accounts

When two separate sets of accounts are maintained in financial and cost accounts the profit or loss figures under two sets may not tally. Under such circumstances, attempts are made to identify the reasons behind such difference. The underlying process is called reconciliation. Reconciliation is necessary to detect error in any one or both of the sets of accounts. Over and above all, reconciliation tests arithmetical accuracy in maintaining accounts in the two sets of accounts, which strengthens internal control.

Reasons for the differences in profit figures may be due to the following :

- i) Items affecting only one set of accounts,
- ii) Under-or over-absorption of overhead,
- iii) Different methods of stock valuation adopted,
- iv) Other factors.

The details under each of the above are mentioned below :

i) Items specific to one set of accounts

a) *Purely Financial Incomes and Expenses*

1. Profit or Loss on sale of fixed assets
2. Interest, dividend, rent, fines, penalties, etc.
3. Cost on issue of shares, debentures, bonds, etc.
4. Fees or commission received on issue of shares, debentures, etc.

b) *Purely Financial Appropriation Items*

1. Provision for tax
2. Provision for dividend payment
3. Writing off Goodwill, Preliminary expenses, etc.
4. Transfer to General Reserve
5. Additional provision for depreciation, bad debt, etc.

c) *Purely Cost Items*

1. Notional interest on owned capital
2. Notional rent on owned building.

Items under (b) above will cause difference only when profit figure after appropriation (financial books) is compared with the profit under cost books. Otherwise, these items may be ignored for the purpose of reconciliation. The items under (c) above will not affect the costing profit or loss. For example, Production Overhead Control A/c is debited for notional rent with a corresponding credit to Costing Profit & Loss A/c. Production Overhead Control A/c is, in effect, a debit item for Costing Profit & Loss A/c. Thus, the two aspects of debit and credit neutralize the effect of notional rent on costing profit or loss. These items are, therefore, to be ignored for the purpose of reconciliation.

ii) Under-or Over-absorption of Overhead

In cost accounting, overheads are absorbed based on a pre-determined rate. It causes under-or over-absorption of overhead. Costing Profit is overstated for under-absorption and vice-versa. Thus, they cause difference in profit figures under two sets of accounts. If, however, such under-or over-absorbed overheads are charged off to Costing Profit & Loss A/c through Overhead Adjustment A/c, then the effects are neutralized retaining profit figure unaffected.

iii) Different bases of stock valuation

In financial accounts, stocks (raw materials, work-in-progress and finished goods) are valued at lower of cost and net realizable value. But in cost accounts, stocks are

valued at cost. So, when stocks in financial accounts are valued at net realizable value, being lower than cost, financial profit is overstated for opening stock and understated for closing stock. Profit figures may also differ even when stocks in both sets of books are valued at cost. For example, cost (of stock) may mean 'latest purchase price' in financial accounts and 'weighted average cost' in cost accounts. Again, composition of cost in two sets may be different. For example, cost of transporting finished goods to the location of sale is included in the cost of finished goods in financial accounts but not in cost accounts.

iv) Other factors

There may be some other items which receive different treatments in the two sets of accounts. For example, depreciation in financial accounts is almost always treated as an annual charge while in cost accounts it is sometimes charged on production unit basis or on hourly basis. Profit in cost accounts may also be affected for under-or over-absorption of direct wages when direct wages, in some exceptional cases, are charged to cost of production by use of a pre-determined rate just like overheads.

After having identified the causes behind the two different profit figures, it is simple to make reconciliation. The process is a kin to the preparation of a Bank Reconciliation Statement. However, the process may be summarily stated as follows :

- i) Start with the profit figure of either of the books of accounts. Say, we start with Profit as per Cost Accounts and want to arrive at profit as per other set of books.
- ii) Analyse individual items causing difference in profit. It is to be ascertained whether a particular item has increased or decreased the profit under cost accounts.
- iii) Add the amounts involved in the items causing difference in profit to the cost profit if the items have reducing effects on cost profit.
- iv) Deduct the amounts involved in items causing increased profit under cost books.

We get the profit as per financial accounts.

If we start with profit as per financial accounts, the amounts involved in items stated in (iii) above are to be deducted and the amounts in items stated in (iv) above are to be added to arrive at the profit as per cost accounts.

5.4 Integrated Accounts

Maintaining separate sets of books for cost and financial accounts needs reconciliation between the profits under two sets. Integrated system of accounting will help avoid reconciliation since accounts are maintained in the single combined set of books.

In the integrated system, duplication of records is avoided. Thus, personal accounts and real accounts are maintained as per financial accounting principles since these are better maintained there. On the other hand, nominal accounts related to cost and sales are better analysed under cost accounting rules; so these are maintained as per those rules.

- **Main Accounts to be maintained**

Maintaining Cost Ledger Control A/c. in Cost Ledger is dispensed with. Other accounts in the Cost Ledger as discussed earlier are retained. In addition, the following accounts, most of which are specific for the financial accounts, are also maintained :

1. Bank Account
2. Debtors Control Account
3. Creditors Control Account
4. Provision for Depreciation Account
5. Discounts Account
6. Accrual and Prepayment Account
7. Fixed Assets Account
8. Share Capital Account
9. Profit and Loss Account
10. Cost Control Account

The first nine accounts are very much the same as they are maintained in financial accounts. Cost Control Account acts as a *Central Control Account*.

- **Specimen Journal Entries**

1. Materials
 - a) *For Purchases :*
 - Debit Stores Ledger Control A/c
 - Credit Creditors A/c (for credit purchases)
 - Credit Cash A/c (for cash purchases)

- b) *For Returns to Creditors :*
Reverse entry to that for (a) above
- c) *For Issues to Production :*
- d) *For Issue of Indirect Materials to Production*
- e) *For Returns to Stores*

For (c), (d), and (e) above, entries are the same as stated for non-integrated Cost Books of Accounts.

2. *Wages :*

- a) Payment (both direct and indirect)
Debit Wages Control A/c
Credit Cash A/c
- b) Charging direct wages for Production
- c) For Indirect Wages charged to Production

For (b) and (c), entries are the same as stated for non-integrated Cost Books of Accounts.

3. *Overheads :*

- a) *For Overheads incurred :*
Debit (Respective) OH Control A/c
Credit Creditors for Services A/c
- b) *For Payments :*
Debit Creditors for Services A/c
Credit Cash A/c
- c) *For Overheads recovered*
- d) *For under-or over-absorption of Overheads*
- e) *For transferring balances of OH Control A/cs*

For (c), (d), and (e), entries are the same as stated for non-integrated Cost Books of Accounts.

4. *Sales :*

- Debit Debtors/Cash A/c
- Credit Sales A/c

5.5 Questions

a) *Long answer type*

1. What principal ledgers and accounts are maintained in a system of cost control accounting?

2. Why is reconciliation of cost and financial accounts necessary? Can it be avoided? If so, when?

(b) Short answer type

3. What are the advantages of maintaining a cost ledger?
4. Give specimen entries in integrated system of accounting for all types of overhead transactions.

(c) Objective type

5. State whether the following statements are True or False :
- (i) Notional transactions do not have any effect on costing profit or loss.
 - (ii) Loss of stock by fire is excluded to be recorded in cost books.
 - (iii) Both types of balances of Overhead Adjustment A/c are transferred to Costing Profit & Loss A/c.
 - (iv) Costing profit is understated for under-absorption of overhead.
 - (v) Cost Control A/c is the same as Cost Ledger Control A/c.
6. Fill in the blanks :
- (i) Work-in-Progress Control A/c is debited for all _____costs.
 - (ii) Balances of Overhead Control A/c is transferred to _____ Account
 - (iii) For absorption of Administration Overhead _____Account is debited.
 - (iv) Undervaluation of opening stock leads to _____stated profit.
 - (v) Double entry system _____ followed in cost books.

5.6 Select Readings

Banerjee, B., *Cost Accounting*, World Press Pvt. Ltd.

Wheldon's *Cost Accounting*, ELBS

Horngren, T., *Cost Accounting—A Managerial Emphasis*, Prentice Hall.

5.7 Hints for Solution (for objective type questions)

5. (i) to (iii) True (iv) & (v) False.
6. (i) direct (ii) Overhead Adjustment Account (iii) Finished Goods ledger Control Account (iv) overstated (v) is.