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FINANCIAL REPORTING | BASIC

# Video Transcription: The Reconciliation Process



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Hi, my name is Don Macdonald. Today we are going to work together to try and understand the reconciliation process in accounting. The term reconciliation has a number of meanings but in accounting it is quite specific.

It is used to describe a process that is part of the control system to ensure that the amounts reported as assets or liabilities in the financial statement are verified. So how do we use this process? Well firstly, by comparing the amount from the accounting records to data from another source to establish whether the amounts agree. Secondly, if the amounts do not agree, identifying and investigating the items that make up this difference. Thirdly, if necessary, we need to update or adjust the accounting records and lastly, we will prepare a note, which details the remaining differences. To illustrate this reconciliation process, let's assume we are responsible for maintaining the fixed assets register of a business.

A fixed assets register is used to maintain control over the assets classified as PPE – “property, plant and equipment”. At the financial year-end, how do we ensure that the details in the fixed assets register are reflected by economic reality? We will use the example of vehicles in a business. What we want to establish is whether the vehicles physically exist and whether the details of each vehicle such as the make, colour and registration number agree with the details in the register. So let's assume that there are twenty vehicles listed in this register. The first step in the reconciliation process is to physically inspect the vehicles and compare the details with those in the fixed assets register. If all twenty vehicles are there and the details for each agree then there is no need to go any further with the reconciliation process as we will have verified the asset: vehicles.

But what happens if we only identify 18 vehicles? We must ensure that the details of the 18 vehicles agree with the details to the fixed asset register. Having done this we are left with a difference of two vehicles. The second stage of the reconciliation process is to identify and investigate those items, which explain this difference. We discovered that one vehicle, vehicle number 11 was sold a month ago but the fixed asset register was not updated. The other vehicle, vehicle number 14, is at a local garage being repaired. The third step is to update the fixed assets register with the sale of vehicle 11. Once this has been done, the register will correctly reflect that the business now has 19 vehicles under its control. The difference such as this one, which can be resolved by updating the business records, we call an adjusting difference.

But we have only identified 18 out of the 19 vehicles, so what about the vehicle being repaired? The fourth step then is to prepare a reconciliation note that shows any remaining differences. The details of vehicle 14 are correctly recorded in the fixed assets register, so no adjustment is required. The remaining difference is a non-adjusting difference and it will be resolved once the vehicle is returned to the business from the garage. The reconciliation note does not form part of the double entry system but supports the validity of the accounting records and the amount reported in the financial statements.

You will have seen that from those three situations, the only one that would appear in a reconciliation note is the non-adjusting difference.



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When preparing financial statements, businesses need to verify, amongst other amounts, those reported as cash and cash equivalent, in other words bank, trade receivables known as debtors, and trade-payable creditors. A reconciliation process is followed for each. Now let's work through another example. Business C sells inventory on credit and at the reported date an asset, trade receivables, is reported in the Statement of Financial Position. This amount needs to be verified by data from another source. This data is contained in the Debtors Ledger, an internal source of data. So we refer to the process as an internal reconciliation process.

The balance on the trade receivables account, which is a control account, represents the total amount owed by business C's debtors. In order to verify this amount, we compare it to the total of the individual debtor's balances in the Debtors Ledger. If the two amounts agree, we need to go no further with the reconciliation. But if there is a difference, the reason for this needs to be investigated. So, how could a difference arise? Well, let's assume that the total credit sales of business C, for a month, was correctly recorded in the sales journal and the total was correctly posted to the trade receivables account. However, we note that one of the sales invoices in the Sales Journal was not posted to an individual Debtors Ledger account. So this would give rise to a difference between the trade receivables account balance and total of the individual Debtors Ledger account balances.

As part of this internal reconciliation process the accounting records of business C would be updated by posting the sales invoice to the individual account in the Debtors Ledger. This is an adjusting difference. Once this adjustment is done the two amounts will agree and the business will have verified the trade receivable asset on the Statement of Financial Position, from the supporting data in the Debtors Ledger. Once this internal process is complete, business C will then arrange to send statements to each of its debtors. The statements contain the data from the Debtors Ledger accounts. In other words, the statement will show the total amount owed to business C together with the details of this amount.

Now let's assume that business C has sold inventory to business D. Business C keeps a record of business D in its Debtors Ledger. Whereas business D keeps a record of business C in its Creditors Ledger. Before business D pays any of its creditors, it needs to verify the amount owing to each individual creditor. This would be done by using data from an external source. That is the statement from business C in this instance. This process is referred to as an external reconciliation process.

If the two amounts do not agree, we need to identify the differences in order to assess how it should be treated. Where possible, business D will update its accounting records with adjusting differences. Any remaining differences will be non-adjusting differences and they will appear in the reconciliation note, very similar to the one with the fixed assets.



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The reconciliation note details why the amount owing to the creditor, according to the updated records, is different from the amount shown as “due” on the statement. Now let’s consider a transaction that would give rise to such a difference. Assume that business D returns some of the inventory it had purchased from business C. We will assume that the return is made on the last day of the month, which means that business C will not receive this inventory back until the following month. In other words, when this statement was issued this returned inventory would not have been reflected in the books of business C. The statement received by business D from business C reflects an outstanding balance of R100 and business C’s individual Creditors Ledger account in the accounting records of business D reflects a balance owing of R80.

By comparing the details on the statement with the details in the individual Creditors Ledger account of business C in the books of business D, a difference of R20 is identified. So what has given rise to this difference? Well, business D’s records are up to date, the returned inventory has been recorded, so the entries are correct and no adjustments are required.

From business D’s perspective, the remaining difference is a non-adjusting difference. Now, there are two types of non-adjusting differences, one is an error. Business C could have made an error in its accounting records and this would be reflected on the statement that we have received from business C. The other difference, the other non-adjusting difference, arises from a timing issue. The difference has arisen because the inventory returned by business D had not been received by business C by the time the statement was prepared. Once the inventory is received by business C, it will update its records and there no longer will be a difference. This difference is known as a timing difference because it gets eliminated through the passage of time. In other words, when the goods arrive at business C and they update their records the difference is resolved.

This non-adjusting timing difference will appear on the reconciliation note prepared by business D. When business D pays business C the R80 a remittance advice is sent to business C explaining how the payment amount was calculated. The remittance advice contains the same information as the reconciliation note but is drafted in a way that highlights why the amount of the payment made differs from the balance on the supplier’s statement. Once this external reconciliation process is complete, each of the amounts owing to the individual creditors will have been verified from an external source. Business D will need to ensure that the trade payables amount, in other words the liability on the Statement of Financial Position, is verified from the total of the individual creditors account balances, which is an internal source and this would be referred to as an internal reconciliation process.

The principles underlying the debtors' and creditors' reconciliation processes apply equally to the bank reconciliation process.

So, to verify the amount reported as part of cash and cash equivalents reported in the Statement of Financial Position, the bank account balance in the general ledger is compared to the bank statement, which is an external source and so an external process is followed. Any adjusting differences identified will result in the accounting records of the business being updated and the non-adjusting differences will appear in the reconciliation note prepared by the business.



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To recap, the reconciliation process is part of the control system to verify the assets and liabilities, which appear in the financial statements. There are two reconciliation processes: an internal reconciliation process, which verifies amounts using an internal source of data, and an external reconciliation process, which verifies amounts using an external source of data. During the reconciliation process, two types of differences arise: adjusting differences, this requires the business preparing the reconciliation to update its accounting records, and non-adjusting differences. Non-adjusting differences arise either from errors made by an external party or arise from a timing issue. And finally, when non-adjusting differences arise, a reconciliation note needs to be prepared.

I hope this video has gone some way to help clarify your understanding of the reconciliation process.