7

VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

STRUCTURE :

7.1. MEANING OF VERIFICATION :

Spicer and Pegler have defined verification as “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”. Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.

Thus, verification includes verifying :-

1. The existence of the assets
2. Legal ownership and possession of the assets
3. Ascertaining that the asset is free from any charge, and
4. Correct valuation

Of course it is not possible for the auditor to verify each and every asset. It was held in Kingston Cotton Mills case that “it is not part of an auditor’s duty to take stock. No one contend that it is. He must rely on other people for the details of stock in trade in hand”.

However, as per the decision given in Mc Kesson and Robins case (1939) the auditor must physically inspect some of the assets. Now the auditor has to report whether the balance sheet shows true and fair view of the state of affairs of the company. Hence, he is required to verify all the assets and liabilities appearing in the balance sheet. In case of failure, the auditor can be held liable for damages.

According to the `statement of auditing practices’ issued by ICAI, “the auditor’s object in regard to assets generally is to satisfy that :-

1. They exist.

2. They belong to the client.

3. They are in the possession of the client or the persons authorized by him.

4. They are not subject to undisclosed encumbrances or lien.
5. They are stated in the balance sheet at proper amounts in accordance with sound accounting principles, and
6. They are recorded in the accounts.

7.2 POINTS TO BE CONSIDERED :

While conducting verification following points should be considered by the auditor :-

1. **Existence :** The auditor should confirm that all the assets of the company are physically existing on the date of balance sheet.

2. **Possession :** The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.

3. **Ownership :** The auditor should confirm that the asset is legally owned by the company.

4. **Charge or lien :** The auditor has to verify whether the asset is subject to any charge or lien.

5. **Record :** The auditor should confirm that all the assets and liabilities are recorded in the books of account and there is no omission of asset or liability.

6. **Audit report :** Under CARO the auditor has to report whether the manangement has conducted physical verification of fixed assets and stock and the difference, if any, between the physical inventory and the inventory as per the book.

7. **Event after balance sheet date :** The auditor should find out whether any event after the date of balance sheet has affected any items of assets and liabilities.

7. 3 SCOPE OF VERIFICATION

Verification includes information on the following :-

1. That the assets were in existence on the date of the balance sheet
2. That the assets had been acquired for the purpose of business only
3. That the assets had been acquired under a proper authority
4. That the right of ownership of the assets vested in the organization
5. That the assets were free from any charge and
6. That the assets were properly valued and disclosed in the balance sheet.

7. 4 OBJECTS OF VERIFICATION :

Following are the objects of verification of assets and liabilities

1. To show correct valuation of assets and liabilities.
2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business
3. To find out the ownership and title of the assets
4. To find out whether assets were in existence
5. To detect frauds and errors, if any
6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
7. To verify the arithmetic accuracy of the accounts
8. To ensure that the assets have been recorded properly.

7. 5 ADVANTAGES OF VERIFICATION

Advantages of verification are as under :-

1. It avoids manipulation of accounts
2. It guards against improper use of assets
3. It ensures proper recording and valuation of assets
4. It exhibits true and fair view of the state of affairs of the company.

7.6 TECHNIQUES OF VERIFICATION :

1. Inspection : It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.
2. Observation : The auditor may observe or witness the inspection of assets done by others.
3. Confirmation : It means obtaining written evidence from outside parties regarding existence of assets.

7.7 VERIFICTION OF ASSETS

The term `verification' signifies the physical examination of certain class of assets and confirmation regarding certain transactions. Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. Vouching goes to prove the arithmetical accuracy and the genuineness of the transactions, whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the Balance Sheet date, rather it purports to prove that the asset ought to exist; on the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the balance Sheet.

Verification of assets involves the following steps:

1. Enquiry into the value placed on assets;
2. Examination of the ownership and title deeds of assets;
3. Physical inspection of the tangible assets; and
4. Confirmations regarding the charge on assets;
5. Ensuring that the assets are disclosed, classified and presented in accordance with recognized accounting policies and legal requirements.

The scope of verification is wide and consequently verification is an important part of the auditor's duties. An auditor should put all his endeavor to satisfy himself whether a particular asset is shown in the Balance Sheet at proper value, whether the concern holds the title to the asset and the asset is in the sole possession of the concern and lastly whether the asset is free from any charge. If the auditor fails to perform his duty, he will be held liable. In case of London Oil Storage Co. Ltd. Vs. Sear Hasluck & Co. (1904) Chief Justice Alverstone remarked : `It is the duty of the auditor to verify the existence of the assets stated in the Balance sheet and he will be liable for any damage suffered by the client if he fails in his duty.

Besides the legal importance, verification also plays an important role to guard against improper valuation of assets like stock-in-trade which may inflate or deflate the profit position of the concern. Improper valuation of assets may also conceal the actual position of the business as reflected in the Balance Sheet.

However, it is not possible on the part of the auditor to physically verify each and every asset because time may not permit him to do so, or he may not have sufficient technical knowledge of the assets concerned. It was decided in the case of "Kingston Cotton Mills: that it is not a part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for the details of the stock-in-trade.

Again, while going through the decision of Mc Kesson and Robins case in 1939, we find that the auditor should physically verify some of the assets. If possible, title documents like negotiable instruments, shares, debentures, securities, etc. are to be thoroughly examined on the last day of the accounting period. He should satisfy himself that the transactions, if any, having bearing on the Balance Sheet date and date of audit are bonafide and are supported with proper evidence. The auditor is also supposed to verify stock-in-trade with reference to the purchase book, the stock records, the gatekeeper's book, etc. though law does not specially compel him to take stock-in-trade.

7.8 VALUATION OF ASSETS

(i) Meaning :

Valuation of assets means determining the fair value of the assets shown in the Balance Sheet on the basis of generally accepted accounting principles. The valuation of assets is very important because over-statement or under-statement of the value of assets in the Balance sheet not only distorts the true and fair view of the financial position but also gives wrong position of profitability.

The valuation of the assets is the primary duty of the officials of the company. The auditor is required to verify whether the value ascertained is fair one or not. For this, he may rely on the technical certificate issued by the experts in the field.

Valuation of assets means not only checking value of the assets owned by an organization as on Balance Sheet date, but also critical examination of the value of these assets

(comparative analysis of different assets).

The auditor has also to see that the principle of valuation of assets is consistently adopted and is based on established principles of accountancy. For the purpose of convenience, those assets are classified as under to determine their value.

1. Fixed Assets
2. Current Assets or Floating Assets
3. Wasting Assets
4. Intangible Assets
5. Fictitious Assets.

1. **Fixed Assets :** Fixed Assets are usually valued at `going concern value' which means cost less depreciation. Cost here means purchase price of the assets plus all incidental manufacturing, buying and installation expenses incurred to bring the assets in use. Depreciation is the provision made for the reduction in the value of the assets on account of their usage, natural wear and tear and obsolescence etc. The depreciation provided should be fair, otherwise the value of fixed assets may not be fair. What is a fixed asset depends on the nature of the business organization.

2. **Current Assets or Floating Assets :** These are usually converted into cash at the earliest opportunity in the process of business activity, e.g. stocks, bills receivables, sundry debtors, etc. Based on conservatism principle, usually current asset are valued at original value (cost price) or market value (realizable value) whichever is lower. Because they are intended to be converted into cash at the earliest possible time, hence what value we may realize is important. This method is adopted to strengthen the financial position of a concern by indirectly providing for expected loss by way of fall in the market value of the assets. This principle is held by the conservatism convention of accounting, i.e. do not expect profits but provide for anticipated losses.

3. **Wasting Assets :** Wasting Assets means those which lose their value gradually upon their use, e.g. a mine, a quarry etc. To value these assets firstly we should determine the usefulness of the assets in terms of units of production etc. and as per their actual use the value is to be reduced on proportionate basis. If in a particular period this type of asset is not used then the value may not diminish also. Thus, these assets are to be reduced on the basis of consumption. But sometimes it may be difficult to adopt this method, then the `cost less depreciation' principle may have to be applied.

4. **Intangible Assets :** Usually intangible assets like goodwill, patent rights, know how, etc. are valued on cost basis. But if the same are acquired by a non-cash transaction, then the fair market value is to be taken as the value of intangible assets. Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realizable value. They are to be valued at actual cost less amount written off as depreciation upto Balance Sheet date.

5. **Fictitious Assets :** Certain lumpsum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the Balance Sheet e.g. preliminary expenses, discount on issue of shares etc. These are all ficitious assets because they do not have any realizable value. They are to be valued at actual cost less amount written off upto the Balance Sheet date.

7. 8.1 Methods of Valuation

The following are the various principles of valuation of assets

(1) **Cost Price (Going Concern Value) :** Under this method actual cost of assets are reduced by the depreciation provided. Usually this method is applied to value fixed assets.

(2) **Market Value :** This refers to the market value of the asset i.e. the price at which the asset is being transacted in the market. This is applied to value the current assets only when this is lower than cost of the asset. Usually market value is adopted to value items having perishable nature.

(3) **Scrap Value :** Assets which are useless for the enterprise may be sold as scrap in the market. The value for which such assets can be disposed of as scrap, is called as scrap value of assets.

(4) **Replacement Value :** This represents the value at which the existing assets can be replaced. That means the price to be paid to acquire such type of assets in the market on the date of the balance Sheet.

(5) **Realisable Value :** The value that can be obtained if the asset is sold in the market i.e. anticipated selling price. Usually, expenses such as commission, brokerage etc. are deducted from it.

7.8.2 Auditor’s position regarding valuation of assets :

So far as the valuation aspect of audit is concemed, the auditor’s position is somewhat different from the other aspects of audit. It has already been pointed out that the auditor is not supposed to have technical knowledge regarding the valuation of assets. Therefore, he has to depend upon the valuation made by the directors, expererts, surveyors, etc, to a great extent. But does it relieve him from liability if certain assets are overvalued or undervalued by the directors, experts or surveyors etc? The reply is definitely no, because the auditor cannot give a guarantee for absolute correctness or the state of affairs when he has to depend upon others, and also where assets are valued according to the estimated depreciation. He has to see that the management tries to show the fairest possible estimate of the position of the state of affairs of the concern. Under these circumstances, the auditor should see that assets are valued according to certain accepted principles of accountancy. He should check the estimation in a reasonable manner. The auditor in any case should thoroughly examine the available papers and documents to arrive at the correct value of assets. In case of a little suspicion as regards the valuation of assets he should probe into the matter.

7.8.3 Distinction between verification and valuation :

1. **Meaning :** verification establishes existence, ownership and acquisition of assets whereas valuation certifies correctness of the value of assets and liabilities.

2. **Time :** Verification is done at the end of the year whereas valuation is done during the year.

3. **Personnel :** Verification is done by auditor whereas valuation is done by the proprietor himself.

5. **Evidence :** The title deeds, receipts of payments constitute documentary evidence for verification where as certificate given by the proprietor is the documentary evidence for valuation.

7. 9 VERIFICATION OF ASSETS – ILLUSTRATION :

(i) Cash in hand and at bank :

Cash in hand includes all the following :

(a) Cash in hand :

1. Special care is necessary with regard to verification of cash balances. There can be no certainity that the cash produced for inspection was in fact held by the custodian.

2. For this reason, the cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the client or to his staff.

3. If there is more than one figure for cash balance e.g. when there is a cashier, a petty cashier, a branch cashier and in addition, there are imprest balance with employees, all of them should be checked simultaneously, as far as practicable, so that the shortage in one balance is not made good by transfer of amount from the other.

4. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared, containing details and the cash balance counted. If he is absent at the time the cash is being verified, he may subsequently refute the amount of actual cash on hand which may put the auditor in an embarrassing position.

5. If the auditor is unable to check balance on the date of the Balance Sheet, he should arrange with his client for all the balance to be banked and where this cannot conveniently be done on the eve of the close of the financial year, it should be deposited the following morning. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at close of the year.

6. Should this not be possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash. This should be

done soon after the cash balances have been counted. The cash book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked.

7. If any cheques, or drafts are included in cash balance the total there of should be disclosed.

8. If there is any rough Cash Book or detail of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book, to prove that, entries in the Cash Book are correct.

9. If the auditor finds any slip, chit or I.O.U's in respect of temporary advances paid to the employees, included as part of the cash balance, he should have them initialed by a responsible official and debited to appropriate accounts.

(b) Cash in Transit (Remittance in Transit)

1. This refers to amount sent by Branch/Depots/Agents etc. to Head Office but physical cash/cheques not yet received by H.O. or vice versa.

2. Such remittance in transit should be verified from subsequent period cash book/pass book as to whether actually it is received or not.

3. Reconciliation of H.O./Branch Accounts should also be checked.

4. If amount is deposited into bank, pay-in-slip can also be verified.

5. See that entry for remittance in transit is passed by only one party and is reversed in the next year.

(c) Petty Cash

1. Petty Cash in hand should be verified with Petty Cash Book

2. Also check up the balance of Petty Cash Account in General Ledger.

3. Vouch the transaction of last month property to ascertain that fictitious payments are not entered into

4. Some of the points given for verification of cash in hand will be applicable for Petty Cash also.

(d) Bank Balance :

1. To verify cash at bank, the auditor should examine the bank pass book and compare it with the balance as shown by the bank column of the cash book.

2. Check bank reconciliation statement with bank statement / pass book of subsequent period.

3. The auditor should get a certificate regarding the balance at the bank directly from the bank.

4. Ensure that the balance as shown by the cash book is brought into the balance sheet as `Cash and Bank' and not `Balance as shown by the pass book'.

5. The auditor should also see that the `cheque outstanding' and `cheques not yet collected' are genuine and not made up in order to conceal the deficiency. If some of these cheques are more than six months old, he should make inquires, and have them reversed in the books of accounts.

6. Cash in Fixed deposits with the bank can be verified by examining the deposit receipt, or getting a certificate from the banker.

7. If there are more than one bank account such as `Dividend Account'. "Interest Account' etc. all such accounts should be checked and the balances should be verified upon the same date. Information regarding their balance should also be obtained from the bank directly.

8. If the bank account shows an adverse balance and the client has deposited any security for the overdraft, the auditor should enquire from the bank the particulars of the security and the amount of the interest charged.

(ii) Bills Receivable

1. The auditor should examine the Bills Receivable Book with the Bills Receivable not matured but in hand on the date of the Balance Sheet.

2. When any bills are in the process of collection the details of the same have to be verified with bank certificates.

3. If the Bills Receivables in hand are many, auditor should make a list of bills for his convenience.

4. If there are any bills that have been discounted, and still not matured, he has to examine the details of the same very carefully and should confirm with the bank because they are to be shown as contingent liabilities by way of a note in the Balance Sheet.

5. While examining the Bills, the auditor has to pay special attention to see that they are properly drawn, stamped and duly accepted.

6. He has to check whether any bills is overdue. If so, auditor should ask for the details of the action initiated, etc. If there are any bills which are doubtful of recovery, he should see whether any adequate provision has been made for the anticipated loss on account of bad debts.

7. He has to see that in case of dishonoured bills, the same is not shown as Bills Receivable. the auditor has also to check up whether noting formalities have been properly complied with or not.

8. In case the auditor has visited his client after the Balance Sheet date, many of the bills due on the Balance sheet date might have matured or honoured. Hence the auditor has to vouch such bills with Cash Book or Pass Book and reconcile the balance.

9. If the bill has been renewed after the Balance Sheet date, then also the value of the original bill due on Balance sheet date should be shown as Bills Receivable and interest on renewed bills properly accounted.

10. If the bills endorsed have been dishonoured, the original drawee is to be debited and endorsee is to be credited.

(iii) Loans advanced

Loans may of different types like :

(a) Loans against the security of land and buildings.
(b) Loans against the security of goods
(c) Loans against the security of stocks and shares.
(d) Loans against the security of insurance policies, and
(e) Loans against the personal security of the borrower.

Therefore, in each case, the duty of auditor in general is as under :

1. Verify whether object clause of the Memorandum provides for granting of such loans.

2. Examining whether a proper loan ledger has been maintained and it is up-to-date or not.

3. Examination of the security lodged against each loan. The loan agreement is to be scrutinized regarding the rate of interest. Due dates of instalment, penally, interest, etc.

4. He should ascertain whether any loan is doubtful of recovery in which case a provision for the expected loss is to be made.

5. Except in case of a banking or finance company, auditor has to ascertain whether the purpose of advancing is connected with business or not. Section 227(4A) of the Companies Act, 1956 requires an auditor to report whether the parties to whom the loans are given are regular in payment of interest and principal and the terms of the loan are not prima facie prejudicial to the interst of the company.

(a) Loans against the security of Land and building

1. The auditor has to examine the mortgage deed, see if the copy has been properly executed and registered in favour of the client.

2. The auditor has to examine the title deeds deposited with the mortage deed.

3. The auditor, if required, has to examine the valuer's certificate in order to ascertain the value and sufficiency of the security.

4. The auditor has to confirm that the property is properly insured and insurance premiums have been paid in time.

5. The auditor has to examine the title of the Borrower to the property, etc.

6. If the mortgage is a second mortgage, the auditor has to confirm that the same is brought to the knowledge of the first mortgagee. In this case he has to take the acknowledgement of title deeds from the first mortgagee.

(b) Loans against the security of goods.

1. The auditor has to examine the nature of the goods and confirm that the goods are really belonging to the borrower. He should see whether the loan is granted against railway receipt, lorry receipt, dock warrant, godown keeper's receipt etc.

2. In case goods are stored in the godown, he has to see that the rent of the godown is paid in full and the goods are fully insured.

3. The auditor should examine the value of the goods by comparing them with the present market value. Regarding quality and quantity, he may rely on the inspector's reports.

4. If the goods are of perishable nature, the auditor has to examine the turnover of the stock of the client.

(c) Loans against the security of stocks and shares

1. He should call for a statement of stocks and shares given as security and confirm that all of them are fully paid up.

2. He should see whether an instrument of transfer is properly stamped and is properly executed.

3. He should see that their value is properly disclosed as per the prevailing market rates.

4. He has to ensure that there is a sufficient margin on the loans advanced.

5. He has to see whether the charge is properly registered or not.

(d) Loans against the security of insurance polices :

1. The auditor should see that the policy has completed at least two years.

2. The auditor should confirm that all the premiums have been properly paid and the policy is in force by examining the latest premium receipt.

3. The auditor should ascertain that due notice of assignment has been given to the insurance company.

4. The auditor should see that the loan has been advanced on the basis of surrender value of the policy as certified by the insurance company.

5. The auditor has to ensure that the premium, if any, paid up by the lender to keep the policy in force is properly debited to the Loan Account of the borrower together with the usual interest.

(e) Loans against the personal security of the borrower

The auditor has to examine the documents like Promissory Note, Guarantor's details and Salary Certificate of the borrower, etc.

(iv) Sundry Debtors :

Sundry Debtors represents the amount recoverable from the customers for sale of goods or rendering of services.

1. The undermentioned procedure should be applied for verification of `Book Debts' or `Sundry Debtors' after receiving a schedule or list of debtors from the client.

(a) Direct confirmation of balances from debtors by sending confirmatory letters.

(b) Year-end Scrutiny of ledgers.

(c) Verification of the position of debts considered bad or doubt ful.

(d) Compliance with legal requirement or presentation.

2. The auditor should arrange to send the letter of confirmation of balances by the client as per client's records and see that the reply of confirmation is forwarded to his office directly. Usually this should be sent within 15 or 20 days of close of the year under the supervision of the audit staff. After the reply is received, the same should be tallied with the balances shown in the Debtors Ledger and difference properly reconciled.

3. After the said procedure is carried out, he should carry out a thorough scrutiny of the debtor's individual accounts. Wherever the number of debtors is very large, Test Checks can be applied.

4. While scrutinizing the ledger, the auditor should focus the light on discounts, returns, cash received, rebates allowed, goods returned etc.

5. On ascertaining the balances of the debtors as genuine and correct, the auditor has to verify the debtors to find out bad or doubtful debts to make a provision for the same. If the debts are bad and irrecoverable or doubtful and they are not provided for properly, the financial statements will not portray a `True and Fair' view. Hence, appropriate provision is to be made by considering the age of the debtor, scrutiny of payments received, management opinion and any other information like financial position of debtors, etc. If the auditor fails in verifying the appropriateness of the provsion made, he shall be held liable for negligence.

6. After ascertaining the position of bad or doubtful debts, he should see that the legal requirements of Schedule VI to the Companies Act, 1956 are complied with. For this purpose, the debtors are to be classified as :

(a) Outstanding for a period of more than six months ; and

(b) Other debts.

7. Over and above this, other requirements like debts considered as good and which are fully secured, debts due from the officers, directors, managers of the company, etc., are to be ascertained for disclosure.

8. If the customers have purchased the goods on hire purchase system and some of the instaiments are not due, the same is not to be shown as `stock out on hire purchase'.

9. Likewise, if the goods are sold on `return or approval' basis, such customer cannot be shown as a debtor at the close of the year.

10. Further, whenever there are credit balances in some debtors account, the same are not to be deducted from other debtors debit balances and net balance is not to be shown in the assets side, but former is to be shown as Sundry Creditors.

(v) Patent and Trademarks :

1. The ownership of patent rights is verified by inspection of certificate issued for grant of patent, by the prescribed authority.

2. If it has been purchased, the agreement surrendering it in favour of the client should be examined.

3. If there are a number of patents held by the client, obtain a schedule giving the full details thereof or verify with reference to the register maintained by the client.

4. It must be verified that patent rights are alive and legally enforceable and renewal fees have been paid on due dates and charged to Revenue Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed.

5. See that the patents are properly registered in the name of the client only.

6. See that the cost of patent is being written off over its useful period of life.

7. In case the patent is acquired, cost paid for the same and all relevant expenses are to be capitalized.

8. If the patent is created by the client by the research experiments and laboratory work, only the actual expenses incurred for it in the process are to be capitalised.

(vi) Copyrights

1. The auditor has to examine the written agreement of assignment alongwith the royalty paid to the authors etc., for such copyrights.

2. He has to see that such assignments are properly registered.

3. If the client is the owner of many copyrights, the auditor should ask the client to prepare a schedule of copyrights and get the detailed information to confirm that the same is shown in the Balance Sheet.

4. Regarding the value of copyrights, it should be remembered that this asset has no value in the long run. Hence, value is determined on revaluation basis and period of copyrights.

5. If any copyrights does not command the sale of any books, then the same should be written off in such year. The auditor has to verify the same in detail.

(viii) Know-how :-

1. Know how is recorded in the books only if it has been paid for. If it is developed in house, it cannot be capitalised. The auditor should keep his in mind while verifying know-how.

2. Know-how can be of two types :

(a) Relating to manufacturing process – The auditor should ensure that the expenditure is written off in the year of payment itself.

(b) Relating to design, plans of plants, building etc. - The auditor should ensure that the expenditure is capitalized and depreciation is charged on the capitalized figure.

In case lumpsum payment is made for both types of know-how, both the types should be segregated on a reasonable basis.

Under the Income-Tax Act, cost of Know-how can be deducted subject to the rules laid down.

The auditor should keep this fact in mind while computing the tax liability for the year under audit.

(viii) Investments :

Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted.

1. Obtain a schedule of investments in hand at the beginning of the audit period. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.

2. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.

3. Balance this schedule and compare the balance with general ledger and Balance sheet.

4. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.

5. Inspect the certificates or securities physically on the Balance Sheet date.

6. Compare the income received with amount due and adjust the accrued income.

7. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.

8. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.

9. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.

10. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.

11. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.

12. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.

13. In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the Balance Sheet.

(ix) Leasehold Property :

Normally the lease or right to use the property is granted for certain number of years. At the expiry of the period of lease, the rights go back to the original lessor. Various steps involved in the verification of leasehold rights are stated below.

1. Inspect the lease agreement to ascertain the amount of premium paid, period of lease, other terms and conditions, like maintenance, insurance, etc.
2. See that the lease is properly registered with the Registrar because a lease for a period exceeding one year is not valid unless it has been granted by a registered document.
3. Ascertain those conditions, the failure of which might result in the forfeiture or cancellation of lease, and see whether they have been properly complied with.
4. See whether sub-lease is valid as per lease agreement, in case if it is granted, by referring to sub-lease agreement.
5. See that the premium paid and acquisition expenses of lease are being amortised (written off) over the period of lease adopting a suitable basis.
6. In case, any provision is to be made under the dilapidation clause for payment on the expiry of the term of lease, see that the same is properly and continuously provided.
7. In case of leasehold land, if any building is constructed by the lessee, see the position and ascertain the correct method of presentation of such expenditure for disclosure in the Balance Sheet.

(x) Goodwill

1. Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called `Goodwill'. It can be verified from the vendor's agreement and the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded.

2. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.

3. He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it.

4. He has also to see the disclosure requirement of Schedule VI and ensure that the fact are disclosed for 5 years subsequent to the date of revaluation.

5. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of Profit and Loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders.

6. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

(xi) Plant and Machinery :

1. Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc. Therefore, the auditor should ask for such a register maintained by the client and see that all items of plant and machinery are recorded properly giving full details.

2. As per the provision of the same section, all fixed assets are required to be physically verified by the management. Therefore, the auditor should enquire whether such physical verification was undertaken or not. If yes, he should ask for necessary papers pertaining to the same. If there is any discrepancy, reasons for the same should be asked.

3. Any new purchase made during the year are to be verified with reference to purchase invoice and other papers regarding installation of the same.

4. Total value of plant and machinery as shown by Fixed Asset Register should tally with ledger account maintained in the financial books.

5. Where any item of plant and machinery is sold, scrapped or transferred the auditor should check relevant entries for the same and verify that they are removed from the Fixed Assets Register.

6. The auditor should verify that adequate depreciation is provided on all items of plant and machinery and method of depreciation is consistently followed from year to year.

7. Auditor should see that the entire plant and machinery stands in the name of the client and are free from any charge or encumbrances. If plant and machinery is mortgaged, then he has to verify that the documents are properly executed and mention of mortgage is made in the Balance Sheet.

(xii) Furniture and Fixtures :

1. The auditor has to see that a proper record showing quantitative details of furniture and fixtures owned by the client is maintained.

2. The auditor has to see that all expenses incidental to the purchase of furniture and fixtures is capitalised along with the purchase price paid for it.

3. The auditor has to enquire whether the furniture and fixtures have been properly insured or not.

4. The auditor has to see that adequate provision for depreciation on furniture and fixtures is made.

5. The auditor if possible can go for physical verification of furniture on test check basis or he can rely on the management certificate to that effect.

6. He has to further see that any damaged or unusable furniture, if existing, is fully written off in the books.

(xiii) Freehold Property (Land & Buildings) :

1. The auditor has to examine the title deeds of the property owned by the client and confirm that the same is freehold.

2. If the property has been purchased during the year, the auditor has to examine the correspondence with the broker, or solicitor in details.

3. When a building has been constructed on the freehold property, the same is to be verified from builder's bill or architect's certificate.

4. Where the title deeds are deposited with the mortgagee on a mortgage, then a certificate from him to that effect is to be obtained for verification.

5. If the title deeds are deposited with the bankers or solicitors for safe custody, the auditor should get a certificate from them to confirm the fact.

6. If required, the auditor should ask the solicitor of the client to confirm the validity of the title deeds relating to the property.

7. The auditor has to see that the conveyance of the property is in the name of the client and the same is properly registered.

8. The auditor has to ensure that the property is properly insured.

9. The auditor should see that separate account for land and building is maintained. Because on land, usually no depreciation is provided.

10. In case there is appreciation of land and buildings value by revaluation, the auditor has to see the basis of revaluation and confirm that the same is properly disclosed in the Balance Sheet, to comply with the generally accepted accountancy principles and also the provision of Companies Act, 1956.

(xiv) Motor Cars :

1. In respect of motor vehicles mileage or usage method is better because the time of total mileage that the particular vehicle will give, can be ascertained without much difficulty and the mileage in

a particular year can also be known, so proportionate cost of the asset can be written off over the mileage traveled. For example, if the total mileage of a vehicle costing Rs. 80,000 is 1,60,000 miles and in a year suppose 15,000 miles are traveled, then the depreciation for that vehicle would be:

$$8000 \times \frac{15000}{160000} = \text{Rs. } 7{,}500$$

2. Where number of motor cars is large, it would be advisable if the client maintains a motor vehicle register. Where no such register is maintained, the balance of Motor Car account in the General Leger should indicate the registration number and cost of each vehicle.

3. The auditor should examine the registration book to see whether the description agrees with the details given by the client. The auditor should see that the person in whose favour registration is made holds it on behalf of the client and gives a confirmation that he holds it and there is no charge on it.

4. Many a times, vehicles are purchased by the client for the purpose of employees who pay a certain sum of money every month from the salaries. When all the money has been paid, the client transfers the car in the employee’s name. The auditor should check the relevant records for recovery made and the transfer price.

5. Sometimes cars are owned by employers and given to employees and cost of maintenance is borne by the client and the auditor in these cases affirms that whenever the client owns a car, he should provide depreciation on it.

6. Similarly, when the car is sold as scrap to the employees the auditor should compare the written down book value with the scrap price realized and see that the balance is charged to revenue account.

(xv) Loose Tools, Patterns, Dies, etc.

Auditor’s duties with regard to the verification and valuation of such assets may be stated as follows:

1. Since the duration of the usefulness of such assets is very low, there is no need of maintaining separate accounts for each of them. The auditor in this case should see whether proper supervision has been exercised over these assets, as there is every possibility of pilferage of such small assets.

2. The auditor should collect a list of small tools, dies, moulds, rigs, etc. from a responsible officer and examine the same very carefully. He should also see that such a list has been certified by a responsible officer.

3. As regards the valuation of small tools, the auditor should see that in the case of the concern which manufactured its own tools, the tools are not to be valued in excess of the cost.

4. Generally, these types of assets appear to be either lost or consumed very rapidly. So the conventional method of depreciation should not be applied in their cases. The suggestion as given by Montgomery in this connection may be stated. “Charging the cost of replacement of such items to maintenance in lieu of depreciating them is usually a satisfactory altemative”. The auditor should see whether the above mentioned suggestion has been accepted or not.

6. The auditor should also see whether such an asset has been properly shown in the Balance Sheet.

(xvi) Assets Acquired on Hire Purchase Agreement

1. Assets purchased on hire purchase basis :

The auditor should take the following steps:

a) verify the minutes book of board meetings and see that there is proper resolution passed by the board to approve the purchase of asset on hire purchase books.
b) Examine the hire purchase agreement carefully and note down the terms and conditions of the agreement.
c) Ensure that installments due are paid and the charges are charged against current profits.
d) See that the depreciation is charged on cash price of the asset.
e) See that the amount due to the hire vendor is shown as a current liability on liability side.
f) For new purchase, check bill agreement or other supporting.

(xvii) Live Stock

a) Check entries in Live Stock Register and compare them with ledger and financial statement.
b) Book value in respect of animals which are dead or not useful should be written off.
c) See whether management has taken physical count on regular occasions.

(xviii) Stores and Spare Parts

1. The asset known as stores and spare parts consists of materials which are means for consumption in the business and not for resale. Lubricants, dyes, fuel, etc., are examples of stores, while spare parts of machinery are preserved to maintain it in proper order.

2. The asset as such should be clearly shown in the Balance Sheet.

3. The auditor should obtain an inventory of stores and spare parts duly certified by a responsible officer. He should count the stock himself and thus verify the existence by personal inspection, if possible.

4. It is to be remembered that the stores consumed are debited to the Manufacturing Account and spare parts used are debited to the Machinery Account.

5. The asset is to be shown at cost price in the Balance Sheet. It is not a depreciable asset by use and provision for depreciation is not necessary.

6. However, the loss on account of breakage or waste on being worn out should be duly written off.

7. The asset should be revalued annually.

(xix) Contingent Assets

Some of the examples of contingent assets may be the following :

(a) Option to apply for shares in another company on favourable terms;

(b) Refund of octroi paid for goods sent out later on;

(c) Claim for money from a previous endorser of a bills receivable discounted but might be dishonoured;

(d) Uncalled share capital;

(e) Legal action for infringement of a copyright, etc.

Usually, contingent assets are not shown at the foot of the Balance Sheet on the assets side and the Companies Act does not require the contingent assets to be disclosed as such.

(xx) Remittance in Tansit

The question of remittance-in-transit will arise where there is a head office and branch office and head office sends cash for meeting the day-to-day expenses. If at the end of the year probably in the last week, cash might have been sent by the head office but not received by the branch office or alternatively branch might have sent its collection from customers to the head office but the head office might not have received it before the end of the accounting period, then it is a case of "Remittance in Transit."

(a) To verify this item the auditor should call for the bank statements of head office and branches and reconcile them. Any cash received by the branch or head office in the first week of the new accounting year might have been in transit on the last day of the previous year. For the purpose of recording such cash in the balance sheet an entry is passed in the books as :

Cash in transit A/c Dr.

To Branch A/c. or Head Office A/c.

(b) Verify cash in transit from the Cash Book/Pass Book or subsequent period as to whether actually it is received or not.

(c) Check the statement of Reconciliation of H.O. and Branch Accounts.

(d) Verify pay-in-slip, if the amount is deposited into the bank.

(e) See that the entry passed as per item no. (a) is reversed in the next year.

(xxi) Miscellaneous Expenditure

According to Schedule VI of the Companies Act, 1956, Miscellaneous Expenditure (to the extent not written off) are as follows :

(a) Preliminary Expenses.

(b) Commission or Brokerage on underwriting or subscription of Shares or Debentures.

(c) Discount allowed on issue of Shares or Debentures

(d) Interest paid out of capital.

(e) Development and other expenditure

(a) Preliminary, Expenses

1. These are the expenses incurred for creating or incorporating a company i.e. legal expenses for drafting Memorandum of Association, Articles of Association, Stamp fees, etc.

2. Auditor should check the prospectus or the statement in lieu of prospectus for amount of preliminary expenses.

3. Contract with promoters, vendors, underwriters should be checked.

4. Board of Directors authorization for payment of expenses should be checked. Receipts should be obtained for payments.

5. Actual expenditure for preliminary expenses should not exceed amount mentioned in prospectus or statement in lieu of prospectus. Such excess should be approved by shareholders in general meeting.

6. Preliminary expenses can be written off against Share Premium Account (Section 78), if any.

7. Preliminary expenses should be written off in a reasonable number of years (usually 3 to 5 years).

8. Preliminary expenses to the extent not written off should be shown under Miscellaneous Expenditure, on the Asset side of the Balance Sheet.

9. Preliminary expenses written off during the year should be shown separately in the Profit & Loss Account.

(b) Commission or Brokerage on Issue of Shares or Debentures (Sec. 76) :

1. Such commission should be allowed by Articles of Association.

2. Rate of commission should not exceed 5% of the share issue price or rate prescribed under Articles of Association, whichever is lower.

3. Rate of commission should not exceed 2.5% of the debentures issue price or rate prescribed under Articles of Association whichever is lower.

4. Amount of commission payable should be mentioned in prospectus or statement in lieu of prospectus.

5. Copy of contract should be filed with the Registrar.

6. However in case of brokerage (i.e. percentage of commission payable to brokers who deal in shares and procuring of shares, etc.) above mentioned restriction of 5% or 2.5% is not applicable.

7. Actual payment should be authorized by Board of Directors.

8. Commission on issue of shares or debentures can be written off against Share Premium Account (Section 78) if any.

9. Such commission or brokerage should be written off in a reasonable number of years (usually 3 to 5 years).

10. Commission or brokerage to the extent not written off should be shown under Miscellaneous Expenditure on Asset side of the Balance Sheet.

11. Commission or brokerage written off during the year should be shown separately in Profit & Loss Account.

(c) Discount allowed on Issue of Shares or Debentures (Sec.79) :

Auditor should verify :

1. Such discount should be approved by ordinary resolution in general meeting as well as it should be authorized by the Company Law Board.
2. Rate of discount cannot exceed 10% unless higher percentage is approved by Company Law Board.

3. Such shares cannot be issued within one year from certificate of commencement. Further such shares should be issued within two months from the date on which issue is sanctioned by Company law Board.

4. Prospectus should contain particulars regarding discount.

5. Discount on issue of shares or debentures can be written off against Share Premium Account (Section 78) if any.

6. Such discount should be written off in a reasonable number of years. (usually 3 to 5 years).

7. Such Discount to the extent not written off should be shown under Miscellaneous Expenditure on Asset side of the Balance Sheet.

8. Discount on issue of share or debenture written off during the year should be shown separately in Profit & Loss Account.

(d) Payment of interest out of Capital (Section 208)

Auditor should verify :

1. Such interest is allowed when construction work started by the company cannot be completed for some years, e.g. construction of plant and machinery, etc.

2. Such interest should be authorized by Articles of Association or by special resolution. Further the Central Government approval is necessary for payment of such interest.

3. Rate of interest cannot exceed 4% p.a. It cannot be paid after the half year immediately succeeding half year in which construction work was completed.

4. Actual payment of interest should be checked with entries in bank statement.

5. Payment of interest out of capital according to Section 208 does not amount to reduction of capital.

6. Such interest can be debited to cost of construction or it can be treated as deferred revenue expenditure which would be shown under `Miscellaneous Expenditure'.

7. In case such interest is transferred to `Miscellaneous Expenditure', it should be written off in a reasonable number of years (i.e. 3 to 5 years)

8. The amount written off during the year should be shown separately in Profit & Loss Account.

(e) Development and other expenditure

Auditor should verify :

1. Board of Directors approval for such expenditure.

2. Receipts should be obtained from persons to whom payment is made.

3. Deferred Revenue Expenditure should be written off as early as possible (usually 3 to 5 years)

5. The amount written off should be shown separately in Profit & Loss Account.
6.

Examples of other expenditure.

(a) Heavy advertisement expenditure for introducing a product.

(b) Research and development expenditure etc.

7.10 AN AUDITOR IS NOT A VALUER

Valuation of assets means determining the fair value of the assets as on the date of the balance Sheet. Verifying such value of assets is an important part of the auditor's duties. As the assets are belonging to the proprietors, it is their basic duty to see that the value of assets is properly determined on the basis of generally accepted accounting principles. What the auditor is required to do is satisfy himself that all the assets are shown at their "full and fair value". Auditor need not himself value the assets. But he has just to see whether the value that have been placed are true, correct and fair. As such he has to apply his skill, intelligence and tactfulness to confirm the values of the assets as indicated. Usually assets are valued by specially qualified persons like valuers and surveyors. Hence he can rely on the certificate issued by those professionals, but must disclose the fact of this in his report. An auditor is not supposed to have special technical knowledge in respect of valuation of assets. But he should always try to examine the value of assets himself with the help of supporting evidence available with the company. He has also to depend many a times upon the valuation made by the directors, partners and proprietors of the organization.

Therefore, we say that "An auditor is intimately connected with values". Because, it is the duly of the auditor to decide the value of the asset himself only he has to see whether the value decided upon is correct, fair and true. Because, if the assets are not properly valued, Balance Sheet will not give a true and fair view of the state of affairs of a concern. Though auditor is not a valuer he is liable for improper valuation of assets if the same is not verified by himself i.e. negligence in the verification of the value of assets makes an auditor liable for negligence. Hence, whenever he feels that the value of any asset as disclosed is not proper or fair he should mention the fact in his report and disown the responsibility. Mere informing the directors or proprietors regarding irregularity does not absolve him from his liabilities. Though the auditor is not the guarantor of the value of asset, he has to be careful while certifying the Balance Sheet and Profit and Loss Account, because third parties place their reliance on the audited Balance sheet to take their important decisions. Therefore, auditor has to take sufficient precautions while accepting the valuation of assets. If he checks the value of the assets intelligently and with utmost care he cannot be held liable for negligence.

As the auditor is liable to an unlimited extent for indeterminate period of time to an indefinite class of people, he has to be very careful while accepting the valuation of assets. Hence, he is not a valuer, but surely connected with values intimately.

7.11. VERIFICATION OF LIABILITIES :

Meaning : The verification of liabilities implies an enquiry into the nature, extent and existence of liabilities.

It involves ensuring the following:

1. That all the liabilities have been clearly stated on the liability side of the Balance Sheet.

2. That all the liabilities reiate to the business itself.

3. That they are correct and authorized.

4. That they are shown in the Balance sheet at their actual figures.

It is an important duty of an auditor to verify the liabilities appearing in the Balance Sheet of the company. The object of verification of liabilities is to ascertain whether there is any improper inflation or deflation of values or improper creation of an imaginary liability in the books. This form of manipulation is done in most cases to inflate or deflate the profits of the concern and thus make the position of the business appear stronger than what actually is, to create a secret reserve. As a result of such manipulation, the Profit and Loss Account and the Balance Sheet prove to be incorrect and thus the Balance Sheet does not exhibit a true and fair view of the state of affairs of the concern. So, the auditor must take all possible steps to ensure that all liabilities are recorded properly in the books of accounts of the business. It is advisable that the auditor should, besides verifying the liabilities as shown in the Balance Sheet, get a certificate from the management that all liabilities of any nature have been included in the books of accounts and the contingent liabilities have been shown by way of a foot-note to the Balance Sheet or have been provided for.

ILLUSTRATIONS

(i) Share Capital : Though capital is not a liability of the company the auditor is required to verify it so that he can report on the genuineness of the balance sheet.

The duties of the auditor can be enumerated as follows :

1. If it is the first year of existence of the company

(a) He should examine the Memorandum of Association and Articles of Association

(b) He should check the Cash Book, Pass Book, Director's Minute Book to find out the number of shares, the various classes of shares, the amount received thereon and the amount due from the shareholders.

(c) If some shares have been allotted to the vendors, he should examine the agreement between the vendors and the company.

(d) In case shares are issued at a premium he should ensure that the premium on issue should be credited to a separate account.

(e) Allotment and call money should be verified.

(f) He should check the forfeiture and reissue of shares, if any

(h) He should ensure that all the relevant provisions of the Companies Act are complied with.

(2) If it is not the first year of the company

(a) The share capital would be the same as in the previous year unless there are some alterations or addition by way of fresh issue or otherwise. He should ensure that the relevant legal provision are fulfilled.

(b) Similarly for reduction of share capital, he should see the provisions of the Act as specified in Sec. 100.

(c) In case bonus shares are issued, the auditor should check whether the permission from concerned authorities is taken, whether proper resolution is passed and whether the capitalization entries are correctly passed.

(d) In case rights shares are issued the auditor should check the bank book, bank statements. He should ensure that the required resolutions are passed and that the permission of the concerned authorities is taken, with particular reference to Sec. 81.

(ii) Reserves and Surplus : Reserves may be general or specific in nature. Sinking fund, Capital Redemption Reserve, Reserve for Contingencies are specific reserves.

Auditor's duty in verification of reserves is as follows :

(1) He should check the Profit and Loss Appropriation account for transfer to reserves, to see the provisions of transfer of profit to reserve are complied with.

(2) He should check the board resolution for transferring the profit to the respective reserves.

(3) He should ensure that the movement in the reserve accounts i.e. additions to/deductions from previous year's balance are properly disclosed as per the requirements of the law.

(4) Ensure that reserves are properly utilized as required by law.

(5) See that the reserves are properly disclosed in the balance sheet as per the law.

(iii) Loans Borrowed

For verification of loans, the auditor should consider the following points :

1. The auditor should examine the Memorandum and Articles of the Company to find out the powers of the Company to borrow money.

2. The auditor should examine the agreement and correspondence regarding the loan.

3. The auditor should vouch the receipts of cash on account of loan, with the receipts issued in respect of the loan and the corresponding entries in the cash book.

4. The auditor should examine the certificate of registration issued by the Registrar of Companies, if the loan has been secured by mortgaging any property.

5. The auditor should vouch the payment of interest with the counterfoils of the receipts issued to the vendors and the corresponding entries in the Cash Book.

6. He should also check the repayment of loan with the counterfoils of the cheque books, the bank pass book and the cash book.

In addition to the above, the auditor may ask for a confirmatory letter from the party who has advanced the loan to ensure that the interest on loan is not due and the recoupments of loan are recorded in the books of account correctly.

In the case of bank overdraft, the agreement with the bank and the security offered should be examined by the auditor.

(iv) Trade Creditors :

1. The auditor should ask for a schedule of creditors and check the same with the purchase ledger as that is already examined by him.

2. He should ensure that all purchase made during the year especially at the end of the year are included in the accounts of the creditors.

3. In case of suspicion about any creditors, the auditor with the consent of the client can ask the statement of account to be sent and verify the same by scrutinizing ledger accounts.

4. He should see the various debtis given for discount, goods returned etc, and confirm that the same are genuine.

6. The auditor should ask for the reason for not paying any overdue creditors.

(v) Contingent Liabilities

Contingent liabilities are those liabilities which may or may not arise in the future for payment. The auditor's duty is to see that all known and unknown liabilities have been brought into the accounts at the date of the Balance Sheet and have been shown in the Balance Sheet separately as such.

1. **Liabilities on Bills Receivable discounted and not matured :** If the bills receivable are discounted with a bank and the money so received from it is made use of, the entire money will be refunded to the bank if the acceptor does not make payment on the date of its maturity. This is why such a contingent liability is distinctly shown in the Balance Sheet by way of a footnote.

2. **Liabilities for calls on partly paid shares :** The amount called on shares held and paid should be verified from the cash book and the liability for the amount uncalled should be ascertained.

3. **Liability under a guarantee :** The auditor should ascertain the liability for a guarantee given by the client for a loan or overdraft to his friend or partner. In case of non payment of such a loan, the possible liability should be ascertained.

4. **Liability for cases against the company not acknowledged as debts :** It is a liability in a disputed case where damages may have to be paid. A contingent liability should be ascertained and a note should be made at the foot of the Balance Sheet.

5. **Liability in respect of arrears of Dividend on Cumulative preference Shares :** The auditor should examine the Articles of Association which should lay down rules in this regard and due provision should be made for such a liability.

Auditor's duty : The auditor should very carefully check the various contingent liabilities named above. There may be some such liabilities for which no provision has been made in the books but merely a note has been made at the foot of the Balance Sheet, e.g. Bills Receivable which have been discounted and which have not matured at the date of the Balance Sheet, arrears of fixed cumulative dividends, etc. For liabilities in respect of which provision has to be made in the Balance Sheet, viz a suit, etc., the auditor should examine such cases and ascertain the amount to be specifically reserved for the purpose. The auditor should examine the Director's Minute Book, correspondence made with the legal advisers and the information obtained from the officials of the business. He has to ensure that proper provision has been made for all such liabilities and if he is not satisfied, he should mention the fact in his report. It is to be remembered that the requirements of the Companies Act regarding the contingent liability should be complied with in the Balance Sheet on the liabilities side.

(vi) Provision for Taxation :

1. In case of a limited company it is compulsory that the taxation provision is to be made. But it cannot be ascertained accurately because the final liability on this account can be known only when the assessment is completed. Therefore, a fair estimate for providing this liability is necessary. Hence, the auditor has to verifty the calculation done to arrive at the provision expected to be made.

2. However, when finally the assessment is over, the auditor should see that the excess or short provision is properly adjusted in the books.

3. Where any appeal is pending and the liability challenged, the same is a contingent liability. Hence the same is to be properly ascertained and disclosed in the Balance sheet.

(viii) Employees' deposits :

Normally, in commercial and industrial ventures, the employees who deal with cash or stores are required to deposit cash security as a safeguard against some possible mis-appropriation or pilferage. Sometimes, the employees instead of paying cash, endorse trustee securities in favour of the employers. It should be remembered in this connection that :

1. Such a security in cash or in securities should be deposited separately in the bank.

2. It should be shown distinctly on the liabilities side of the Balance Sheet.

3. He should verify the amount of deposits by reference to the certified schedule received from the client.

(viii) Reserve for Bad and doubtful Debts

The verification should be done as follows :

1. The auditor should obtain a certificate from some responsible officer of the business and then check the amount provided for bad and doubtful debts.

2. The schedule of debtors should be compared with the balance of ledger accounts to ascertain the possible amount of bad and doubtful debts.

3. The adequacy of such a reserve has specially to be checked. He should examine the nature, the circumstance of a particular business and the necessary rules in practice in this connection.

(ix) Bills Payable :

The auditor should verify the Bills Payable in the following ways:

1. The Bills Payable Book should be checked with the Bills Payable Account.

2. The Bills Payable already paid should be checked from the Cash Book and the returned Bills Payables should be examined.

3. To verify the Bills Payables which have not yet matured at the year end, the auditor should examine the Bills Payable book and should check the Cash Book of the succeeding years to see whether any payment has been made in respect of such bills. In case of any doubt, the auditor may ask the drawers for the confirmation of the bill.

4. The auditor should see if any charge has been created on the assets of the concern by accepting the bill and he should see that the facts are disclosed in the Balance Sheet.

(x) Proposed Dividend :

1. The auditor should ensure that the dividend proposed complies with the provisions of the Companies Act, the decisions of the Court, especially in the matters of provision for depreciation, distribution of capital profits, transfer to reserves etc.

2. The auditor should verifty the board resolution and the entry in the Profit and Loss Appropriation account.

3. The auditor should ensure that as per the requirements of the Companies Act, 1956 gross dividend has been provided for.

4. To ensure completeness, the auditor should cross-check the names in the dividend list with those in the register of shareholders.

(xi) Outstanding Expenses :

The auditor should obtain a certificate from a responsible officer to the effect that all the outstanding expenses have been included in the current year's accounts. The amount paid on various accounts should be verified from the entries in the Cash Book. It should be ensured that the outstanding expenses included that part which is unpaid at the date of the Balance Sheet. The following points should be noted.

1. He should carefully note that all expenses, e.g. rent, rates, interest, wages, salary, audit fee, legal expenses, etc., have been accounted for in the books.

2. He should check entries in the books passed on the basis of invoices to ensure that they are not related to the year under audit.

3. He should compare all the paid and unpaid expenses of the current year with those of the previous year to see that there is not much difference.

4. It should be ensured that all outstanding wages and salaries have subsequently been paid.

(xii) Bank Overdraft

The verficiation of bank overdraft will be on the same lines as that of loans and advances. The difference is that it is the financial assistance obtained from the bank. The auditor should examine the Bank Pass book and call for a statement of mortgaged assets. It is to be remembered that the assets so mortgaged should be clearly stated as such in the Balance Sheet.

(xiii) Debentures :

1. The auditor has to examine the provisions regarding the power of the company to issue debentures as contained in Memorandum and Articles of Association.

2. If the debenture is issued as mortgage debenture, he has to verify the registration certificate issued by the Registrar.

3. He should carefully examine the terms of debentures issue as contained in Trust Deed and ensure that the same have been properly complied with.

4. The auditor should vouch the cash received on this account with the cash book.

5. The auditor should verify whether the interest on debentures is paid or provided, properly at regular intervals invervals or not.

6. In case the debentures have been redeemed during the year the same is to be confirmed with the Minutes of Board of directors. Counterfoils of the cheque books. Bank Pass book and Cash book, returned debenture certificate etc.

7. If the debentures have been issued as a collateral security, then he should see that the fact is properly disclosed in the Balance Sheet.

(xiv) Unclaimed Dividend

For verifying unclaimed dividend, the auditor should follow the following procedure.

1. See that the Bank Account from which dividend is paid is properly reconciled. See that dividend account is opened for each year to avoid mistake of one year's dividend getting mixed up with next year's dividend. See that no entries remain in these Bank Accounts reconciliation like accounts debited by bank but not accounted in books, etc. because then the Unclaimed Dividend shown in the books will be wrong.

2. See that wherever dividend is declared on shares, where calls are in arrears and directors have decided to adjust the dividend payable against calls in arrears, the appropriate entries have been booked.

3. See that a full list of shareholders who have not claimed dividend is prepared. This is necessary firstly to prove that there are no mistakes commited while reconciling the Bank Account and secondly to prove the accuracy of the Member's Register. The auditor should compare this list with the Member's Register to see that unclaimed dividend for every shareholder is matching with the number of shares held by him as per Share Register. This will also disclose if any dividend is paid to a shareholder who has already transferred his shares provided he has not encashed his dividend warrant.

5. See that if the statutory time limit of 3 years is over, the money being in Unclaimed Dividend Account is transferred to the Central Government with details of shareholders who have not claimed the dividend.

(xv) Calls in Arrears :

The auditor should verify Calls in Arrears as under :

1. Find out whether calls in arrears are arising on account of capital issued during the year or is continuing on account of capital issued in earlier years.

2. If it is on account of capital issued during the year, see that correct amount has been arrived at towards call in arrears by referring to the application form money paid towards application, shares allotted, total share money payable, calls made, calls money payable and calls paid. For this he will have to conduct share allotment audit to arrive at all the relevant data.

3. In case calls are in arrears from earlier years, see that reminders have been sent to the shareholders for payment of calls. If the Board has decided to charge interest on such calls in arrears see that reminder contains the request to pay the calls in arrears with interest. If any part of the calls in arrears have been received during the year on which interest was payable see that such call moneys are received with interest.

4. If any transfer application has been received for shares on which some calls are in arrears, see that no transfer has been effected without arrears having been paid first.

5. If the Directors have declared dividend, see that dividend payable on such shares is proportionately reduced and if the directors have decided to appropriate dividend on such shares where calls are in arrears see that dividend is not physically paid out but appropriate accounting entries crediting calls in arrears and debiting dividend payable is passed.

6. See that, if the Board has passed any Resolution forfeiting shares on which calls are in arrears, the same is reflected properly in the accounts by passing of necessary entries and such shares are not

continued to be shown as part of capital at full value and calls in arrears continued to be deducted therefrom.

(xvi) Fixed Deposits :

The auditor should keep in mind the following points while conducting a fixed deposit verification –

1. Fixed Deposits should be accepted according to Section 58A of Companies Act, 1956 and Reserve Bank of India's guidelines.

2. Fixed deposits from director for less than six months (but exceeding 3 months) should not exceed 10% of paid up share capital and free reserves.

3. Total fixed deposits should not exceed 25% of paid-up share capital and free reserves.

4. Fixed deposit should not be accepted if the period exceeds 36 months.

5. Interest on fixed deposits can not exceed 15% p.a.

6. Brokerage can be paid subject to limits mentioned below.

   (a) Upto 1 year – not to exceed 1% of amount of deposits.

   (b) 1 to 2 years – not to exceed 1.25% of amount of deposits

   (c) 2 to 3 years – not to exceed 1.50% of amount of deposits.

7. Liquid assets should be maintained at not less than 10% of deposits maturing 31^{st} March.

8. Receipts should be issued to the deposit holders.

9. Fixed Deposit Register should be maintained.

10. Return of fixed deposits should be sent to the Registrar before 30th June. In case it is not sent, auditor should mention it in the Auditor's Report as per Section 45 MA of Reserve Bank of India Act, 1934.

11. Interest accrued but not due should be provided and it should be shown under Current Liabilities.

12. Fixed Deposits received along with accrued and due interest would be shown under `Unsecured Loans'.

7.12 DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Point of Difference	Vouching	Verification
1. Meaning	The act of examining the vouchers is known as vouching. A voucher is any documentary evidence in support of a transaction entered in the books of account. Vouching involves estabilishing the arithmetical accuracy	Verification an be explained as establishing the truth or securing some kind of confirmation with respect to the assets and liabilities appearing in the Balance Sheet of a concern. Verification goes beyond vouching. It seeks to establish that assets as stated in the Balance Sheet of a

2. Nature & Purpose	and the authenticity of the transactions of a concern. Vouching proves that an asset ought to exist.	concern exist in fact and that the liabilities are properly disclosed. Verification proves that an asset does exist.
3. Time	It is done during the whole year.	It is done at the end of the year.
4. Utility	Certifies correctness of records.	Certifies correctness of assets and liabilities.
5. Personnel	It is done by the junior staff of the auditor under the supervision of a senior person.	It is done by the auditor himself assisted by senior.

7.12.1 EXERCISES

1. What do you mean by “Verification”? What are the points to be considered by an auditor during such Verification?

2. Why should an auditor verify assets which are shown in the balance sheet?

3. What is Verification? How does it differ from Vouching?

4. What is Valuation? Discuss – “Auditor is not a Valuer, but he is intimately connected with values”.

5. How would you verify the following – (1) Plant & Machinery (2) Building (3_ Motor cars and Vehicles (4) Freehold Land (5) Leasehold Land (6) Assets on Hire Purchase (7) Goodwill (8) Patents (9) Know-how (10) Wasting Assets (11) Miscellaneous Expenditure not written-off (12) Deferred Revenue Expenditure (13) Fictitious Assets (14) Investments (15) Immovable Properties (16) Investment in Partnership Firms (17) Debtors (18) Bills Receivable (19) Loans given (20) Loans Given against security (21) Cash (22) Bank Balance (23) Share Capital (24) Loan Taken (25) Loans Taken against Security (26) Secured Loans from Banks (27) Loans taken against Mortgage of Property (28) Secured Debenture (29) Creditors (30) Bills Payable (31) Provision for Income-Tax (32) Unclaimed Dividends (33) Contingent Liabilities (34) Proposed Dividends (35) General Reserves (36) Capital Reserve (37) Sinking Fund,

6. How would you check the valuation of the following :

   (1) Tangible fixed Assets (2) Wasting assets (3) Freehold Land (4) Leashold Land (5) Building (6) Plant & Machinery (7) Goodwill (8) Deferred Revenue Expenditure (9) Investments (10) Securities against Loans.

7.13 STOCK VERIFICATION

(i) Meaning of Stock-In-Trade

According to Accounting Standard 2, Stock is a tangible property held for -

(a) sale in the ordinary course of business or

(b) in the process of production for such sale or

(c) for consumption in the production of goods (i.e. consumable stores).

(ii) Verification of Stock

Verification of stock means physical counting, measuring and to verify so as to determine the quantity of stock to be considered for stock valuation.

Verification of Stock-in Trade is more difficult than of any other asset due to the following reasons –

(a) It is subject to frequent changes and constitutes the largest current asset of the business.

(b) Numerous methods of pricing the stock-in-trade are in existence.

(c) The determination of its value directly influences the sales and income of the year.

(d) It is exposed to greater risk of defalcation or manipulation

(iii) Objectives of verification of stock-in trade are :

(a) Ascertainment of the correct profit/loss made during the accounting year.

(b) Disclosure of True and Fair financial position of the business.

(c) Preparation of correct statement of claims for loss of stock, if any, due to fire, flood etc.

(d) Determination of the value of stock on consignment.

(e) Determination of value of stock sold on `Sale or return basis'.

(f) Ascertainment of ownership of stock.

(g) Ascertainment of the fact whether the stock is free from any charge.

7.13.a Auditors duty as regards verification of stock :

As the correctness of the profit of a business depends to a great extent on the accuracy of the valuation placed on the closing stock, it will be readily appreciated that the verification of this asset forms one of the most important part of an auditor's duty. While verifying the stock-in-trade the auditor has the following duties –

(a) Ascertain the method of stock-taking and the basis of valuation.

(b) Ensure that the stock-sheets have been subjected to a good internal check, e.g. they are certified as to have taken prices, extension and additions while determining the stock and also generally approved as correct by managing director.

(c) Check calculations and additions.

(d) Check a few of the important items with actual invoices as to prices.

(e) Examine some of the quantities in stock-sheets with those shown by the stock books, if such stock books are kept.

(f) Ascertain that the stock is valued on the same basis as in the previous year.

(g) Ascertain that obsolete and unsaleable stock is shown at fair market prices.

(g) Compare the percentage of gross profit on turnover with that of the previous period and also enquire into the cause of any notable fluctuation.

(i) Ensure that the goods entered as sold and not delivered are not included.

(j) Ensure that the goods bought and not entered in the invoice book are included.

(k) (i) Ascertain that the value of unfinished goods is

taken at actual cost and the basis of valuation is the cost of the materials consumed and the wages spent thereon upon the date of the Balance Sheet. Sometimes a percentage is added in the above to cover the factory cost, such as foreman's wages, fuel, power, lighting, heating, depreciation of plant etc.

(ii) In case of finished goods, a reasonable percentage in respect of office cost has also to be added to the works cost.

(l) See that the goods sold on approval basis are properly included in closing stock.

(m) See that the stock held does not include goods held on consignment as an agent.

(n) Examine carefully the stock sheets and ensure that the stock includes only the goods dealt with by the client and does not include any asset purchased.

(o) Confirm that stock has been valued at cost or market price, whichever is less.

(p) Obtain from a responsible officer of the organization a certificate regarding the procedure followed in valuation of stock.

(q) Obtain a certificate from client certifying that :

(i) Physical verification of stock is done.

(ii) All goods included in the stock are property of the company.

(iii) Cut off procedure is properly followed. (Cut off is a transaction which separates one accounting year from the next accounting year. Last document nos. of goods received notes, goods accepted notes, debit and credit notes etc. should be obtained at the time of stock-taking).

(iv) The basis of valuation is the same as was followed in the previous year.

7.13.1 Auditor's duty regarding verification of stock based on case laws

Case I : Kingston Cotton Mills Co. Ltd. (1896)

It was held that it is not part of an auditor's duty to take stock. Auditor can rely on other people for details of stock-in-trade. In the same judgement, Justice Lopez observed that `An Auditor is not bound to be a detective'. It was held that in the absence of suspicious circumstances auditor can rely on certificate given by the company.

Case 2 : Irish Woollen co. Ltd. v/s Tyson & others (1900)

It was held that there was certainly no duty on the auditor to take stock.

Case 3 : Westminster Road Construction Co. (1932)

It was held that the auditor is liable for damages for not detecting the overvaluation of work-in-progress even though sufficient information was available to him. He will be guilty of negligence if he fails to take notice of all available evidence.

Case 4 : Mckesson and Robbins (1939)

It was held that the auditor should verify inventory either by test or by observation or by combination of these two methods. Auditor was held liable for certifying a Balance Sheet in which stock-in-hand represented was totally non-existent.

Position in India :

(a) In the case of audit of a limited company the auditor has to report whether the company final accounts are in agreement with the books.

Also under Schedule VI to the Companies Act, 1956 the auditor should ensure that the closing stock is disclosed under the head Current Asset as under :

Stores and spare parts

Loose tools

Stock-in-trade

Work-in-progress.

(b) According to CARO physical verification should be conducted by management at reasonable periods for finished goods, stores, spare parts and raw materials.

Therefore, primary duty of verification is on the management but as per Mckesson and Robbins case the auditor should test check or by observation or by combination of these two methods ensure that stock-sheets include proper quantity.

(c) U/s 209(1)(b) of the Companies Act, 1956 proper books of accounts should be maintained by the company for all sales and purchases of goods.

(d) U/s 541(2) of the Companies Act, 1956 if proper books of account at the time of winding up are not kept and if annual stock-taking statement and statement of goods sold and purchased for two years immediately preceding the starting of winding up is not kept then the auditor shall be held liable if he fails to point out this fact in his audit report.

(e) According to the Statement on Auditing Practices issued by the Institute of Chartered Accountants of India (ICAI) the auditor is expected to verify the inventories in the following manner :

1. Obtain a certificate from the management regarding physical inventory. However, the auditor must take reasonable care to satisfy himself that -

(i) The procedures of stock taking were reasonable and would justify the certificate given by the management and

(ii) The procedures were actually followed.

2. The auditor should check the original physical stock sheets. If possible he should be present at least for sometime during the stock taking and conduct a few sample checks.

3. The auditor should ensure that the book stocks were adjusted for any excess or shortage found on physical verification.

4. In respect of stocks which are not lying with the concern (goods sent for processing, goods on consignment etc) the auditor must obtain and examine the confirmations from the parties holding the stock.

Thus, the above decisions settled the principles as under :

(a) The stock basically belongs to the shareholders and hence it is the duty of the management to physically verify them. Most of the time an auditor has no requisite staff or technical qualification to verify them properly. Hence, the auditor is not responsible for not verifying physical stock of a company existing at the Balance sheet date. In other words, it is not a part of auditor's duty to take stock.

(b) An auditor can rely on the certificate given by the management regarding the verification and valuation of stock existing on the date of the Balance Sheet, after properly scrutinizing the relevant documents available in this matter (as seen in the case of Mckesson and Robbins).

After this discussion the professional bodies of accountancy of the world have opined that though it is not the duty of the auditor to take stock he should ensure that verification of stock has taken place properly either by presenting himself on the date of verification of stock or by actually taking the stock on the date of the Balance Sheet or by ensuring that physical stock-taking was carried out by his client properly.

Therefore, mere reliance on the certificate of management without resorting to any type of test check or evaluation cannot save an auditor from the charge of negligence.

7.14 VALUATION OF STOCK-IN-TRADE

(i) Meaning :

Valuation of stock-in-trade means finding out the proper value of the closing stock for recording in the books and disclosure in the account.

(ii) Auditor's duty as regards stock valuation

1. The auditor should ensure that there is no change in the method of valuation.

2. In case there is a change in method of valuation of stocks as compared to the previous year, the auditor should disclose this fact in his report and ensure that the method is proper and recognized.

3. The auditor should ensure that the stock is valued and recorded according to the generally accepted principles of evaluation. He should ensure that the valuation is done in confirmation with the guidelines issued by the ICAI.

4. The auditor should check the computational accuracy of stocks by testing a few calculations involved in valuation.

5. The auditor should ensure that there is no over/under valuation of stock which will distort the true and fair view of the accounts.

6. The auditor should see that as required by the Schedule VI to the Companies Act, 1956, the values of stores and spare parts, loose tools, stock-in-trade and work-in-progress must be disclosed separately.

7. Under MAOCARO,1988 a company auditor has to report whether

   (a) He is satisfied on the basis of the examination of stocks, that suchvaluation is fair and proper in accordance with normally accepted accounting principles.

   (b) The basis of valuation of stocks is same as in the proceeding year. If there is any change in the basis of valuation the auditor has to report the effect of such change.

   (c) Any unserviceable or damaged stores, raw materials or finished goods were determined on physical verification and the provision for loss made and

   (d) In the case of a trading company any damaged goods have been determined and the provision for loss made.

8. As required by CARO, the auditor should ensure that the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles. The principles are laid down by the ICAI viz.

   a. Statement on Auditing Practices.

   b. Accounting standards – 2, Valuation of Inventory

   The auditor should ensure that the provisions of the above statements are taken care of while valuing stock.

8. The auditor should see that accounting policy for valuation of inventories including the methods used is disclosed in the final accounts.

7.15 VERIFICATION AND VALUATION OF GOODS ON CONSIGNMENT

Meaning of Consignment Sale –

It is a transfer of goods by principal (i.e. consignor) to the agent (i.e. consignee) at another place for sale on commission basis.

Verification and Valuation of stock on Consignment :

(i) Unsold stock should be physically verified by the management.

(ii) Auditor should obtain a certificate from consignee for unsold stock.

(iii) Account sale from consignee should be checked to find out how much quantity should remain with the consignee.

(iv) Goods sent on consignment basis cannot be treated as sale. Revenue cannot be recognised unitl goods are sold to the third party.

(v) Further, consignee should not be debited for goods sent to him by consignor.

(vi) Unsold stock should be valued at lower of cost and market value. Cost should include non-recurring expenses of consignor and consignee. Valuation of closing stock at cos should include loading, carriage, insurance, freight, octroi, unloading charges etc. However, selling and distribution expenses should not be included in cost.

(vii) Normal loss on consignment should be segregated from abnormal loss. Cost of item should be increased for normal loss, e.g. evaporation etc. However, abnormal loss e.g. theft, fire etc. should be transferred to Profit and Loss Account.

(viii) In case goods are sent at invoice price, stock reserve should be created for unsold stock.

7.15 VALUATION OF

1. Goods on Approval :

(a) Goods sent on approval basis

When goods are sent to the customer on approval basis, the property in the goods remains with the sender till the customer approves them. If the customer does not communicate his decision within the prescribed time, it is assumed that the goods are sold to him.

On the Balance Sheet date if the customer has some time left to communicate his decision or has already communicated his unwillingness to accept the goods then the property in the goods remains with sender and the goods will be included in the stock of the sender. These goods will be valued at cost. Damages, if any, caused during the course of transit should be reduced and adjusted. Such goods cannot be valued at a price higher than the market price.

(b) Goods received on approval basis :

Goods received on approval cannot be included in the closing stock of the receiver unless he has approved such goods and recorded the same in his books of account. These goods should be valued at cost plus incidental expenses on purchase.

7.15.02 Goods in Tansit

(a) Goods in Transit Outward

When Goods sold are in transit and the seller has already invoiced them and the sales invoice is recorded in his books of account, the goods do not belong to the seller.

b) Goods in Transit Inward.

Till the goods are received they cannot become the property of the purchaser. But if the risk has already commenced and if the purchaser is responsible soon after their dispatch by the seller, the purchaser has to pass the entry in his books. The goods would still be in transit and should be recorded as such. Such goods should be valued at cost plus incidental expenses incurred.

7.16 EXERCISES :

1. What do you mean by verification of stock. State the auditor's duties in this respect ?

2. What is stock valuation ? Explain the duties of the auditor in this respect.

3. Write short notes on valuation of :-

   (a) Goods Sent on consignment

   (b) Goods in transit

   (c) Goods on approval.

4. Define Stock-in-Trade. Discuss the objectives of Stock Verification.

5. Discuss the position of the statutory auditor in regard to existence and valuation of stock.

AUDITING TECHNIQUES:- VERIFICATION

5.1 AUDIT OF ASSETS

BOOK DEBTS/ DEBTORS:

The term ‘book debts’ suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Verification of debtors may be carried out by employing the following procedures:

(a) Examination of records;
(b) Direct confirmation procedure (also known as ‘circulation procedure’)
(c) Analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor. The general procedure is as under:

Examination of Records

(z) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

(it) The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with related control account. Any differences in this regard should be examined.

(Hi) Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the

case of significant debtors, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

(z'v) While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects :

(a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.

(/?) Where the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.

(c) Whether transfers from one account to another are properly evidenced.

(d) Whether provisions for allowances, discounts and doubtful debts should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.

(v) The following are some of the indications of doubtful and uncollectible debts, loans and advances :

(a) The terms of credit have been repeatedly ignored.

(b) There is stagnation, or lack of healthy turnover, in the account.

(c) Payments are being received but the balance is continuously increasing.

(d) Payments, though being received regularly are quite small in relation to the total outstanding balance.

(e) An old bill has been partly paid (or not paid), while later bills have been fully settled.

(/) The cheques received from the debtors have been repeatedly dishonoured,

(g) The debt is under litigation, arbitration, or dispute.

(h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues, *e.g.* a debtor has either become insolvent, or has closed down his business, or is not traceable.

(z) Amounts due from employees, which have not been repaid on termination of employment.

(;) Collection is barred by statute of limitation.

(vi) Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.

(vit) In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

(vz'z'z) The auditor should examine whether contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.

Direct Confirmation Procedure

(z) The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. The utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

(z'r) The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

(z'z'z) The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor.

(z'v) The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or *(b)* as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity.

(v) The form of requesting confirmation from the debtors may be either *(a)* the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or *(b)* the 'negative' from of request wherein the debtor is requested to respond only if he disagrees with the balance shown.

(vi) The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are

weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities. ,,,.,.

(vii) The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances.

(viii) In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

(ix) Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous; this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of All debtor accounts. While selecting the debtors to be circularized, special attention Should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor Should consider accounts in respect of which provisions have been made or balances have been written off during the period under audit of earlier years and request Confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with *nil* Balances. The nature of the entity's business *(e.g.,* the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be Considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

(x) In appropriate cases, the debtor may sent a copy of his complete ledger account for a specific period as shown in the entity's books.

(jci) The method of selection of the debtors to be circularized should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped, The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

(xii) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

Analytical Review Procedures •

In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances :

(a) comparison of closing balances of debtors, loans and advances with the corresponding figures or the previous year;

(b) Comparison of the relationship between current year debtor balances and the current year sales with the corresponding budgeted figures, if available;

(c) Comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) Comparison of current year's aging schedule with the corresponding figures for the previous year;

(e) Comparison of significant ratios relating to debtors, loans and advances with similar ratios for other firms in the same industry, if available;

(*/*) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgement of the auditor.

STOCK – AUDITOR'S GENERAL DUTIES

Patterns, Dies, Loose Tools, etc.

Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such assets although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused stock on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum stock account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing stock, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

EMPTIES & CONTAINERS QUOTED INVESTMENT AND UNQUOTED INVESTMENT.

Trademarks and Copyright

The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable.

Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights arid verified that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at the cost of each financial period. The auditor should seg that revaluation has been made on a fair and reasonable basis. Where he finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue.

Patent Rights

The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. It has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained . Since the amount paid in respect of each patent should be amortised over its life or a lesser period if its commercial life is shorter, it should be seen that the rate at which the value of each patent is being written off is adequate; its value would be completely written off by the time it would cease to have a commercial value. If the patent has been created by the client by research, experiments and laboratory work, the auditor should ascertain that only the actual cost incurred in the process has been capitalized. However, in all cases the registration cost should be capitalised.

Know-how

Know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types :- (t) relating to manufacturing process; and *(it)* relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, design and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such a case depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred.

Where the amount paid for know-how is a complete sum in respect of both manufacturing process and related to plans, designs etc. such amount should be apportioned amongst them on a reasonable basis.

Where the consideration for the supply of know-how is a series of recurring annual payments as royalties, technical assistance fees, contribution to research, engineering, etc. are charged to the profit and loss account each year.

Plant and Machinery

In the absence of a Plant Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.

In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Profit and Loss Account or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern.

Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register.

When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

Land and Buildings

Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not.

The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any second or subsequent mortgage. If ground rents, outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that he amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated at appropriate rates, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated at a higher rate.

If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculation the amount of deprecation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such an expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write up the book values of land and buildings even though their market values have increased but, where this has been done it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

(i) *Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realized for it.*

(if) *This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinized.*

(lit) *If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.*

(iv) *Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.*

(v) *The prices obtained for various plots of land sold should be checked with the pian map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.*

(vi) *Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.*

FURNITURE & FIXTURES

5.2 AUDIT OF LIABILITIES

OUTSTANDING EXPENSES

Outstanding Expenses:

i) Obtain the list of outstanding expenses classified by nature of expenses.

11) Compare current year’s outstanding expenses with that of the previous year and enquire the material variations if any.

iii) Verify carefully the estimates of outstanding expenses.

iv) Examine the documentary evidence supporting the outstanding expenses.

v) See that the usual outstanding expenses are paid of by the time of audit.

vi) Make sure that provision has been made for all the usual outstanding, e.g. last Salary, wages, rent etc

v) Examine the correspondence, minute book, etc.

vi) Verify the service contracts made by the company and see that all outstanding arises have been provided for

ix) See that outstanding expenses have been disclosed in the balance sheet under liabilities.

BILLS PAYABLE:-

Bills Payable

These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed.

The steps involved in their verification are :

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(a) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.

(b) Trace all the entries in the Bills Payable Book into the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.

(c) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

(d) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.

(e) Verify that the charge, if any created on any asset for the due payment of bills has been appropriately disclosed.)

6.11.4 Loans (secured and unsecured) •

A loan is usually obtained on the basis of *a* loan' agreement. The auditor should refer to it to ascertain the condition on which the loan has been obtained for confirming that all the conditions as regards repayments of the loan, payment of interest thereon and provision of security have been duly complied with. Further, where practicable, he should write to the party to confirm the balance of loan outstanding at the end of the year. A loan can be raised only by a competent authority - in the case of a company by the Board of Directors, in that of a partnership by the partners acting jointly and it that of proprietor concern by the proprietor himself. In the case,of a company there may exist restrictions on the loans being raised in the Memorandum or Articles of Association. The right of the Board of Directors of a public company or private company which is subsidiary of the public company, under clause *(d)* of sub-section (1) of section 293 of the Companies Act to borrow money is restricted to the aggregate of the paid up capital of the company and its free reserves. However, the company in a general meeting can relax such a restriction by specifying the amount upto which amounts may be borrowed by the Board of Directors. The deed of partnership in the case of a firm may also contain restrictions on the amount of loans that the partners can raise.

The auditor should therefore, examine the right of the borrowing authority to confirm that the loan or loans have been raised in the proper exercise of the authority vested in the Board of Directors or the partners as the case may be.

If the loan is secured by a charge on an asset of the company, the document through which it has been created should be inspected and particulars of the assets charged should be verified. In the case of a company, he auditor should further see that particulars of the charge have been duly entered in the Register of Charges and verify that the charges have been registered with the Registrar of Companies. It should further be confirmed that particulars of the charge have been properly disclosed in the Balance Sheet.

In view of the provisions contained in sub-section (IA) of section 227, it is necessary for an auditor to find out the purpose or purposes for which the loans have been raised; also confirm whether these have been utilized for the specified purpose or for some extraneous purposes.

CONTINGENT LIABILITIES

Accounting Standard 4 issued by the ICAI deals with the "Contingencies and Events occurring after the Balance Sheet Date". According to it "a contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence or non-occurrence, of one or more uncertain future events." The regard has to be to conditions or situation at the balance sheet date , the financial effect of which is to be determined by future events which may or may not occur.

The definition clearly envisages that either there may be contingent losses or contingent gains. As a matter of prudence, contingent gains need not be accounted for in financial statements since this may result in the recognition of revenue which may never be realised. Therefore, we have to consider contingent loss for which corresponding liability should be accounted for in financial statements. Before discussing the accounting treatment of contingent losses, let us understand contingent liabilities in clear terms.

A contingent liability is a possible liability of a presently determinable amount or one indeterminable which has arisen from past dealings or actions that may not become a legal obligation in the future. The uncertainty as to whether there will be any legal obligation distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against a company in respect of infringement of a patent and the companv does not possess a legitimate defence, the liability, though the amount of it is uncertain would be an actual liability, but if the claim is untenable in law, the liability would only be a contingent liability. Though both of them in actual practice are described somewhat loosely as contingent liabilities, their natures are different. In one case, the liability is admitted but its amount is uncertain while in the other, the very basis of the obligation is denied. There is another type of contingent liability, as in the case of partly paid shares, or in respect of contract for capital expenditure wherein there is an obligation to pay a certain sum of money upon which there will be acquisition of an asset of corresponding value. Contingent liabilities also arise when some of the Bills Receivable as discounted or when guarantees are given for loans granted to the third parties.

From the auditing point of view, different types of contingent liabilities are divided into two broad categories, one in respect of which a provision has been made and the other for which there is no provision. AS 4 provides guidance in respect of circumstances when provision has to be made for contingent losses. It states that the amount of a contingent loss should be provided for by a charge in the statement of profit and loss if :

(a) it is possible that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date ; and

(b) a reasonable estimate of the amount of the resulting loss can be made.

If disclosure of contingencies is required by following above considerations, then, the following information should be provided:

(a) The nature of contingency;

(b) The uncertainty which may affect the future outcome;

(c) An estimate of the financial effect or a statement that such an estimate cannot be

Made; The Companies Act, 1956 requires disclosure of following liabilities by way of a note:

(1) Claims against the company not acknowledged as debts.

(2) Uncalled liability on shares partly paid.

(3) An ears of fixed cumulative dividend.

(4) Estimated amount of contracts remaining to be executed on capital account and not provided for.

(5) Other money for which the company is contingently liable.

The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified.

The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to indisposed claims and legal actions pending against the company.

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