Unit - 5

VERIFICATION AND VALUATION OF ASSETS

5.1 VERIFICATION

Verification means proving the correctness. One of the main works of auditor is verification of assets and liabilities. Verification is the act of assuring the correctness of value of assets and liabilities, title and their existence in the organization. An auditor should be satisfied himself about the actual existence of assets and liabilities appearing in the balance sheet is correct. If balance sheet incorporates the incorrect assets, both profit and loss account and balance sheet do not present true and fair views.

Thus, verification means to confirm the truth or accuracy and to substantiate. It is a process by which the auditor satisfies himself not only about the actual existence, possession, ownership and the basis of valuation but also ensures that the assets are free from any charge. While verifying the assets, an auditor should consider the following points:

- Ensuring the existence of assets.
- Acquiring the assets for business.
- Ensuring the proper valuation of assets.
- Ensuring that the assets are free from any charge.

Definitions

1. "Verification is the proof of accuracy of extension, footings, posting, existence and ownership of assets."

   - Arthur Holmes

2. "Verification of assets implies an inquiry into the value, ownership and title, existence and possession and presence of any charge on the assets."

   - Spicer and Pegler

3. "The verification of assets is a process by with the auditor substantiates the accuracy of the right hand side of the balance sheet and must be considered as having three distinct objects:

(a) Verification of the existence of assets

(b) The valuation of assets

(c) Authority of their acquisition

-Lancaster

5.2 OBJECTS OF VERIFICATION

1. **Correct Valuation of Assets and Liabilities :** To ascertain whether the assets and liabilities have been shown in the Balance Sheet at their correct value, the valuation should have been made on the principles of accounting.

2. **True and Fair View :** The purpose of verification is to determine the health of financial statements. After verification, the auditor can say that financial statement shows a true and fair view of the state of business affairs.

3. **Existence of Assets :** The purpose of verification is to ascertain the existence of assets. The books and papers may show the existence of assets, But it may have been destroyed, sold, discarded or stolen, The verification is used to see the actual position of assets. The existence of assets is essential.

4. **Ownership and Title of the Assets :**The purpose of verification is to certify ownership. The vouchers, documents, deeds, agreements and other papers can be used to note the Teal ownership. The auditor can satisfy himself that assets are really owned by the business.

5. **Free of Charge :** The purpose of verification is to check that asset is free of any charge. The assets may be pledged or mortgaged for borrowing money; In this case, lenders have charge over the assets, The freeholds leasehold and mortgage property can be stated in the Balance Sheet.

6. **Arithmetical Accuracy :** The purpose of verification is to note the arithmetical accuracy of the assets stated in the accounting books. The recording, posting totals, sub-totals, addition, disposal and deprecation of some sort of calculations. The auditor should examine the accuracy of whole work.

→ owning, Controlling

7. **Verify Possession :** The purpose of verification is to see the possession of assets. The assets must be safeguarded. The responsible officers may be given a position of assets. The assets should be used only for the business. The verification can determine the actual location of assets.

8. **Depreciation Plans :** The purpose of verification is to examine the deprecation plans Of management. The assets are not the same in nature. The life of an asset is different. There is a need to charge deprecation according to accounting principles. The auditor can note the reasonable deprecation has been charged on all assets.

13. **Business Position :** Verification of assets and liabilities disclose the real position of the business. If assets value is greater than the liabilities then business will be stable otherwise not.

14. **True Picture :** After verification auditor gives the true picture of the business condition through financial statement. It is not possible for the auditor to give his opinion about the assets without verification.

5.4 PROCEDURE OF VERIFICATION

Following points are important in the procedure of verification :

1. **Verify Assets Register :** The assets register should be collected by the auditor from the company. It can be used to verify the sale and purchase assets. The entries in the register should be approved by officer of the company.

2. **Schedule of Assets :** The auditor can collect the schedule if assets and can verify the various things like opening balance, addition and other information's relating to assets. The schedule must be signed by the officer.

3. **Physical Verification :** The auditor can go to that place and verify the asset where that is lying. Management helps the auditor for verification.

4. **Verify the Custody :** The custody of the assets can be verified by the auditor that these are the hands of relating in charge or not.

5. **Addition of Asset :** The new assets purchase by the company must be recorded in the books of accounts. This addition must be verified by the auditor.

6. **Disposal of Assets :** The auditor can verify the entry of asset which is sold during the year. It may be sold on profit or loss.

7. **Transaction Approval :** The auditor must verify that every transaction is made by the order of the competent authority or not. He should verify the signatures on every document.

8. **Verify the Cost :** The cost of asset should be verified by the auditor by checking the documents like vouchers and journal entries.

9. **Verify the Internal Control :** The auditor should verify that internal control system is applied or not. If it is applied then auditor should verify the effectiveness of this system.

10. **Loan on Asset :** The amount of loan taken against any asset as security must be verified by the auditor. It can be also verified from the lender.

11. **Verify Disclosure :** In case of disclosure auditor should verify that all disclosure requirements have been followed by the govt. laws or not.

12. **Verify Title Deed :** Auditor can verify the title deed to determine the real ownership of a business. In this regard various other papers like agreements and vouchers may be checked.

13. **Verify Depreciation :** The auditor can verify the depreciation amount of each asset re partly. The fixed asset depreciation is determined according to its working file.

14. **External Verification :** The auditor can verify the assets from lenders borrowers, banks and from the other parties related to the business.

15. **Capital and Revenue :** The auditor can distinguish the capital and revenue expenditure. The capital expenditure becomes the parts of asset with the revenue expenditure is transferred to profit and loss account.

16. **Stock Valuation Certificate :** It is duty of the management to provide this certificate. For the preparation of report the auditor may obtain this certificate from the officer incharge.

17. **Verify Correspondence :** The auditor can verify the correspondence made between the lawyers, borrowers and lenders. It is very useful for understanding the facts related to business activities.

18. **Reply of Management Raises :** Auditor sometimes raises objection and asks to reply some questions in this regard. For the removal of these objections management submits its reply. This reply letter is very useful and becomes the part of the working paper.

5.5 DIFFERENCES BETWEEN VERIFICATION AND VOUCHING

	Vouching	Verification
Meaning	Vouching means checking the accuracy of the transactions recorded in the books of accounts.	Verification means a process to substantiate the validity of assets and liabilities appearing in the Balance Sheet.
Basis	Documentary Evidence	Observation and Documentary Evidence
Examination	Items of Profit & Loss account	Items of Balance Sheet
Carried out by	Audit clerks	Auditor
Time Horizon	Year-round	At the end of the financial year.
Objective	To examine the correctness, validity and completeness of the transactions.	To confirm the ownership, possession, existence, valuation and disclosure of the items appearing on the Balance Sheet.

5.6 VERIFICATION OF LIABILITIES

Verification of liabilities is equally important as that of verification of assets. The Balance Sheet will reveal the true and fair view of the state of affairs of the business concerns only when the liabilities as well as assets are properly valued and verified.

Verification of liabilities aims at ascertaining whether all the liabilities of the business are properly disclosed, valued, classified, and shown in the Balance Sheet. The auditor should see that they are correctly stated in the Balance Sheet. He should obtain a certificate from the responsible official as to the correctness of liabilities.

Objectives of Verification of Liabilities

1. Balances in the creditor's accounts reflect a true position as to the liabilities of the business.
2. All liabilities of the client's business, including those not recorded in the books of account whether intentionally or otherwise, are disclosed in the financial statements.
3. They are properly valued in accordance with generally accepted accounting principles.
4. They are properly classified and disclosed.

5.7 VALUATION

Valuation is the act of determining the value of assets and critical examination of these values on the basis of normally accepted accounting standard. Valuation of assets is to be made by the authorized officer and the duty of auditor is to see whether they have been properly valued or not. For ensuring the proper valuation, auditor should obtain the certificates of professionals, approved values and other competent persons. Auditor can rely upon the valuation of concerned officer but it must be clearly stated in the report because an auditor is not a technical person.

An auditor should consider the following points regarding the assets while making valuation off assets:

- Original cost
- Expected working life
- Wear and tear
- Scrap value

5.8 OBJECTIVES OF VERIFICATION AND VALUATIONS OF ASSETS AND LIABILITIES

Assets and liabilities are very important aspects of business. Balance sheet is prepared on the basis of them and an auditor should prove the true and fairness of information provided by balance sheet. So it is very important for an auditor. Its importance can be highlighted as follows:

1. **To Show the Actual Financial Position :** Balance sheet is prepared to show the actual financial position of a business. If proper valuation is not made, such balance sheet does not provide true and fair information. So, to provide information about the real financial position, verification and valuation of assets are essential.

2. **To Know the Real Position Of Profit And Loss :** Depreciation and other expenses on assets will be incorrect if proper valuation of assets is not made. So, to calculate the actual amount of profit and loss, proper valuation of assets and liabilities is necessary.

3. **To Increase Goodwill :** Proper valuation gives fair information about profitability and financial position of a business. So, people can get information which creates positive attitude towards company. Positive attitude of public increases goodwill.

4. **To Assure Shareholders :** Valuation and verification provide actual information about assets and liabilities to the shareholders which assure the safety of their investment.

5 **Easy For Sale :** At the time of sale of the company, it can be sold at the price which is enlisted in the balance sheet, but the assets whose valuation is not made need valuation before selling the company.

6. **Easy To Get Loan :** Company discloses the balance sheet proved by auditor for public knowledge which increases the trust of the company. Financial institutes provide loan easily to such companies.

7. **Easy To Get Compensation :** Whenever the loss occurs due to any incident, insurance company provides compensation on the basis of valuation of assets. So, the company can easily get compensation.

5.9 VALUATION OF ASSETS

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 :** Current Assets or Floating Assets 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 up to Balance Sheet date.

5. **Fictitious Assets :** Certain lump-sum 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 fictitious assets because they do not have any realizable value. They are to be valued at actual cost less amount written off up-to the Balance Sheet date.

5.10 METHODS OF VALUATION OF ASSETS

Valuation of various assets can be made by using different methods. Valuation of fixed assets can be made in different ways. Some of the major methods are as follows:

1. **Cost Method :** In this method, valuation of assets is made on the basis of purchase price of the assets. It is very simple method of valuation of assets. Sometimes, existence of one asset depends on the existence of another. Then it is difficult to use this method.

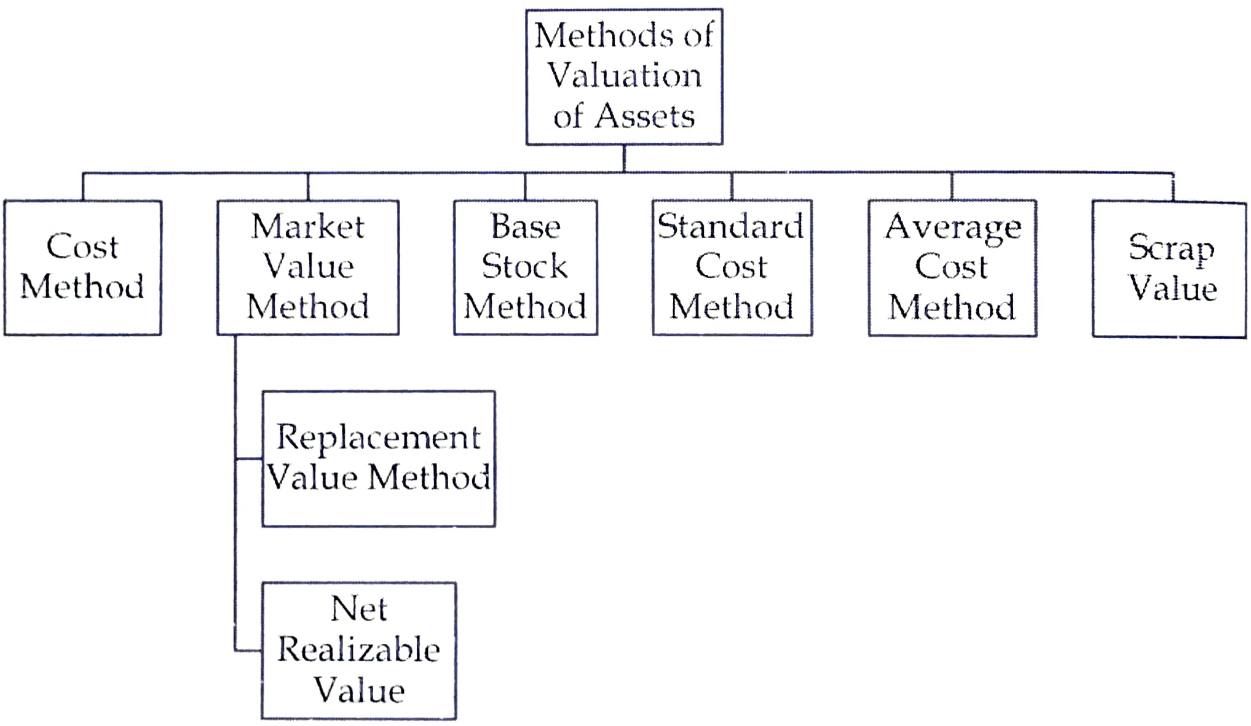
2. **Market Value Method :** Valuation of assets can be made on the basis of market price of such assets. But if same nature of assets is not available in the market, it is very difficult to determine the value of such assets. So, there are two methods related to it. They are:

   i. **Replacement Value Method :** If same asset is to be purchased then on the basis of same value, valuation of assets can be done.

   ii. **Net Realizable Value :** It refers to the price in which such asset can be sold in the market. But expenditure incurred at the sale of such asset should be deducted.

3. **Base Stock Method :** Under this method of valuation, company should maintain certain level of stock and valuation of stock is made on the basis of valuation of base stock.

4. **Standard Cost Method :** Some of the business organizations fix the standard cost on the basis of their past experience. On the basis of standard cost, they make valuation of assets and present in the balance sheet.



5. **Average Cost Method :** It is a simple method for the valuation of such assets which cannot be distinguished. Like petrol, petrol is kept in the tank but e cannot separate its stock on the basis of lot. So, valuation of stock is made adding to all the cost and dividing by the quantity.

6. **Scrap Value :** A value which may be obtained from the assets if it is sold as scrap.

5.11 AUDITOR'S POSITION AS REGARDS TO VALUATION OF ASSETS

It is not an auditor's duty to determine the values of various assets. It has been judicially held that he is not a valuer or a technical man to estimate the value of an asset. But he is definitely concerned with values set against the assets. He has to certify that the profit and loss account shows true profit or loss for the year and balance sheet shows a true and fair view of the state of affairs of the company at the close of the year.

Therefore he should exercise reasonable care and skill, analyses all the figures critically, inquire into the basis of valuation from the technical experts and satisfy himself that the different classes of assets have been valued in accordance with the generally accepted assumptions and accounting principles. If the market value of the assets are available i.e., in the case of share investment then he should verify the market value with the stock exchange quotations. If there is any change in the mode of the valuation of an asset, he should seek proper explanation for it. If he is satisfied with the method of valuation of the assets he is free from his liability.

5.12 VERIFICATION AND VALUATION OF DIFFERENT TYPES OF ASSETS

INTANGIBLE ASSETS

An intangible asset is an asset that is not physical in nature. Goodwill, brand recognition and intellectual property, such as patents, trademarks, and copyrights, are all intangible assets.

(a) Goodwill : Goodwill is an intangible asset. It is the value of the reputation of the firm It enables the firm to earn more than the normal rate of profit. It has no physical existence as such. It does not diminish in value with use. It has the potentiality of self-growth. It can be raised merely by book entries.

Verification : To verify the value of goodwill auditor has to examine the purchase agreement. Auditor should find out from the purchase agreement that the amount of this asset is correct. Good will usually appears in the balance sheet at cost. There is no legal compulsion to write it. If company likes to write off then auditor should see that the amount written off is according the resolution of the board. Important point about goodwill is that it does not depreciate by use.

(b) Copyrights : A copy right is the exclusive legal right to produce or reproduce some kind of literary work. It is the legal protection provided to an author by which the publication of his work by other is prohibited. The period of copyright is for the life of the author and fifty years after his death.

Verification :

1. The auditor has to examine the written agreement of assignment along with 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 copyright 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.

(c) **Trade Marks :** A trademark is a unique symbol or word(s) used to represent a business or its products. Once registered, that same symbol or series of words cannot be used by any other organization, forever, as long as it remains in use and proper paperwork and fees are paid.

Verification : Auditor should verify the patents, trademark with the help of relevant documents. He should examine the schedules and check that all these are certified by the responsible officer or not. If any agreements made it should also be checked by the auditor. Auditor should also check that renewal fees have been charged or not.

The auditor should see that they are registered in the name of the client and this can be done by examining the certificate issued by the Registrar. In case a trade mark has been purchased he should also vouch the payment.

Valuation : The valuation method of the most suitable method of valuation of trade marks. It should be seen that trademarks are properly valued and shown in the Balance Sheet.

FIXED ASSETS

Fixed assets indicate a firm's non-current assets that can generate long-term financial gain and provide an idea of the firm's operating performance.

(a) **Land and Buildings :**

Verification : In case of land and building auditor should verify the title deeds. If the auditor is doubtful about it then may refer the matter to the solicitors of the company. If the property is mortgaged then he should take the certificate from the mortgagee to that effect.

To verify the value of land cost price should be considered by the auditor. To know the original cost of the property auditor should verify the deed of transfer. In case of building valuation builder's receipts and depreciation should be considered.

Verification of Freehold Land and Building : Auditor should verify the title deeds first of all. He should check that building is in the name of the client. He should vouch the addition made during the year in the building or land. If any land or building is sold during the year auditor should vouch such sales. He should also verify that profit or loss on such sale is recorded correctly. He should also check the depreciation of the property.

Verification of Leasehold and Land Building : Auditor should verify the leasehold property by verifying the lease terms. Auditor should note down the conditions of lease and check the property physically if possible. He should also verify the amount of debt received against the mortgage property and the duration period. Lease rental should be debited to the revenue account. Auditor must verify the last receipt of the rent payment. In case of lease building repair depreciation etc. Should be debited to revenue account.

(b) Verification of Plant and Machinery :

1. Auditor will verify the plant and machinery in the following way :
2. Auditor should vouch the purchase of a plant with the receipts and invoices.
3. It should also be checked that all the expenditure on this account is a capital charge.

   If the plant is erected by the client own men then auditor should check that allocations of plant have been made correctly.
4. Auditor should check the schedule of the plant and machinery which should be certified by the engineer.
5. Auditor should also do the physical checking of the machinery if possible.
6. Auditor should also verify that sufficient amount of depreciation is provided for this asset or not.

(c) Verification of 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.

VERIFICATION OF INVESTMENT

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.

VERIFICATION OF CURRENT ASSETS

(a) Cash in Hand

1. Special care is necessary with regard to verification of cash balances. There can be no certainty 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 thereof 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 initialled 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 inquiries, 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

(e) 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.

(f) Sundry Debtors

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

1. The under mentioned 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 doubtful.

   (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 provision 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

   (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 instalments 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.

(g) Stock in Trade (Inventories)

The verification and valuation of the stock-in-trade is one of the most important duties of an auditor in order to arrive at the correct profit and loss of the concern under audit. In various cases, it has been decided that the auditor cannot be asked to take the stock or value it. Practically also, it is impossible for the auditor to physically verify every item of the stock-in-hand because of various reasons i.e. limited time and the lack of technical knowledge etc., still he has to exercise reasonable care in regard to stock verification and valuation. He should make enquiry into the system of internal check, the method of stock taking and the basis of valuation.

The auditor should conduct some tests in order to ascertain the effectiveness of these systems. He should compare the rough stock sheets with fair stock sheets. He should also check the stock books to ascertain the correct position of the stock-in-hand. He should also obtain a certificate from a responsible officer stating that the quantities and the valuation of the various stocks are correct and all the items are the property of the concern. He should also obtain a list duly certified about the obsolete goods which have been discarded.

5.13 METHOD OF STOCK TAKING

The stock verifier goes to the godown and calls out the number and other relevant particulars of the items of each class of goods and another clerk enters these particulars in the stock sheet. Then two clerks of another batch will check the stock-sheet.

The Stock-sheet will then be sent to a responsible officer who fills in the rate of each item of goods at which they are to be valued. The work of calculation is entrusted to a clerk who will calculate the value of each class of goods and his work is then checked by a senior clerk. All those connected with the stock-taking put their initials on the work done by them so that if later on any mistake is found the concerned official may be held responsible for the mistake. All stock-sheet are stand-by the general manager or partner as the case may be.

Care should be taken that goods-in-transit are included. Similarly balances of the unsold stocks at the branches or with the approved agents or 'sent on approval' should be included in the stock-sheet. But goods received by the client on sale or return basis or as a consignee and goods sold but not yet delivered should not be included. The auditor should obtain a certificate with regard to the accuracy of the stock-sheet and its valuation from the senior officer of the concern.

5.14 VALUATION OF STOCK-IN-TRADE

The auditor should consider three principles while valuing the closing stock. One is that stock should be value at cost or market price, whichever is lower at the date of balance sheet. Another principle is that all anticipated losses should be taken into account but anticipated profits should be ignored. Third principle is that the method once adopted should be consistently followed.

The following are the different methods of finding out the cost price of the stock-in-hand :

1. **Unit cost or Actual cost :** Under this method each article, batch and parcel of consignment is valued at its individual cost, but it is not usually capable of application.
2. **Average Cost :** Under this method, the average cost per unit is calculated. The average should be weighted average. The total value of goods (quantity $\times$ price) held in stock and those purchased and sold should be divided by the total number of units. This method is adopted when the goods purchased at different times have been mixed up and it is not possible to identify the goods.
3. **First-in First-out (FIFO) :** In this method the whole of the stock is valued at the rate of the latest consignment purchased. This method assumes that the goods issued out of the stores are those which were received first. This method is easy to operate if the prices do not fluctuate very frequently.

4. **Last-in-First-out (LIFO) :** This method is the reverse of FIFO. In this method the whole of the stock is valued at the rate at which the earliest purchases were made. This method assumes that the latest receipts of the materials are issued first and the unsold stock represents the earliest purchases and is priced accordingly.

5. **Base Stock :** Here it is assumed that certain minimum or basis quantity of material should always remain in the store. Therefore the stock should be valued at normal long period price, and not on the basis of dost price or the market price whichever is lower. Excess stock may be valued at cost price or market price whichever is lower.

6. **Standard Cost :** In this method the stock is valued at a predetermined cost per unit, known as standard cost. This method is convenient where goods pass through a number of processes and are manufactured on large scale basis.

7. **Adjusted Setting Price :** In this method the unsold stock is valued at the prevailing price out of which the normal profit plus the estimated cost of disposal i.e., selling expenses and overhead expenses, are deducted.

5.15 MARKET VALUE

For the calculation of market price there are two methods in use :

1. **Replacement Cost Method :** It is the cost of replacing an asset at the date of the balance sheet. It means the price at which similar types of goods can be presently purchased from the market.

2. **Net Realisable Value Method :** Is means the price at which the goods can be sold in the market after deducting the necessary selling expenses.

Whether net realizable value is used or replacement cost method be used, it will depend upon the purpose for which the stock is held. If the purpose is to resale the stock, it may be valued at net realizable value and if it is retained for use then replacement cost method be applied.

5.16 VALUATION OF DIFFERENT ITEMS OF STOCK

1. **Raw Materials :** Normally the raw material is purchased for manufacturing goods, hence it should be valued at cost price plus a reasonable proportion of incidental expenses like carriage and freight and excise duty etc. If the raw materials were purchased at different times and the lots could not be identified then average price may be taken. It should be noted that such raw materials should never be used at a higher price than the market price. But a provision for the write off must be made in respect of damaged and obsolete raw materials. Some materials like wine, timber etc., appreciate in value and hence may be valued at higher price than the cost price. But such value should not be in excess of the market value.

2. **Semi-Finished Goods :** In case of semi-finished goods which are in the process of manufacture at the date of balance sheet, they will be valued at the cost price of the raw materials used, plus the proportionate amount of wages and other direct expenses and a percentage of overhead expenses. The auditor should see that the amount in respect of selling and office expenses is not included.

3. **Finished Goods :** These goods may be of two types. Firstly, the goods which have been manufactured and are in a deliverable state, will be valued at the manufacturing cost, that is, material, labour and a proportion of factory expenses. If the cost price of the manufactured goods is higher than the market price and they must be valued at market price.

   Secondly, in some trading concerns goods are purchased for the purpose of resale. The cost of such goods would be the aggregate of the invoice price (including sales tax, excise duty etc.) and other direct expenses like carriage etc.

4. **Stores :** These are goods which may be in hand at the date of the balance sheet stores are held for use and not for sale in the original form. Examples are Coal, Oil, and Fuel etc. They should be valued at cost price. If the market price of such stores has gone down, it has been suggested that they must be written down.

5. **Spare Parts :** Spare parts are used in connection with the maintenance of production facilities. The auditor should get a list of such parts from the works manager. They should be valued at cost price and are not required to be written down to the market value if that value is lower at the date of the balance sheet.

6. **Goods on Consignment :** It may happen that at the date of the balance sheet, the whole of the consignment or part of it may not have been sold. Such unsold consignment of goods should be valued at cost price, plus proportionate expenses, etc., but it should not be valued at higher price than market price of similar goods. The anticipated losses should be considered while valuing such stock of goods.

5.17 VERIFICATION OF LIABILITIES

I. Verification and Valuation of Trade Creditors

1. The correctness of liabilities depends upon the correctness of purchases. Hence, the auditor should compare the percentage of gross profits to purchase with that of the previous years to verify the correctness of purchases.

2. The auditor should obtain a Schedule of creditors and verify them with the balances of ledger accounts and statements of account received from creditors.

3. He should check the Purchases Book and Purchases Returns Book with the help of invoices, credit notes, etc. He should also check the postings into the Ledger.

4. He should examine the Goods Inward Book to ensure that the goods purchased have been actually received.

5. He should see that all the purchases made during the year have been accounted for especially at the end of the year.

6. He should examine the discount allowed to creditors during the period and see that these substantiate the credit balances.

7. In case of hire purchases, the auditor should see that the conditions of Hire Purchase Agreement are properly complied with.

8. He should examine the entries made at the beginning as well as at the end of year to check the employees have passed any fictitious entries in this regard.

9. If any debt is found unpaid for a long time, an enquiry should be made since it is possible that instead of paying to the creditor, the amount might have been misappropriated.

II. Verification and Valuation of Bills Payable

In case of bills payable, the auditor should follow the following verification procedure:

1. The auditor should obtain a Schedule of bills payable and its totals should be compared with the Bills Payable Book and Bills Payable Account.

2. The bills paid after the Balance Sheet date should be examined with the entries passed in the Cashbook.

3. The auditor should obtain confirmatory statements from the drawers directly with the permission of his client.

4. He should pay special attention to the bills that have been paid between the date of the Balance Sheet and the date of his audit has been duly written in the books.

III. Verification and Valuation of Loans

1. The auditor should verify the existence of loans, if any. In case of a company he should examine the correspondence, contracts, and Directors' Minute Book.

2. The auditor should ascertain the terms of loan, amount of loan, period and nature of loan, etc. by referring to the loan agreement.

3. He should confirm the balances of the unpaid loans directly from the creditors of the company with the permission of his client.

4. In case of loans or overdrafts taken from a bank, an agreement with the bank and a certificate to that effect should be obtained and examined.

5. The auditor should see whether the interest due has been paid or not. If the interest is due but not paid till the date of the Balance Sheet, he should see whether the same has been clearly shown as liability therein.

6. In case of a Joint Stock Company, the auditor should examine the borrowing powers of the company. He should also examine the Register of Charges, and should see that a charge created has been registered with the Registrar.

7. It should be seen that the interest on loans has been paid up to date. If not he should see whether the amount due is recorded as unpaid in the books of accounts.

IV. Verification and Valuation of Outstanding Liabilities for Expenses

1. In case of outstanding liabilities, the auditor should obtain a certificate from a responsible officer of the company stating that all expenses become payable have been brought into account.

2. He should see whether necessary provision for all the outstanding expenses have been made by checking receipts and other vouchers.

3. He should compare the expenses shown as unpaid during the current year with those of the last year and if he finds any difference, the same should be enquired into.

V. Verification and Valuation of Capital

Capital is not the liability of an entity but still the auditor is required to verify it in order to report the genuineness and correctness of the Balance Sheet. In case of a firm, the auditor should verify capital with the help of Partnership Deed, Cashbook and the Passbook. He should see that it has been properly recorded in the books of account. In the case of a company, verification of capital can be discussed under the two heads:

(a) **First Audit :** In case of first audit, the auditor should examine the Memorandum of Association to see what is the maximum capital, which the company is authorized to raise. He should also check the Articles of Association.

The Cashbook, Passbook, and Minute book of the Board of directors should be examined by the auditor in order to find the amount of shares and different classes issued, the amount collected on each shares, and the balance due from the shareholders in respect of calls, etc.

The shares allotted to vendors, should be examined with the contract between the vendors and the company.

(b) **Subsequent Audit :** Normally, in case of subsequent years, the share capital would be the same as in the previous year unless the company has made any alteration or addition by fresh issue or otherwise. If he come across any change, he should see that the relevant provisions of Secs. 94, 95 and 100 to 105 of the Companies Act have been duly complied with.

VI. Verification and Valuation of Reserves and Fund

Reserves and funds are appropriations out of profits. The directors of a company determine the amount of reserves and funds to be created taking into account the circumstances of the business. The reserve and funds are to be shown on the liability side of the Balance Sheet with footnotes.

VII. Verification and Valuation of Debentures

1. In case of debentures, the auditor should verify the Memorandum of Association and the Articles of Association of the company and ascertain the power of the company to issue debentures. He should find out what is the borrowing limit and ensure that the company has not exceeded the same.

2. He should verify the Debenture Trust Deed to verify the amount of debentures issued and securities offered. If necessary, he can obtain a certificate from the debenture holders to verify the amount of debentures issued.

3. He should enquire as to what arrangement has been made for the redemption of debentures. In case debenture redemption fund has been created, he should verify the Articles of Association.

4. If the debentures are issued at premium or at discount, the auditor should see that the debenture premium and discount on issue of debenture are properly dealt with in the books of account.

5. He should verify Register of Charges and Register of Debenture Holders to see that the debentures shown in the Balance Sheet agree with the debentures recorded in the books of account.

VIII. Verification and Valuation of Income Received in Advance

Sometimes the firm receives some amount in advance, which is to be actually received in the next year. It is treated as a liability and should be shown in the liability side of the Balance Sheet. The auditor should verify whether the items of incomes received in advance are recorded in books. The auditor should obtain a Certified Schedule of income received in advance and verify the same. He should ensure that income received in advance is fully shown in the liability side of the Balance Sheet.

IX. Verification and Valuation of Employees Deposits

In commercial and industrial establishments, it is usual to require the employees. Who deal with cash or stores to give security deposit. It acts as a safeguard against some possible misappropriation or pilferage on the part of such employees. Sometimes, the employees instead of paying cash as security deposit endorse trustee securities in favor of the employers. In such cases, the auditor should see whether such a security in cash or in securities deposited separately in the bank. He should see whether they are shown distinctly in the liabilities side of the Balance Sheet. He should verify the amount of deposits by reference to the Certified Schedule received from the client.