UNIT -3
VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

INTRODUCTION

In vouching the auditor examines the documentary evidence available in support of the transactions recorded in the books of accounts. But it is not enough. It is also the duty of an auditor to verify the existence of assets and liabilities. For example-while vouching the payment for the purchase of land, the auditor will examine all documentary evidence in support of payment made. But it is also his duty to see that whether land is in the name of his client or not. He has to verify its existence. Hence he must verify that various items appearing in the balance sheet are in possession of the concern under audit.

MEANING

Verification means 'Proving the truth' or 'Confirmation'. It is a process by which the auditor satisfies himself not only about the actual existence, possession, ownership and basis of valuation but also ensures that the assets are free from any charge or lien.

DEFINITIONS:

1. **Spicer and Pegler** have defined verification in the following words- 'The verification of assets implies an enquiry into the value, ownership and title, existence and

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possession, and the presence of any charge on the assets'.

2. In the words if **Lancaster**- 'The verification of assets is a process by which 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 existence of assets

b) The valuation of assets

c) Authority of their acquisition

3. In the words of **J.R. Botliboi** - 'The auditor must satisfy himself that assets really existed at the date of the balance sheet and were free from any charge and that they have been properly valued. In verifying the liabilities, he has to see that all liabilities have been inserted at their proper figures and that no liability has been omitted'.

Hence, verification of assets involves the following;

1) Comparing the ledger account of the assets with the balance sheet

2) Verifying the existence of the assets on the date of the balance sheet

3) Enquiring into the value of assets

4) Enquiring into the ownership of the assets

5) Ensuring that the assets are free from any charges

The duty of the auditor with regard to the verification came before the court in the famous case of **'The London oil storage co., Ltd V/s seer Husluck and Company (1904)'**

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1. **Nature of Work :** Vouching examines the entries relating to transactions recorded in the books of accounts.

2. **Time :** It is done throughout the year.

3. **Basis :** It is based only based on documentary examination.

4. **Valuation:** It does not include valuation.

5. **Personnel :** Usually it is done by Junior Audit Clerks.

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Valuation is not merely the determination of the values of the assets as appearing in the balance sheet. But it is also critical examination of these values on the basis of generally accepted principles of accountancy.

The valuation of assets should be done by the officials of the concern. Auditor can also rely upon the certification of competent persons such as valuers, surveyors etc. But he should mention this fact in his audit report.

"An auditor is not a valuer" because, he does not posses the technical knowledge to find out the value of assets. At the same time the valuation and its basis will differ according to the type of assets and the purpose for which they are held.

In this connection we should remember the words of **Lancaster.** He says "An auditor is not a valuer and cannot be expected to act as such. All that he can do is verify the original cost price and to ascertain as for as possible that the current values are fair and reasonable and are in accordance with the accepted commercial principles".

Mr. De paula also said that 'It must be borne in mind that the actual valuations are made by the proprietors or officials of the concern who have a practical knowledge of such assets, and that the auditors duty is confined to testing the valuation as far as he can, and in this way satisfying himself with the position shown to be correct. He cannot, however, in any way guarantee the accuracy of the valuations'

So, from the above two views of experts it appears that an auditor is not liable, if in the absence of suspicious circumstances, he relies on trusted officials of the company.

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But an auditor should exercise reasonable care & skill analyse the figures carefully and critically, inquire into the basis of valuation from technical experts & satisfy himself that different items shown in the balance sheet are properly valued in accordance with generally accepted principles of accounting.

The auditor should consider the following points while valuing various types of assets.

1. **Original Cost of the Assets:** It is the price paid for acquisition of an asset. It includes cost price plus expenses incurred in connection with the purchase of an asset and its installation charges if any.
2. **Market Price:** It is the value which an asset can fetch in the market when sold.
3. **Expected working life** of an asset.
4. **Wear and tear** of the assets.
5. **The Break - up value of the assets-** The break - up represents the value of an asset on the basis of its probable life and the number of years for which it is use do Break-up value of the asset is taken into consideration when the business is to be wound up.
6. **The chance of assets** becoming obsolete
7. **Replacement value-** It is the sum of money needed to purchase another asset of the same type to replace the existing one.
8. **Book value :** It is the value at which an asset appears in the books of accounts. It is usually cost minus depreciation written off so far.

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CLASSIFICATION OF ASSETS

For the purpose of valuation, assets are classified as under:

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

1. Fixed Assets :

The following are the important features of fixed assets.

a) Which are acquired by the business for its permanent use .

b) Which are acquired not for resale in the ordinary course of business.

c) Which are acquired by the concern for the purpose of earning profit.

d) They are not consumed in the very process of manufacture.

It is not easy to say which assets are fixed and which are current. That depends upon the nature of the particular asset and the use to which it is put.

For example: machinery is fixed asset for a tyre manufacturing company. But it is current asset for a concern dealing in such machinaries.

Fixed assets are to be valued at cost price less total depreciation in their value by constant use. But the cost of depreciation is also more or less arbitrary. Because, it is

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only an estimate. Fixed assets cannot be valued at replacement cost or at realisable value

2. Current Assets:

Important features of current assets are:

1. Which are acquired or produced for the purpose of sale
2. They are held temporarily for the purpose of ultimately converting then into cash

Raw materials, work in progress, finished goods, stores, debtors etc, are examples of current assets.

These assets should be valued at the original cost or market price whichever is less as they are held with a view of converting them into cash. Generally appreciation in the value of such assets is ignored.

3. Wasting Assets

Wasting assets refer to assets where value diminishes on account of exploitation or extraction or depletion such as mines, queries etc. although, they are of fixed nature, their

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4. Intangible Assets

These are certain assets which can neither be seen nor touched. These are having no physical existences. For example goodwill, patents, copyrights etc. Most of these assets are not readily converted into cash. They go with the business. They are least liquid most of them are unsalable unless the business or a part of it is sold.

Normally, they are valued at the cost. If they are purchased the expenditure incurred for the acquisition of such assets would be considered as cost. Where, the rights emerging from such assets are for a limited period, the cost of such assets can be written off over this period.

5. Fictitious Assets

Fictitious assets are of peculiar in nature. Actually they are revenue expenditure, capitalised with the object of spreading the expenditure over a period of years the benefit accrues. These expenses are treated as assets till they are written off from the future profits as per the provisions of the relevant Act. For example preliminary expense, share issue expenses, discount on issue of shares etc.

Valuation of certain important Assets

1. **Good will:** It is an intangible asset. It is defined as the assessed value of reputation of a business or as the difference between the purchase price and the net assets, which are purchased and the excess amount paid represent the goodwill acquired by the business. The value of goodwill of a firm varies with their earning capacity. It increases with rise in the profits and decreases with the fall of profits.

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It is shown in the balance sheet when it is brought into books due to admission, retirement, business purchase etc. Good will may be calculated based on the average profits of certain number of years of a business.

In case of business arising out of purchase of business the auditor should verify the terms and agreements of purchase and the valuation of assets made for this purpose.

The auditor must find out that the good will originally acquired by the business was written off in the good will account.

Where there is an increase in goodwill by revaluation he should satisfy himself as to its reasonableness.

The auditor should also verify the goodwill account for different years to satisfy the changes in the amount of goodwill where revaluation of assets and liabilities of business has been done.

Totally, the auditor has to ensure that the amount of good will shown in the Balance sheet is correct.

From the sound financial point of view goodwill must be written off out of the annual current profits or reserves, within a reasonable period. It is shown in the books at cost less any amount written off.

2. Stock-in-Trade: Stock-in-trade includes merchandise meant for sale in the normal course of business and materials and supplies used in the process of manufacture of the product for the purpose of sole.

Traditionally,inventories or stock in trade refer to current

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assets held for manufacture or for resale. Stock-in-trade is the life blood of a business. It comprises of

a) Stores and spare parts

b) Loose tools

c) Raw materials

d) Work-in-progress

e) Finished goods and

f) Scrap or by-products.

Its incorrect recording, verification and valuation will adversely affect the profit and loss of the period. It will also affect the balance sheet and the assets and net worth will present a wrong picture. Therefore, verification and valuation of stock in trade should be given utmost care and attention.

Actually, it is not the duty of the auditor to value stock-in-trade. His job is only to check the valuation of stock-in- trade done by the employees of the concern. So, his responsibility begins when the valuation of stock-in- trade by the employers of the concern has been completed. The auditor should use his skill, ability, intelligence and experience to form his opinion about correctness and propriety of stock-in-trade.

It is very difficult for the auditor to physically verify each and every item of stock in hand as he may not possess technical knowledge and moreover he has no time to do so. But there are differences of opinion regarding the duties of auditor about the valuation of stock-in-trade. There are a number of judgments which make his duties clear.

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The following are important judgments of courts in connection with duties of an auditor regarding verification and valuation of stock-in-trade.

1. **Kingston cotton mills case (1869):** According to the judgment in this case, Justice Kindly said -'the auditor, if he performs his job with due care and no doubtful circumstances exist, has a right to rely on the statements of responsible officials and if he accepts the certificates given by them concerning valuation of stock-in-trade he is not guilty of negligence'.

2. **Irish woolen mill co., Ltd V/S Tyson and others case (1900):** In this case the learned judge observed that - 'there was no duty cast on the auditor to take stock. What he did was to have the calculations checked in his office and this was done with proper care'.

3. **Westminster Road construction and Engineering Co, Ltd case (1932) :** In this case it was decided that auditor was liable for not detecting over valuation of assets and omission of liabilities from the balance sheet, if such could be detected by the application of reasonable care and skill.

4. **Henry Squire Ltd V/s Ball Baker and company case (1991) :** In this case it was held that, 'it was not the duty of the auditor to take stock or value stock. He should simply check the list of stock taking.

From the above judgments it is clear that:-

1) It is not the duty of the auditor to value stock.

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2) Auditor can rely on the reports and statements certified by some responsible official.

3) But he should exercise reasonable care and skill while verify & valuing stock in trade.

4) And also he should verify the existence of stock in hand see that it is valued according to certain accepted principles of accountancy.

VERIFICATION OF STOCK-IN-TRADE

The auditor should examine the following points regarding verification of stock-in-trade.

1) Whether internal check system exists in the co., or not and how much it can be relied upon.

2) He should review the procedure and arrangements for the maintenance of stock records and find out any discrepancy therein.

3) Goods account should be compared with stock.

4) He should obtain a list of stock-in-trade

5) Stock statements should be compared with previous years statements shortage or excess should be enquired into.

6) It should be seen whether old and out of date stock has been written off or not.

7) The quantity of stock should be verified from purchase and sale statements.

8) The auditor should take care that goods received on sale or return basis are not included in stock. These goods should be kept separate from the stock.

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9) All the goods purchased during the year and belonging to the client though not in his possession, should be included in the stock. That means, stock lying for sale on ports, warehouses, with agents or with the customers on approval should be included in stock.

10) The auditor should suggest the management that the persons entrusted with verification of stock should be competent and should have sufficient time to carryout verification. Such persons should not have the custody of stocks or responsible for maintenance of stock records.

VALUATION OF STOCK-IN-TRADE

If stock in not properly valued, it would affect the profit and loss account. If the stock is over valued, it will result in artificial, false and misleading profits. If the stock is under valued, it will also result in misleading results.

As we know, stock is a floating asset and is meant for resale. The accepted basic principle of accounting is to value floating assets at cost or the market price, whichever is lower. It is a sound accounting principle that losses should always be anticipated but no account should be taken of the expected profits which may not be realized. Even if the increase in market price seems to be permanent in nature, the valuation is still to be done at cost. The reason is that profits are taken into account only when the goods are sold.

Similarly if there is a fall in the price of goods, it must be valued accordingly. Because, as stock is a current asset, it must be brought into account at its realizable value at the

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date of balance sheet, if it is lower than the cost price.

What is cost price?

We understood that stock should be valued at cost price or market price whichever is lower. Here, the logic is to take into consideration the expected loss but no credit is taken for unrealized profit, now, the question is what is cost price?

The following are different methods of finding out the cost price of stock of goods.

1) **Unit cost method:** Under this, each article or batch of goods is valued at the actual price at which it is purchased in different lots.

2) **Average cost method:** In this case goods in stock are valued, at average cost price of various consignments taken together.

3) **First - in First - Out (FIFO) Method:** Under this method, stock is valued the rate at which the most recent purchases were made.

4) **Last - in First - Out Method:** Under this method, the stock is valued at the rate at which the earliest purchases were made.

5) **Base stock Method:** Under this method a specific quantity of stock is always carried at the original cost and it is always carried at the original cost and it is not supposed to be issued unless there is an emergency. Any quantity over and above the base stock is issued in accordance with the other method which is used in conjunction with this method.

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6) **Adjusted selling price method:** Under this method an estimated cost is found out by pricing unsold stock at the prevailing selling expenses including overhead charges.

7) **Standard cost :** Under this method the stock is valued at some pre determined cost per unit called standard cost.

8) **Highest - in - first out (HIFO) :** This method is based on the assumption that the closing stock of materials should always remain at the minimum value. So that issues are priced at the highest value of available consignments in store.

In view of the number of methods available to choose from, it is pertinent to ask which method to choose. In general it should be valued on a consistent basis from year to year. According to international accounting standards committee stock-in-trade should be valued at lower of historical cost and not realizable value. The institute of chartered

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securities, etc is registered in the ... company or the Reserve bank of India which has issued such scrip's and that a certificate of title has been issued in the name of the holder.

b) **Inscribed stock :** It is that type of stock where no certificate by the issuing authority is issued to the purchaser of a stock. A stock receipt is issued to the purchaser giving the nominal amount purchased and amount received. But his name is inscribed in the register of stock maintained by one of the joint stock banks or the RBI.

c) **Bearer Bonds and share warrants :** As the name it self indicate its meaning. As it is easily transferable from one hand to another the auditor should actually inspect such securities. If they have been deposited with the banker for safe custody the auditor should get a certificate from the banker.

VERIFICATION OF INVESTMENTS

The auditor should consider the following points while verifying the investments.

1. The auditor should ask for a schedule of investments held by his client.
2. The schedule of investment should give full particulars of investments such as

a) Name of the investment

b) The cost of investment

c) The market price

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d) Book Value

e) Date on which the investment was acquired

f) Rate of interest payable

g) Dates of payment of interest

h) Tax deducted etc.

3. The auditor should examine all the investments simultaneously and compare it with the schedule.

4. If the numbers of investments is large and they cannot be inspected at one sitting, the investments which have been checked must be locked and sealed in a box so that they may not be produced again for inspection.

5. If investments are held by any trustee on behalf of the company, the trust deed executed by such a nominee should be examined. It there is no Trust deed he should get a certificate from the trustee.

6. Ensure that the transaction for the purchase and sale of investments are supported by due authority and documentation e. g. broker's note, bill of costs, Receipts etc.

7. Where investments have been purchased or sold cum-dividend/ ex-dividend, cum - interest/ ex-interest see weather proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

8. Carryout a surprise inspection of investments in hand at least once during the year, where a substantial number of investments is held by the concern in its custody.

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9. Ensure that investments belonging to third parties but held by the company are properly identified and segregated at the time of inspection.

10. If securities are kept in the custody of the secretary of the company, they should be held by him jointly with some other officers of the company. Such securities should be registered in the name of the company as is required under Sec 49 of the companies Act.

11. If the securities have been entrusted to the Bankers for safe custody, the auditor should get a certificate from the bank that so many securities are held by it for safe custody and that they are free from any charges.

12. Where investments are held by a third party other than Banks on behalf of the concern, he should see whether there is a justification for such other party to hold the scrips. He should also verify the evidence of securities held by third parties.

VALUATION OF INVESTMENTS

After verifying the existence of the investments the auditor should proceed to find out whether they are properly valued at the date of the balance sheet.

The auditor's duty in this regard includes the following.

1. Ensure that investment have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements.

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2. The basis of valuation of investment will, to a large extent depend upon the purpose for which they are held. so the auditor should consider the following points :-

a) If they are to be held as a fixed asset for the purpose of earning interest/ dividend these are to be valued at cost which includes brokerage and stamp duty paid thereto.

b) If they are to be held as current assets, these should be valued at cost or market price whichever less is.

c) For the underwriters. If they have to purchase the shares, which had been underwritten by them, the cost price will be the face value less the underwriting commission'.

3. Auditor should examine whether the method of valuation followed by the concern in consistently applied.

4. He should see whether in computing cost of investments, the expenditure incurred on account of transfer fees, stamp duty brokerage etc included in the cost of investments.

5. He should ascertain the market value of the quoted securities from official quotations of the stock exchange.

6. Ascertain the method adopted by the concern for determining the market value of unquoted securities, see if the method is reasonable consistent and correct.

7. Some times, the auditor may come across situations, where the market value is much below the cost of acquisition of investments ordinarily, he should ignore a temporary full in the market value, but where the fall in value seems to be of a permanent nature, he should

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see that adequate depreciation is provided.

8. Where the auditor is unable to determine the value of any investment accurately he should fully disclose the facts regarding this and qualify his report accordingly.

VERIFICATION OF LIABILITIES

The verification of liabilities is of equal importance as that of an asset. The auditor has to satisfy himself that the liabilities whether existing or contingent, have been properly determined and disclosed in the balance sheet. In case the liabilities are overstated or understated in the balance sheet shall not represent a true and fair view of the state of affairs of the company. Similarly profit and loss account will be incorrect. For example if some expenses have been incurred but they have not been entered in the books of accounts, the profit and loss account will be incorrect and will show more profit and the balance sheet will not show such a liability.

Therefore, the auditor should ensure that

a) The liabilities shown in their balance sheet is actually payable.

b) All liabilities are properly recorded.

c) Liabilities are payable for the legitimate operations of the business.

d) The nature of contingent liability has been disclosed in the balance sheet by way of footnote.

In addition to the above the auditor must also obtain a certificate from a senior official stating that :–

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books of accounts and

b) Also that all the contingent liabilities have either been disclosed in a foot note to the balance sheet have been provided for.

WESTMINSTER ROAD CONSTRUCTION ENGINEERING COMPANY LTD CASE (1932)

In the above case, it was held that the auditor must take reasonable care to satisfy himself that all expenses and liabilities which could be expected to have incurred have been brought into account.

In this case the learned Judge Bannel .J observed that 'If the auditor found that a company in the course of its business was incurring liabilities of a particular kind it becomes his duty to make specific inquiries as to the existence of such liabilities and also before he signs a certificate as to the accuracy of the balance sheet to go through the invoices files of the company in order to see that no invoice relating to liabilities has been omitted'.

Now, let us discuss some of the important items of liabilities.

1. Capital :

It is the money invested in the business by its proprietors. The proprietors may be sole owners, partners or share holders in case of Joint Stock Company.

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I. In case of Partnership firm the auditor has to consider the following aspects

a) Firstly, he should examine the partnership deed.

b) Secondly, he must find out the original capital contributed by each partner and the rate of interest payable on capital.

c) Thirdly, he should see that capital accounts of partners are correctly maintained or not.

d) Fourthly, he should verify all transactions affecting the capital accounts.

e) Fifthly, he should examine the cash book, pass book, withdrawals of the partners and profit and loss earned.

II In case of Joint stock companies the auditor has to consider the following points

a) He should examine the memorandum of association and the Articles of Association. Memorandum of Association will give the information as to the maximum capital of the company is authorised to raise.

b) He should examine the cash book. Passbook, minute book of the Board of Directors meeting to find out the number and different classes of shares issued, the amount received on each share and the balance due from the share holders in respect of calls etc.

c) If certain shares have been issued to vendors he should examine the contract between the vendors and the company.

d) In case of newly floated company the auditor should undertake an exhaustive checking of all the share capital transactions.

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g) He should find out as to how many shares of each class have been allotted as fully paid up by way of Bonus Shares. The auditor should specify the source from which bonus shares are issued e.g. capitalisation of profits or reserves or from share premium account.

h) Where there is only one class of shares issued by the company, the auditor should ensure that it has been styled as equity capital in the balance sheet.

i) Where the company has issued Redeemable preference shares, the auditor should see that the terms of redemption have been clearly shown together with the earliest date of redemption.

He should see that the amount originally paid up in ... been added to

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2) The purchase ledger should be examined with the books of originals entry, invoices, credit notes etc.

3) He should find out whether all purchases made at the close of the year have been credited to the suppliers accounts by referring to the goods inward book and purchases book.

4) If necessary, he may ask for statements of accounts from creditors check the accuracy of the amounts.

5) If the client maintains provision in respect of discount on creditors he should check the same with reference to the creditors accounts.

6) Where goods have been purchased on hire purchase basis, he should see that the conditions of the agreement properly complied with.

7) He should pay special attention to the entries made in the beginning or at the end of the year. There may be possibilities of fictitious entries in this respect being passed by the employees of the concern.

8) 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.

9) He should also verify the return outward books with the help of the credit notes supplied by the vendors of goods.

10) He should see that, out of the loans and advances received on some other count are not treated as trade debts.

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