Verification of Liabilities

Verification of liabilities is as important as the verification of assets. If liabilities are not properly verified and valued, the balance sheet will not reveal a true and fair view of the state of affairs of a business concern. Verification of liabilities is aimed at ascertaining that all the business liabilities are properly disclosed, valued, classified and presented in the balance sheet. The auditor should see that liabilities are not overstated or even deliberately omitted. He should obtain a certificate from some responsible official as to their correctness.

In the famous case of **Westminster Road Construction and Engineering Co. Ltd.**, it was decided that

> "the auditor is liable for omission of liabilities from the balance sheet, if such liabilities could be detected by the appreciation of reasonable care and skill."

Now we discuss the verification and valuation of various liabilities as follows.

1. Capital

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It is not a liability in the strict sense of the word. Nevertheless, it is a liability popularly known as internal liability. The auditor is required to verify it so as to certify the correctness of the balance sheet.

In case of a firm, the auditor should verify the liability on account of capital with the help of Partnership Deed, Cash Book and the Pass Book. He should see that it has been properly recorded in the books of account.

In the case of a Company, the auditor's job may be grouped under two heads: (a) *First Audit*, (b)

2. Debentures

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The auditor should note the following points while verifying debentures.

(i) The auditor should refer to the Memorandum and Articles of Association to find out whether the company has got power to issue the debentures and that the limits, if any, has not been crossed.

(ii) 'Debenture Trust Deed' should be inspected and with its help, the debenture account in the ledger should be examined.

(iii) If necessary, the auditor can obtain a certificate from the debenture holders.

(iv) Since debentures are supposed to be redeemed, the auditor should see the arrangements for their redemption.

(v) The debenture may be issued at par or at a premium.

(a) If they have been issued at par, but redeemable at premium, such a loss should be charged to the Profit and Loss Account.

(b) If they have been issued at premium the auditor should see how they have been dealt with in the accounts. Such a premium may not be utilised for distribution of dividends, unless there is some specific provisions in the Articles.

(c) If they have been issued at discount, the debentures must be shown in the balance sheet at face value and such a discount should be written off as soon as possible.

(vi) The auditor should also see the details as given in the Register of Mortgages and Charges.

(vii) If an insurance policy has been taken for their redemption, auditor should verify that such a policy has been duly assigned to the trustees for the debenture holders.

(viii) If some profit is made on the redemption of the debentures, it should be treated as capital profit.

Imp 3. Trade Creditors

(i) The first task of the auditor is to ask for a schedule of the creditors. The schedule should be checked with the balance of ledger accounts and statements of account received from creditors.

(ii) The purchase ledger should be checked with the books of original entry, invoices, credit notes etc.

(iii) If the client maintains provision in respect of discount on creditors, he should check the same with reference to the creditors' account.

(iv) He should see that all purchases during the year have been taken account of. Special care should be exercised with regard to the purchases made at the close of the year.

(v) Where goods have been purchased on hire-purchase basis, he should see that the conditions of the agreement are properly compiled with.

STOCK-IN-TRADE (INVENTORIES) — Imp

The correct recording and auditing of stock-in-trade or inventories are of a paramount importance. Stock-in-trade is the life-blood of a business. It comprises a variety of items including:

(a) Stores and spare parts ;
(b) Loose tools ;
(c) Raw materials ;
(d) Work-in-progress ;
(e) Finished goods ; and
(f) Scrap or by-products.

If stock-in-trade is incorrectly recorded, verified or evaluated, the resultant profit or loss for the period will be incorrect. It will also affect the Balance Sheet and the assets and the net worth will present a wrong picture. If stock-in-trade is overstated, it may lead to payment of dividends or other expenses based on inflated profits. If it is understated, secret reserve will be created and it may also lead to a fall in share-values due to disclosure of low profits. Verification and valuation of stock-in-trade should, therefore, be given utmost care and attention.

... has listed the following six reasons fo

Verifications. The auditor should proceed for the verification of stock in the following manner:

(a) He should review and be familiar with the procedure and arrangements for the maintenance of stock records and find out any discrepancy therein.

(b) He should examine how effectively the management controls the receipts and issues of stock.

(c) He should secure a copy of the client's physical stock- taking instructions in advance of the actual stock-taking, and see whether these contain adequate safeguards against possible errors or frauds.

(d) He should compare the rough original stock-sheets with the fair copies, noting any material alteration therein which should be carefully enquired into.

(e) He should then, test some of the items of the stock with the stock records with regard to quantity and value. Material difference, if any, must be enquired into.

(f) He should test-check the physical existence of at least 5% of the items to ascertain whether records do correctly represent the stock-in-hand.

(g) He should examine and find out that no goods which do not belong to the client (for example, goods sold to customers before the date of the Balance Sheet, goods received on consignment, sales or return basis etc.) have been included in the stock. Similarly, all the goods purchased during the year and belonging to the client though not in his possession,

6. Outstanding Liabilities for Expenses

The auditor should obtain a certificate from a responsible officer of the company stating that all outstanding liabilities for expenses incurred have been brought into account.

The auditor can verify those items of expenses which usually constitute outstanding liabilities. For example, salaries payable, legal expenses, rent, wages, audit fees etc.

7. Contingent Liabilities

Contingent liability is a liability which may or may not arise.

According to Monogomery, "the term contingent liability should be used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arises from past circumstances or action which may or may not become a legal obligation in the future."

Unless a contingent liability is quite negligible, its existence should be disclosed by an appropriate note in the Balance Sheet. According to Part 1-A of Schedule VI of the Indian Companies Act, 2013 disclosure of a contingent liability need only be made through a footnote in the Balance Sheet specifying the amount involved.

Examples of Contingent Liabilities:

(i) Liabilities on Bills Receivable discounted and not matured.
(ii) Liability under a guarantee.
(iii) Liabilities arising out of litigation in respect of trademarks, copyrights etc.
(iv) Liabilities for penalties under forward contracts.

... inspect the various contracts entered into by the company and ... His duty is to ensure that all such likely