

CHAPTER

VERIFICATION OF ASSETS

Meaning and definition of verification of assets

7.1 The auditor has to express an opinion about the truthfulness and fairness of the state of affairs as indicated by balance sheet and results of operations as reflected by the profit and loss account. In order to do so, he has to verify the assets i.e. to establish correspondence of actual facts or details with those represented. Some of the definitions of verification of assets given by eminent authors are stated below:

*Spicer and Pegler*¹ state :

"The verification of assets implies an inquiry into the value; ownership and title; existence and possession; the presence of any charge on the assets."

*Joseph Lancaster*² has defined verification of assets as :

"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) the verification of the existence of the assets, (b) the valuation of the assets, and (c) the authority of their acquisition."

On the basis of above definitions, *verification of assets* can be stated as "a process of substantiation of assets recorded in the books of account, by means of physical inspection and examination of legal and official documents, and then forming expert opinion as to existence, ownership, possession, classification and valuation of assets of an entity."

Objects of verification of assets

7.2 The auditor's objective with regard to verification of assets generally is to satisfy himself that—

- (i) they exist;

1. Spicer and Pegler, *Practical Auditing*, 13th Edition.

2. Lancaster, Joseph, *Principles and Practices of Auditing* (1947).

- (ii) they belong to the client;
- (iii) they are in possession of the client or person authorised by him;
- (iv) they are not subject to undisclosed encumbrances or lien;
- (v) they are stated in the balance sheet at proper amount in accordance with sound accounting principles; and
- (vi) they are recorded in the accounts.

The above six objects are discussed in brief below :

- (i) **Existence** - The physical verification of fixed assets is primarily the responsibility of the management and not the auditor. In order to verify the existence of assets, he should examine the records with reference to the documentary evidence and the internal controls.
- (ii) **Ownership** - Ownership of the assets should be verified by examining the title deeds. In case the title deeds are held by other persons such as solicitors or bankers, confirmation should be obtained directly by the auditor through a request signed by the client. In case of assets without any document to title, such as debtors, cash and work-in-progress, the auditor should verify the ownership by designing audit procedures to ascertain the efficacy of internal control system.
- (iii) **Possession** - The auditor should ascertain that the assets are in the possession of the client. If any asset is in possession of any other person, it should be seen that such possession has been duly authorised by the client.
- (iv) **Adequate disclosure of encumbrances or lien** - The duty of an auditor with regards to such disclosures is two fold—firstly, he should adopt audit procedures to ascertain whether any asset is subject to charge. Examples of some such procedures are—representations obtained from the management and confirmation obtained from bank with regards to the purpose of holding securities. Secondly, if a charge exists, the auditor should ensure its proper disclosure in the financial statements.
- (v) **Valuation** - The auditor should satisfy himself that the assets have been valued in the financial statements according to the generally accepted accounting principles.
- (vi) **Disclosure** - The auditor should examine whether assets have been disclosed as per generally accepted accounting principles and statutory requirements, if any.

Difference between vouching and verification

7.3 Both vouching and verification relate to the examination of books of account or documentary evidence in support of existence of assets, mentioned in the financial statements. However, they can be distinguished on the basis of following points—

- (i) **Meaning and scope** - Vouching is a process of *substantiating the occurrence* of the transactions recorded in the books of account with reference

to *relevant documentary evidence*. On the other hand, verification is a process of *substantiating existence* of assets and liabilities with reference not only to *relevant documentary evidence* but it also includes *forming an expert opinion* on different aspects (such as existence, ownership, possession, etc.) of an asset and existence, obligation, etc. of liabilities. Thus, verification is wider in scope and vouching is followed by verification.

- (ii) **Object** - The object of vouching is to *verify the authority, authenticity and genuineness of transactions* recorded in the books of account. But the object of verification is to satisfy the auditor as to *existence, ownership, possession* (in case of assets) or *completeness* (in case of liabilities), *valuation and disclosure of items* mentioned in the balance sheet.
- (iii) **Level of expertise** - Vouching is done generally by *junior level clerks* having sufficient knowledge of the accounting principles. While verification should be either done by the *senior clerks* or the auditor having sufficient knowledge not only of the accounting principles but also of various compliance and substantive audit procedures and of statutory requirements, if any.
- (iv) **Relationship with financial statements** - Vouching is concerned with all items of profit and loss statement and with those balance sheet items undergoing change during the year. Verification is concerned only with items of balance sheet.

Difference between verification and valuation of assets

7.4 Both verification and valuation are necessary for the purpose of ascertaining true and fair view of the state of affairs and the results of operations as indicated by the financial statements. These concepts differ on following points—

- (i) **Scope** - Valuation of assets is a part and parcel of verification. Verification includes *ascertaining existence, ownership, possession, proper valuation and adequate disclosure* of an asset. While valuation relates only to the *examination of the accuracy and propriety of value* of various assets appearing in the balance sheet.
- (ii) **Object** - The object of verification by the auditor is to satisfy himself with regard to *existence, ownership, possession and valuation of an asset*. The object of valuation of assets undertaken by the management, on the other hand, is to *value the assets as per generally accepted accounting principles*.
- (iii) **Responsibility** - The *auditor* has a duty to verify the assets and may be held guilty of negligence in case of improper verification of assets. Auditors, on the other hand, are not expected to be the valuers. Valuation is the duty of the *management* and the auditor can rely on a certificate issued by an authorised valuer as to the valuation of assets in the balance sheet.

Auditor's duty with regard to valuation of assets

7.5 The financial position of a business is reflected by its balance sheet and its working results, by the profit and loss account. The *true and fair view* indicated by

both statements depends on the valuation of assets considerably. The question as to auditor's duty with regards to valuation of assets was addressed by Lopes L.J., in *Kingston Cotton Mills* case. He observed that the auditor is fully justified in relying on the representations made by the 'tried' servants of the company, provided he takes reasonable care and exercise requisite skill. The scope of auditor's duties has since then been enlarged and the following generalisations can be made with regards to his duty for valuation of assets—

- (i) Auditor is not a valuer.
- (ii) He can rely on the representations made by the management and opinions and certificates issued by technical experts, surveyors, etc. for the purpose of valuing the assets.
- (iii) Before relying on such representations and certificates, the auditor should apply audit procedures to ensure that the valuation done by the management or as indicated by certificates issued by experts, has been made as per accepted accounting principles and statutory requirements, if any. The assessment of appropriateness of procedures for determination of cost (by inspecting underlying documents), computation of depreciation or amortisation charges and determination of market value *i.e.* net realisable value or the replacement cost of the asset should also be undertaken.
- (iv) If the auditor does not exercise reasonable care and skill for the purposes of verification of valuation of the assets, he may be held guilty of negligence. In *State Street Trust Co. v. Ernest*, the auditor was held guilty of negligence because he certified bills receivable at their face value even though he had come across several cases of unsatisfactory collection during his examination.

Thus, though auditor is intimately concerned with values, *valuation is no part of the auditor's duty*. It is limited to verification of valuation stated in the financial statements.

Verification of specific fixed assets

Freehold land

7.6-1 The auditor should follow the audit procedures mentioned below to achieve the objects of verification of freehold land.

Objective	Audit Procedure
(i) Existence and ownership	<ul style="list-style-type: none"> • Inspect original title deeds and conveyance or purchase deed which should be in the name of the client. • Vouch payments in case new land has been purchased during the year.
(ii) Possession and determine liens, if any	<ul style="list-style-type: none"> • Title deed should be in custody of owners. • In the case of mortgage, obtain a certificate from mortgagee or his lawyer confirming the possession of the title deed. • If any charge or encumbrances exist on land, the auditor should ensure they have been properly disclosed.

<i>Objective</i>	<i>Audit Procedure</i>
(iii) Valuation and disclosure	<ul style="list-style-type: none"> • Land is a non-depreciable asset. It is, generally, shown in the balance sheet at historical cost which includes purchase price, broker's commission, stamp duties, registration fees, legal charges and also levelling, clearing and draining charges. • Where payments are made to the municipality for constructing sidewalks, laying of sewers, etc. such costs should, preferably, be shown separately in 'Land Improvement Account' and adequate depreciation should be provided for on it. • If land and building were purchased as a package, the auditor should determine their values separately. For the said purpose, he should review documents such as appraisal report by valuers and tax assessment valuation report which can provide a basis for apportionment of costs between land and building.

Documents to be inspected : title deeds; conveyance/purchase deed; certificate from mortgagee or his lawyer; minutes book or resolutions, appraisal report, tax assessment valuation report.

Building

7.6-2 The audit procedures for verification of building are given below :

BUILDING

<i>Objective</i>	<i>Audit Procedure</i>
(i) Existence, ownership, possession and determine liens, if any	<ul style="list-style-type: none"> • The audit procedures followed for ascertaining the existence, ownership and possession are similar to those of freehold land. • The extent of liens against building can be determined by examining records and obtaining proofs similar to freehold land.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> • Buildings should be valued at cost less depreciation. • In case land and building have been purchased together, ensure that cost has been segregated for depreciation purposes on a reasonable basis. • Ascertain the reasonableness of basis used to calculate the cost if building is purchased or constructed. • In case of revaluation, depreciation should be provided at revalued amount as reduced by estimated residual value.

Documents to be inspected : title deeds; conveyance/purchase deed; certificate from mortgagee or his lawyer; minutes book or resolutions.

Plant and machinery

7.6-3 The audit procedures to verify plant and machinery are given below :

PLANT AND MACHINERY

Objective	Audit Procedure
(i) Existence and ownership	<ul style="list-style-type: none"> • Inspect Plant Register which contains detailed particulars relating to various machines and equipment along with their original cost, rate and amount of depreciation, accumulated depreciation, additions and sales from time to time. • Ensure physical verification of plant and machinery was done by the management; method adopted was reasonable; its frequency was reasonable and test check book records with physical verification reports. • Vouch new purchases with relevant documentary evidence. • Verify sale of plant and machinery with evidence indicating authorisation to sell, invoice copy, carbon copy or counterfoil of cash receipt and should ensure that journal entries have been passed to remove the entire related accumulated depreciation.
(ii) Possession and liens, if any	<ul style="list-style-type: none"> • Confirm the existence of lien or floating charge, if any, by inspecting register of charges, approval by appropriate authority, certificate from client's legal adviser and confirmation from mortgagee.
(iii) Valuation and disclosure	<ul style="list-style-type: none"> • Plant should be valued at cost of acquisition less depreciation. • Ascertain the basis for computation of cost in case of purchase or construction of plant and machinery. • Ascertain whether profit or loss on sale of the machinery has been calculated correctly and disclosed properly in the profit and loss account.

Documents/Book to be inspected : Plant register; minutes book; BOD's resolution; purchase invoices; register of charges

Furniture and fixtures

7.6-4 The procedures which may be adopted by the auditor to verify furniture and fittings are :

FURNITURE AND FITTINGS

Objective	Audit Procedure
(i) Existence and ownership	<ul style="list-style-type: none"> • Examine Stock Register which has details regarding the date of purchase, cost of furniture and fitting, depreciation rate, location, stock number allotted to it and other facts.

Objective	Audit Procedure
	<ul style="list-style-type: none"> • Ensure stock number is painted on furniture and fitting • Ensure that the management prepares a statement of inventory and reconcile it with stock register at the end of each period. • In case of purchase, verify the furniture with reference to authorisation by appropriate authority, purchase invoices, stock register and bank statement.
(ii) Possession and determine liens, if any	<ul style="list-style-type: none"> • These assets are rarely subject to lien. Physical inspection or relevant documents can be examined to determine it.
(iii) Valuation and disclosure	<ul style="list-style-type: none"> • These assets are valued at cost less depreciation. • Cost should be verified by reference to purchase invoices and vouchers of expense incidental to such purchase. • Ensure that cost of furniture and fittings which have become unserviceable or has been lost is written off to profit and loss account under proper authority. • Examine whether disclosure is as per statutory requirements, if any.

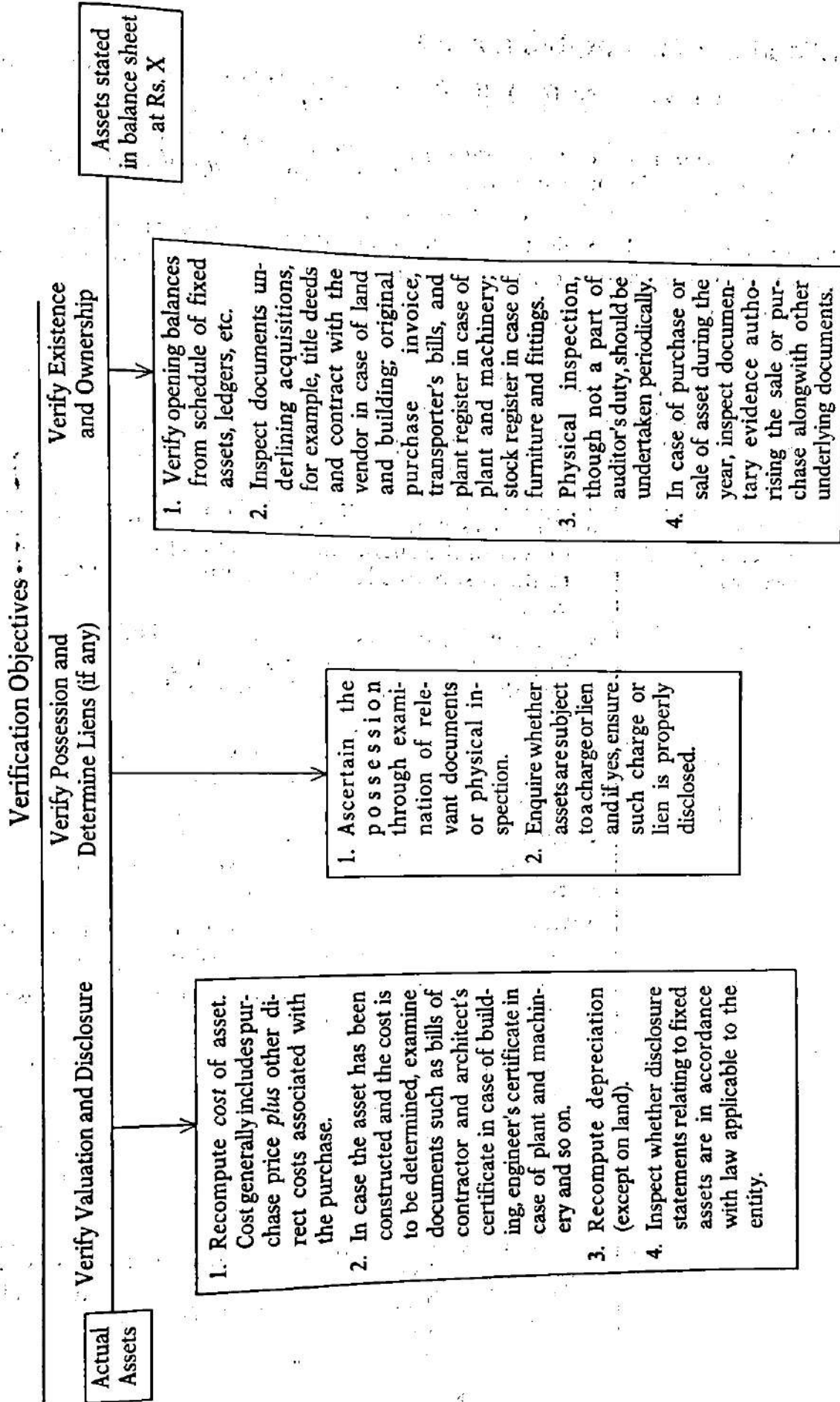
Documents/Books to be inspected : Stock register; statement of inventory; purchase invoices; minutes book; BOD's resolution; voucher of expenses.

7.6-5 Motor vehicles

Objective	Procedure
(i) Existence and ownership	<ul style="list-style-type: none"> • Examine registration certificate which contains information as to ownership, identification of the vehicle and other important details. • Examine insurance policies taken for motor vehicles and road tax receipts for information regarding ownership of the equipment. • Examine Vehicle Register, which is maintained if number of vehicles is large
(ii) Possession and determine liens, if any	<ul style="list-style-type: none"> • Ensure if a floating charge is created it has been disclosed in the balance sheet.
(iii) Valuation and disclosure	<ul style="list-style-type: none"> • Assets should be valued and disclosed at cost less depreciation • Cost includes purchase price and cost of accessories • Ensure depreciation is being provided with reference to distance in kilometres covered by the vehicle as against the mileage which it is expected to run during its lifetime.

Documents to be inspected : Registration certificates, insurance policies bond, road tax receipts, vehicle register

FIGURE 7.1
SUMMARY OF AUDIT PROCEDURES FOR VERIFICATION OF FIXED ASSETS (LAND, BUILDING, PLANT AND MACHINERY AND FURNITURE AND FITTINGS)



Verification of intangible assets

7.7 Accounting Standard (AS) 26, *Intangible Assets* defines intangible asset as below :

"An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others or for administrative purposes."

Examples given by the Standard include computer software, patents, copyright, motion picture films, customer lists, mortgage servicing rights, franchisees and goodwill among others.

Patents

7.7-1 A patent is an exclusive right granted by the Government to manufacture and dispose of or otherwise benefit from the results of the invention of a product or process. The audit procedures to verify patents are given below :

Objective	Audit Procedure
(i) Existence, ownership and possession	<ul style="list-style-type: none"> ● Obtain a schedule of patents duly signed by a responsible officer of the client and trace each patent on the schedule to the respective ledger account <i>i.e.</i> 'Relevant Patent Account'. ● Inspect documents underlying acquisition <i>i.e.</i> certificates or patent letters issued upon the registration of the patent and the assignment deed, if patent has been purchased. ● Examine aspects such as powers of vendor to sell patent rights, manner of payment of purchase consideration; period for which patent has been assigned, etc. in case of purchase of patents. ● Ensure that renewal fees, if any, have been paid on due dates and have been debited to profit and loss account and credited to the Patent Account. ● Obtain confirmation letters from the client's legal adviser as to the validity and existence of each patent.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> ● Ensure that patents are being shown at cost <i>less</i> amortisation charges <i>i.e.</i> at its unamortised value. ● Cost of a patent includes its purchase price and registration cost, if bought outright ● If the patent has been developed by the client in-house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalised. ● Ensure that the cost is written off over the legal term of its validity or over its useful commercial life, whichever is shorter. AS-26 has suggested ten years as useful life until and unless there is clear evidence that useful life is longer than ten years.

Copyrights

7.7-2 Copyrights are exclusive rights for the reproduction and sale of printed or otherwise produced writings, drawings, musical compositions, maps, works of art and so forth. The audit procedures to verify them are indicated below :

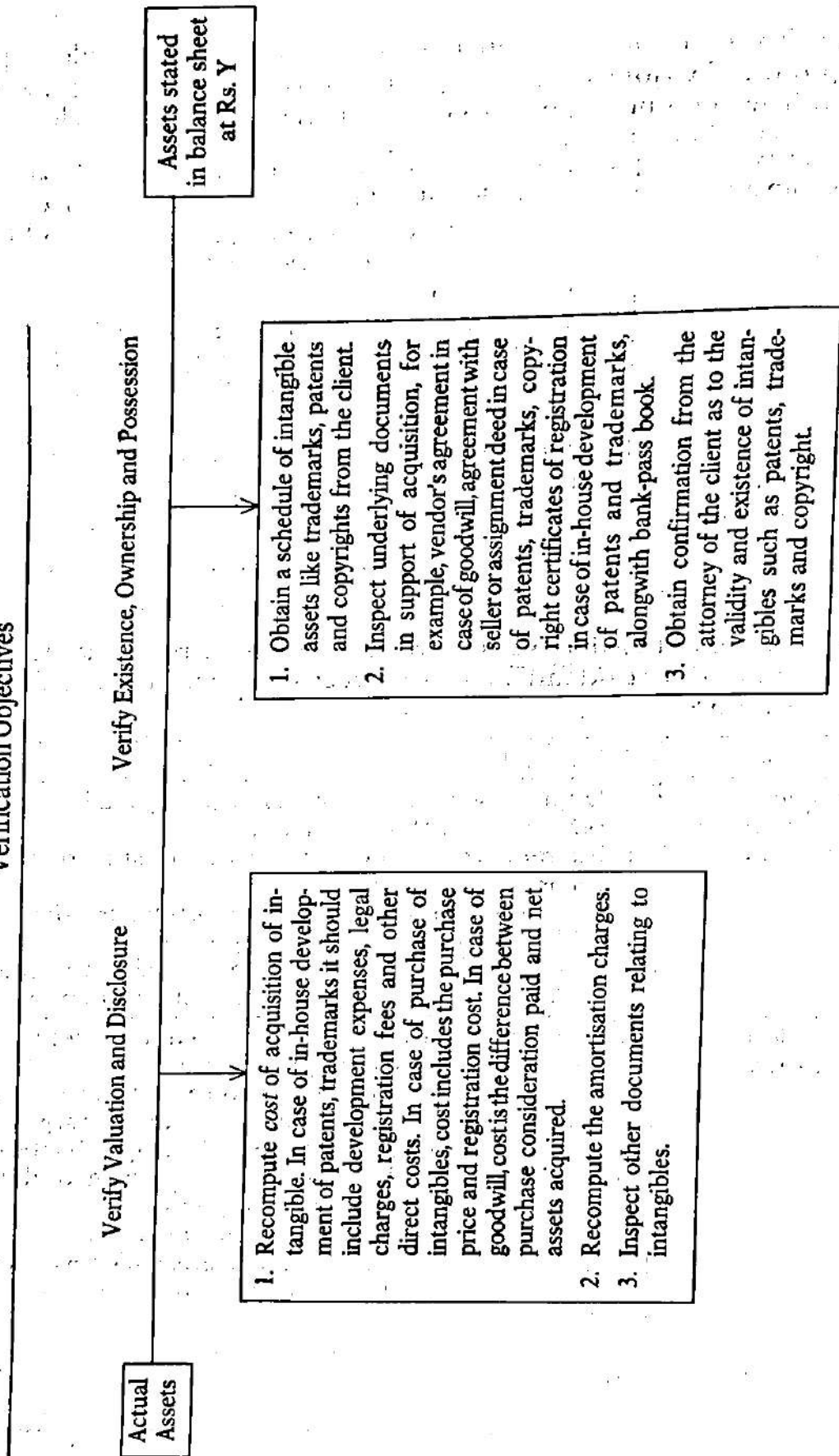
<p>(i) Examine existence, ownership and possession</p> <p>(ii) Examine its valuation and disclosure</p>	<ul style="list-style-type: none"> • Copyrights are generally <i>purchased</i>. Verification of copyrights should be done with reference to <i>original agreements</i> surrendering rights in favour of the client, <i>relevant correspondence</i> and other supporting documentary evidence. • In case of large number of copyrights, the auditor should obtain a <i>schedule of copyrights</i> duly signed by a responsible official of the client and verify their existence. • No charge or lien can be created on copyrights. • It is similar to that of patents.
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Trademarks

7.7-3 A trademark is a distinctive sign, symbol, design or brand name established to enable the purchaser to identify the product easily. It can be verified by adopting following procedures :

<i>Objective</i>	<i>Audit Procedure</i>
(i) Existence, ownership and possession	<ul style="list-style-type: none"> • Obtain a schedule of trademarks, signed by a responsible officer of client, very carefully. • Examine certificate of registration issued by the office of the Registrar of Trademarks. • In case trademarks has been purchased, the agreement with the seller should be examined. • Examine the last renewal fees receipt to ascertain the validity and legal enforceability of a trademark.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> • Trademarks are shown in the balance sheet at their cost <i>less</i> amortisation charges till date. • Ensure that if trademarks were purchased, the cost includes purchase price and registration charges. • In case trademarks have been developed by the client, the cost should include cost of developing outlays, design costs, and other associated direct costs. • The cost should be amortised over the period of legal validity or useful commercial life, whichever is shorter.

FIGURE 7.2
SUMMARY OF AUDIT PROCEDURES FOR VERIFICATION OF INTANGIBLES
 Verification Objectives



7.7.4 Goodwill

GOODWILL

(i) Existence, ownership and possession	<ul style="list-style-type: none"> • Ensure that no goodwill is recorded, if no consideration has been paid. As per AS-10, goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Internally generated goodwill is not recognised in the books of account. • According to AS-26, goodwill is equal to purchase consideration less fair value of net assets acquired. In order to verify such goodwill, the auditor should refer to minutes of the meeting of board of directors, vendor's agreement and also examine the allocation of acquisition price to various assets and goodwill.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> • As per requirements of AS-26, goodwill should be written off over a ten year period and be shown at cost less accumulated amortisation • In case the firm is not earning above normal profits, the auditor should discuss with the client the need to write it off.

Current assets

Investments

7.8-1 In carrying out verification of investments³, an auditor may employ the procedures mentioned below (Based on *Guidance Note on Audit of Investments* issued by ICAI) :

Objective	Audit Procedure
(i) Existence, ownership possession	<ul style="list-style-type: none"> • Inspect whether the investments made are within the and authority of the entity. • Inspect the investment register with reference to relevant documentary evidence such as allotment letters, brokers' notes, statements issued by depository, etc. • Check the adjustment made in the cost of acquisition or sales value of the security in case of ex-dividend/interest/right/bonus or in case of cum-dividend/interest/right/bonus purchase or sales • Carry out physical examination of securities on the last day of balance-sheet or a date close to it. • Examine statements and certificates issued by the depository or custodian for the scrips held by them. • Obtain certificates from third parties in case they hold investments owned by the client. In such cases be should insist on physical inspection of securities.

3. 'Investments' here means investments only in the form of shares, debentures or other securities.

Objective	Audit Procedure
	<ul style="list-style-type: none"> • Examine justification for keeping investments with third parties other than banks⁴. • Ascertain the reasons for holding investment otherwise than in the name of the entity.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> • Compare valuation practices against those prescribed by recognised accounting principles, (AS-13) specially with regards to determination of cost of investments, classification of investments, into long term investments (to be valued at cost) and current investments (to be valued at lower of cost or fair value). • Examine whether investments have been disclosed in balance sheet according to recognised accounting principles and relevant statutory requirements, if any.

7.8-2 Debtors

Objective	Audit Procedure
(i) Existence, ownership and possession	<ul style="list-style-type: none"> • Obtain a schedule of debtors duly signed by a responsible officer and examine it with reference to individual debtors' accounts. • Inspect underlying documents (such as invoice, transporter's receipt, credit memos and so on) for each debtor. • Vouch collection of accounts receivable subsequent to balance sheet date. • Examine reliability of debts as at the date of balance sheet. • Recompute the provision for bad and doubtful debts and compare it with past periods. • Inspect relevant correspondence such as court order declaring insolvency of a debtor, correspondence between the client and his lawyer for bad debts written off. • Inspect memorandum record for subsequent recovery of debts declared bad.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> • Examine to ascertain whether debtors have been properly classified and disclosed in balance-sheet in accordance with recognised accounting principles and statutory requirements, if any.

4. This principle has been laid down by the judgment in *City Equitable Fire Insurance Co. Ltd.* (1924) case. In this case, a large number of investments appearing in the balance sheet of the company were held by the company's stock brokers for safe-custody and they, in turn, pledged these investments. The auditor relied on the 'false certificate' issued by the brokers for the purpose of verifying investments. If the auditor would have insisted upon the physical inspection of the underlying investments, he could have easily discovered the fraud. The judge held the auditor guilty of negligence. He remarked, "an auditor is not ever justified in omitting a personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left. A company's brokers are not the proper persons with whom the securities are, lodged for safe custody, however respectable those brokers may be."

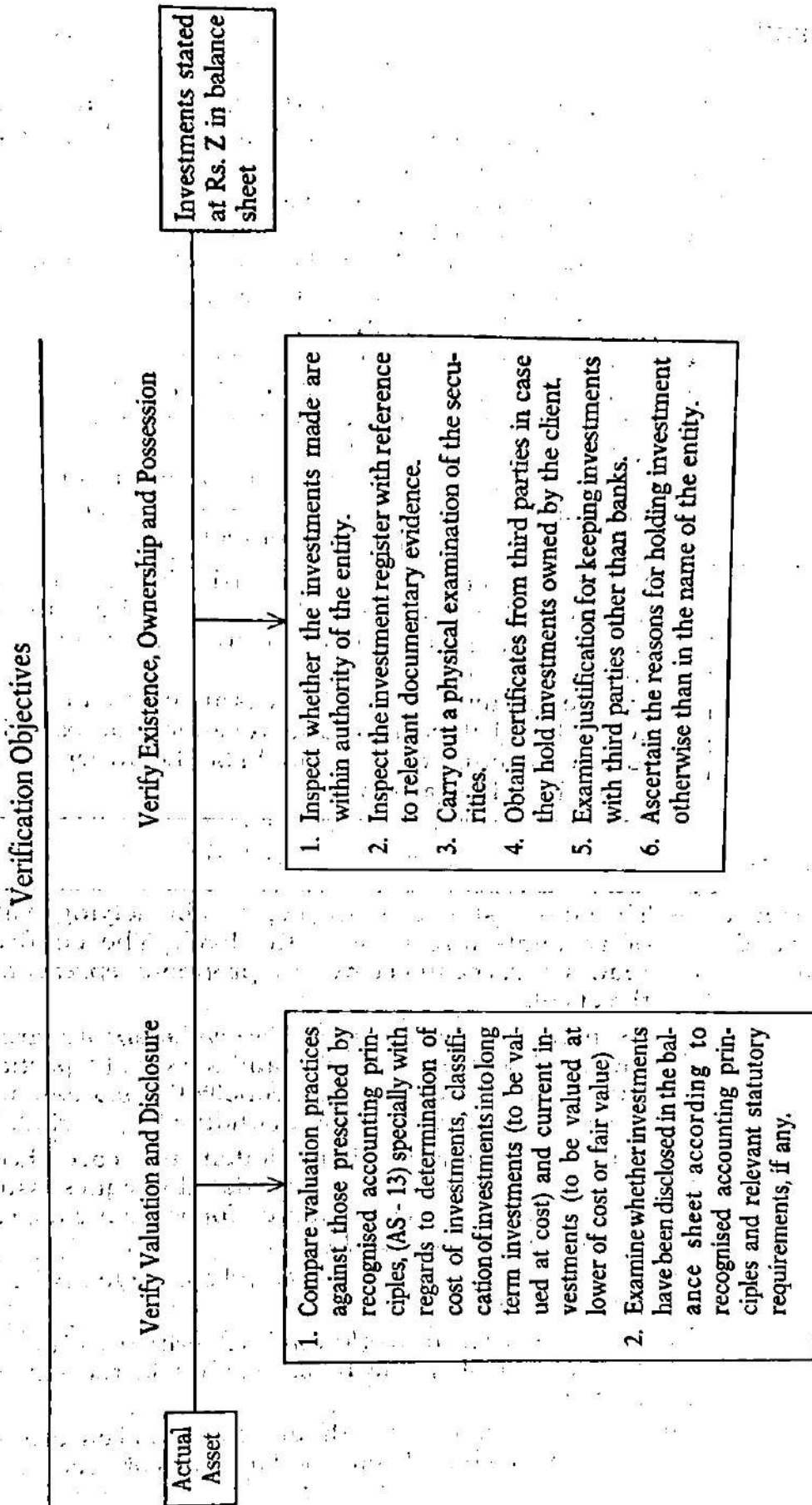
7.8-3 Cash-in-hand

Objective	Audit Procedure
(i) Existence, ownership and possession	<ul style="list-style-type: none"> • Physically count the cash at the close of business on the last day of the fiscal period under audit or a date close to it. • The year end verification should be supplemented by surprise checks of cash during the year. • If possible, all cash balances such as petty cash, balance of staff societies, etc. should be verified simultaneously and count should always be made in the presence of the custodian of each of the funds. • Do not include IOUs in cash-in-hand. • Carryout surprise verification of cash during the year, particularly, when the entity is consistently maintaining unduly large cash balances. • Ensure that there is no difference between actual cash-in-hand and balance as per books. If it exists, call for an explanation from the management.
(ii) Valuation and disclosure	<ul style="list-style-type: none"> • Ascertain whether cash has been disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any. • Ensure that temporary advances are not included in cash-in-hand and if postage and revenue stamps exist in a substantial number, they should be shown separately and not included in cash-in-hand.

7.8-4 Cash at bank

(i) Verify existence, ownership and possession	<ul style="list-style-type: none"> • The auditor should confirm cash at bank lying in all types of accounts <i>directly</i> with the bank. The confirmation request must be signed by an appropriate representative of the client. • Examine the <i>bank reconciliation statement</i> prepared as on the last day of the year. The auditor should, particularly, examine those items in the reconciliation statement which have been outstanding for an unduly long period. • While examining the bank statements, care should be taken to ensure that the post dated cheques issued/received have not been accounted for as payments/receipts of the period under audit. • Inspect <i>fixed deposits receipts</i> and <i>bank advices</i> for verifying fixed deposits. • <i>Remittances-in-transit</i> should be verified with reference to their credit in the bank account in the subsequent period. • In case of <i>stale cheques</i>, the auditor should ensure suitable adjustments have been made in books of account.
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FIGURE 7.3
SUMMARY OF AUDIT PROCEDURES FOR VERIFICATION OF INVESTMENTS



	<ul style="list-style-type: none"> • Examine that suitable adjustments have also been made in respect of <i>funds</i> lying in the bank accounts in <i>foreign countries</i>, which are subject to foreign exchange restrictions and get affected by exchange rate fluctuations. • Review the total number of bank accounts maintained by the entity to ensure that there are no <i>inoperative accounts</i> through which fraud is possible.
(ii) Verify valuation and disclosure	<ul style="list-style-type: none"> • Cash at bank should be shown in the financial statements as per the recognised accounting principles and statutory requirements, if any. In case of limited companies, ensure that balances with scheduled banks and non-scheduled banks are shown separately as per the requirements of Schedule VI to the Companies Act, 1956. • Ensure stale or dishonoured cheques are not included in the balance sheet. • Examine whether proper disclosures have been made of balances or deposits with specific charge or restrictions, <i>for example</i>, amounts lying in banks which are under liquidation or moratorium and amounts lying in foreign banks which are subject to exchange control restrictions.

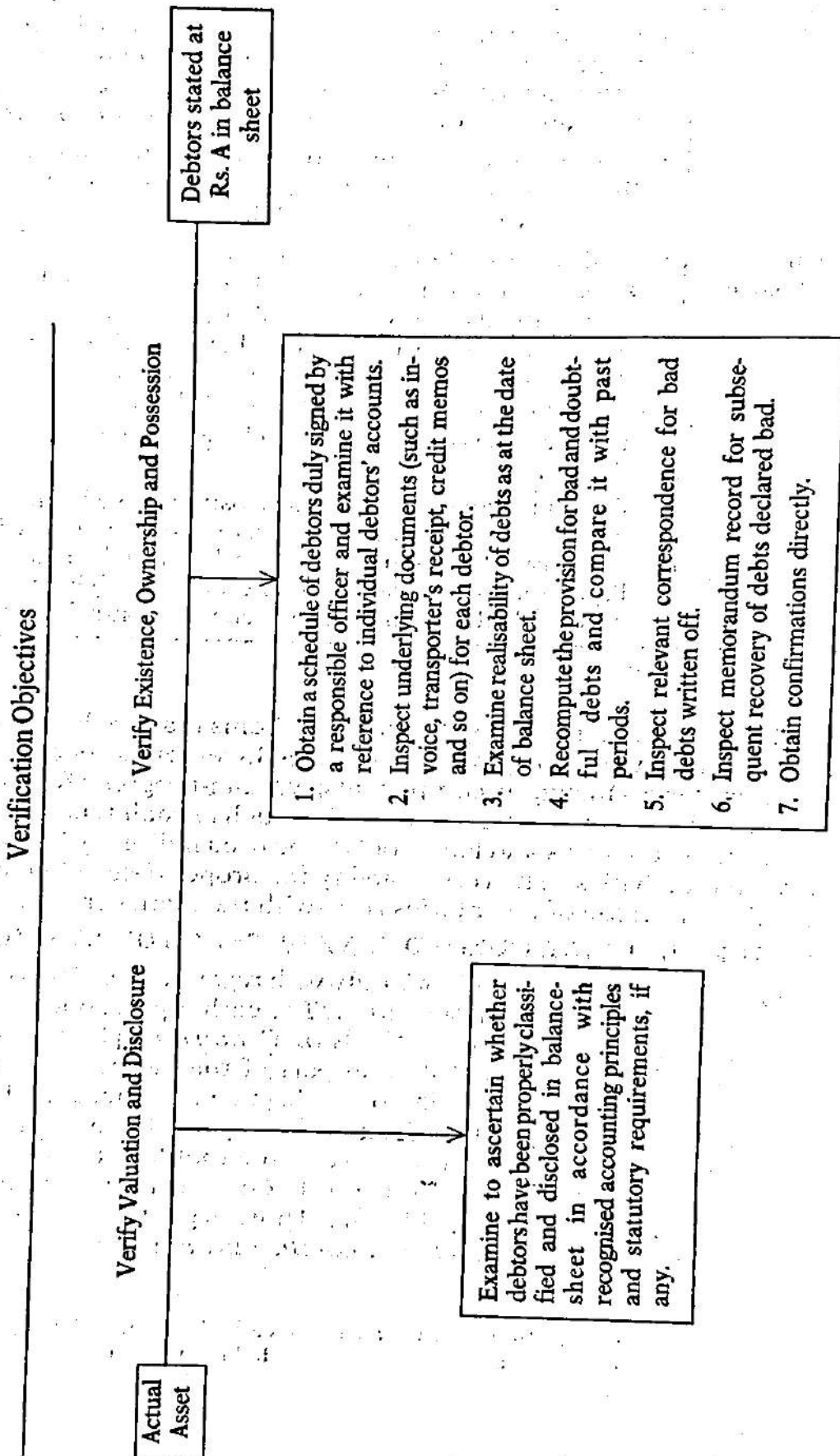
7.8.5 Inventories

- **MEANING** - Inventories consist of tangible items that are held for sale or use in the production of goods and services. Inventories generally consist of raw materials including components; work-in-progress; finished products including by-products and materials such as maintenance supplies, stores and spare parts and loose tools to be used indirectly in production or related activities.⁵ The responsibility for proper determination of the quantity and value of inventories rests with the management.
- **AUDITOR'S DUTY WITH REGARD TO VERIFICATION OF INVENTORY**
 - (a) The perception of auditor's duty with regard to verification of stock has changed in the last century. The earlier perception was based on the judgment given in *Kingston Cotton Mills* [1896] case. In this case, it was held that it is no part of the auditor's duty to take stock and he is not guilty of negligence if he accepts the certificate of a responsible official in this regard. It was further stated that the auditor is entitled to assume that 'tried' servants of the company are honest. He can rely on their representations, provided, he takes reasonable care. Thus, as per the judgment, *physical verification of stock was not the duty of the auditor.*

5. As per the Guidance Note on *Audit of Inventories* issued by ICAI the following are treated as fixed assets and hence capitalised i.e. are not included in inventories—

- (a) Stand-by equipment
- (b) Servicing equipment
- (c) Specialised spares for fixed assets

FIGURE 7.4
SUMMARY OF AUDIT PROCEDURES FOR VERIFICATION OF DEBTORS



- (b) The decisions in the *Westminster Road Construction and Engineering Co. Ltd.* [1932] case in Britain and *McKesson and Robbins* [1939] case in U.S.A. resulted in a reconsideration of auditor's duty in connection with the verification of stock-in-trade. In the *Westminster Road Construction* case, it was held that an auditor was guilty of negligence if he failed to detect over valuation in work-in-progress despite the availability of evidence from which such over valuation could be reasonably deduced. In *McKesson's* case auditor was held responsible for physical verification of stock-in-trade. Although auditor is no longer required to physically count the stock (as decided in *McKesson's* case), the standard audit practices with regard to verification and valuation are essentially based on the decisions given in these two cases. *The audit practices lay emphasis on observation of physical count of inventory by the auditor and testing of the client's procedures for physical count of inventories.*
- (c) The Guidance Note on *Audit of Inventories* issued by the Institute of Chartered Accountants of India has also recommended audit procedures, for verification of inventories, based on the principle laid in *Westminster* case and *McKesson* case. The following discussion is based on the said note.
- **AUDIT PROCEDURES TO BE FOLLOWED IN CASE OF VERIFICATION OF INVENTORIES**
 - (i) **Verify existence, ownership and possession**
 - (a) Examine *stock records* (on a sampling basis) with reference to relevant documentary evidence such as *receiving reports, inspection reports, material issue notes*, etc. Stock records are generally maintained in the form of stores/stock ledger⁶ and, if not, the auditor should increase the extent of other verification procedures.
 - (b) Observe *physical count* of inventory by the management. This, though not a part of auditor's duty, is necessary if he is placing reliance upon the system of physical verification of inventories by the management.
 - (c) While attending the physical verification of the stock, the auditor should :
 - inspect *inventory count instructions* given by the management to the staff performing such function and ensure they are being actually followed;
 - review the *procedures* adopted by the entity to account for the movement of inventories from one location to another during physical count;
 - examine whether *cut-off procedures* over physical stocks are proper; and

6. Stores/stock ledger maintained on a perpetual basis shows in respect of each major item of inventory quantities and value of receipts, issues and balances.

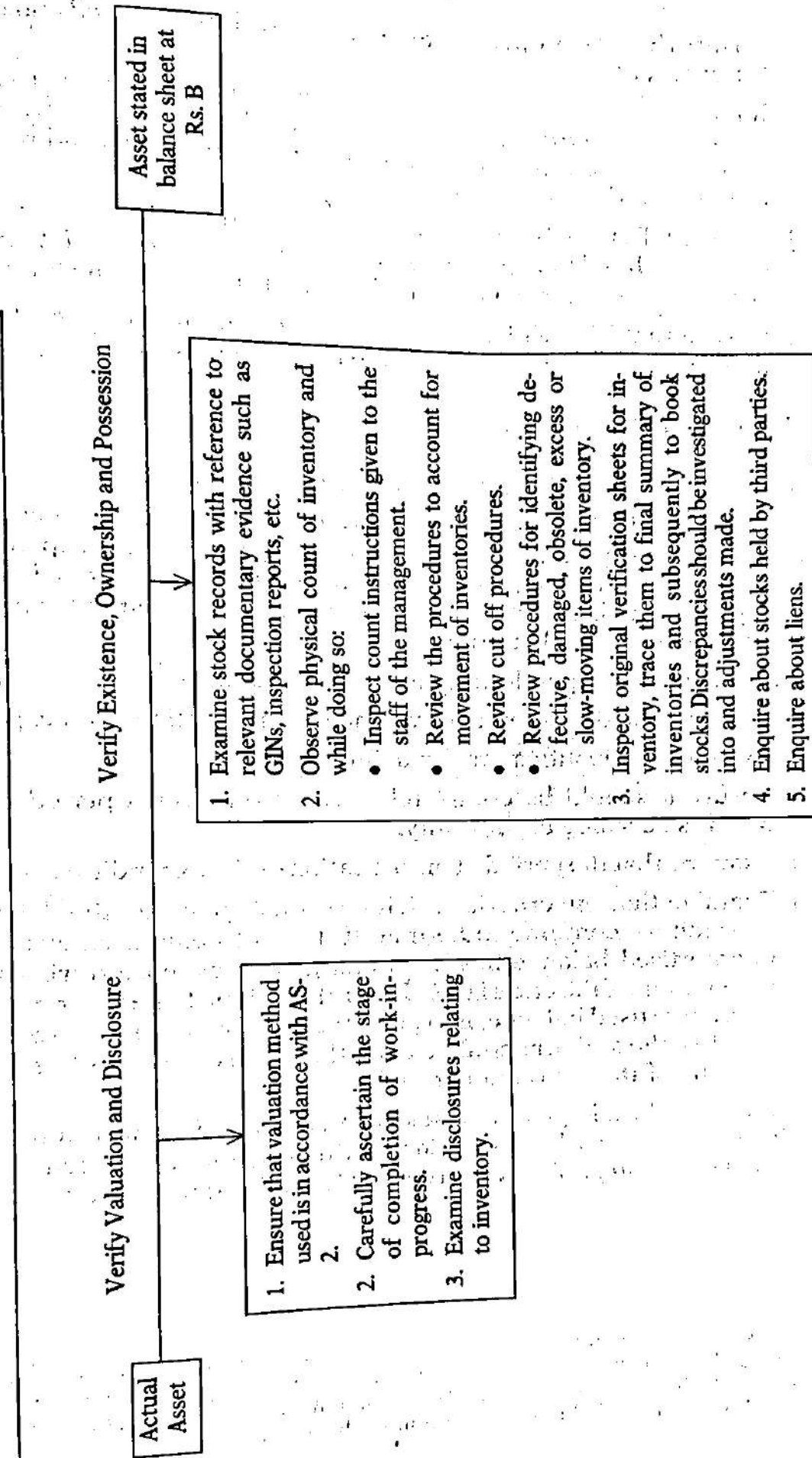
- review the *procedures for identifying* defective, damaged, obsolete, excess and slow moving items of inventory.
 - (d) Review the *original verification sheets*, trace a sample of entries into the *final summary of inventories* and compare it with book stocks. In case of discrepancies between the book stocks and stocks as per physical verification, ensure that they have been properly investigated into and suitable adjustments on account of such discrepancies have been made.
 - (e) For verification of ownership, the auditor should inspect on a test basis, the documents underlying the acquisition of individual inventory items, including *purchase orders, receiving reports and vendors' invoices*.
 - (f) In case of stocks held by third parties such as consignees and agents, the auditor should obtain *direct confirmations* from them.
 - (g) Enquire about *liens* on inventory. They might have been subject to a floating charge.
- (ii) **Examine valuation and disclosure**
- (a) The auditor is not a valuer. His duty is only to verify the inventory valuation stated in the financial statements. He should begin his work with regards to this by investigating the valuation method used by the client and ensuring that inventories are valued in accordance with recognised accounting principles. Accounting Standard (AS)2, *Valuation of Inventories*, issued by ICAI has enumerated the generally accepted accounting principles involved in valuation of most type of inventories.
 - (b) In order to assess the appropriateness of valuation of work-in-progress, the auditor should carefully ascertain its *stage of completion*. For this purpose he may examine the cost records, hold discussions with officers concerned and adopt other audit procedures, as he may think fit.

Bills receivable

7.8-6 The auditor should examine the internal control system with regards to bills receivable and he may adopt the following audit procedures to verify bills receivable—

- (i) Verify the *opening balance of bills receivable* with reference to audited balance sheet of the last year.
- (ii) Examine the transactions recorded in the bills receivable book with reference to the *relevant documentary evidence* such as covering note sent by the customer alongwith payment on maturity of the bill, covering note issued by the bank on discounting, etc.
- (iii) Carry out a *physical verification* of the bills receivable on hand as at the end of the year.

FIGURE 7.5
SUMMARY OF AUDIT PROCEDURES FOR VERIFICATION OF INVENTORY
Verification Objectives



- Ensure they are properly drawn, stamped, duly accepted and not overdue for payment.
- (iv) If bills have been *discounted with bank*, then they should be verified with reference to *confirmation* obtained from the bank and entries in the *cash book*. *Contingent liabilities* in respect of such bills should be shown as a footnote to the balance sheet.
 - (v) If some bills have been *dishonoured*, the auditor should ensure adequate provision has been made for irrecoverable amount. Ensure the concerned party has been informed of the dishonour of its bill.
 - (vi) Ensure that bills which have been *matured* but the *amount* in respect thereof *has not been received*, have been renewed subsequently.

Verification of other items

Deferred Revenue Expenditure/Miscellaneous expenditure⁷

7.9-1 Expenditure which is essentially of a revenue nature but its benefits extend to future accounting periods is treated as deferred revenue expenditure. The unwritten off portion of such expense appears as an asset on the balance sheet. It includes expenses such as huge expenditure on advertisement campaign and development expenses on plantations.

In order to verify such expenditure, the auditor should—

- (i) Examine the documentary evidence substantiating such expenditure.
- (ii) Examine the justification for deferring it.
- (iii) Ensure it should be completely written off over a period over which benefits accruing to the entity.
- (iv) Examine that the period of amortisation of the expenditure is reasonable.
- (v) Examine that the criteria which previously justified the deferral of the expenditure continue to be met. If it is not being met, ensure that the unamortised balance has been charged as expense during the period under audit. If the criteria for deferral continue to be met but the amount of unamortised balance of expenditure is more than the expected future benefits, the auditor should ensure that such excess has been charged to revenue of the period under audit.
- (vi) Examine the adequacy of disclosure as required by Accounting Standard (AS) 26, '*Intangible Assets*', Ensure that the financial statements disclose the accounting policy with regards to such expenditure.

7. The discussion is based on *Guidance Note on Audit of Miscellaneous Expenditure (2003)* issued by the council of the ICAI. Preliminary expenses, expenses relating to subscription or issue of shares, Research and Development Expenditure, besides other items of expenditure are included under the ambit of this Guidance Note.

Capital Commitments

7.9-2 Capital commitment is the amount of capital expenditure on fixed assets which management wants to spend in near future. It is disclosed as a note to the balance sheet. The auditor should—

- (i) Examine the minutes of Board's meetings, purchase order and agreement, if any, with respect to capital commitments.
- (ii) Obtain a management representation to this effect.
- (iii) Ensure that notes to the balance sheet clearly mention the contracted value of the capital expenditure and the amount already disbursed if any.

KEY POINTS

I. Difference between vouching and verification

DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Basis	Vouching	Verification
(i) Meaning	Substantiating the occurrence of transactions	Substantiating the existence of assets and forming an opinion on different aspects
(ii) Scope	Narrow	Wide
(iii) Object	Verify the authority, authenticity and genuineness of transactions	Satisfy as to existence, ownership, possession, valuation and disclosure of items.
(iv) Level of expertise	Done by junior level clerks	Done by senior clerks and auditor himself
(v) Relationship with financial statements	P&L A/c & some B/s items	Only B/s items

2. Difference between verification and valuation of assets

DIFFERENCE BETWEEN VERIFICATION AND VALUATION

Basis	Verification	Valuation
(i) Scope	Includes valuation	Is a part of verification
(ii) Object	To verify existence, ownership, possession and valuation	To ensure assets have been valued according to generally accepted accounting principles
(iii) Responsibility	Auditor	Management