CHAPTER 8

VERIFICATION OF LIABILITIES

Concept

8.1 Liabilities are financial obligations of an enterprise other than owner's equity. These are classified as long-term and short-term liabilities depending upon the time for which resources are needed. Long-term liabilities, which include loans and borrowings, debentures, deposits, etc. are obligations created to generate funds for business for a long period of time (usually more than one year). Resources needed for only a short period of time such as bank overdraft and bills payable and obligations created during the normal course of operations of the business, for example, wages payable and interest payable constitute short-term or current liabilities.

The process of substantiation of liabilities recorded in the books of account by examination of legal and official documents and then forming an expert opinion as to existence, obligation, completeness, valuation and disclosure of liabilities of an entity is called **verification of liabilities.**

Objects of verification of liabilities

8.2 In order to verify the liabilities, the auditor has to ensure that they adhere to following objects—

(*i*) **Existence** - Liabilities shown in the balance sheet are actually payable.

(*ii*) **Obligation** - Liabilities represent obligations of business to third parties created for its legitimate operation.

(*iii*) **Completeness** - All known liabilities have been properly accounted for. Contingent liabilities should have also been shown as a footnote to the balance sheet.

(*iv*) **Valuation** - Liabilities are stated in financial statements at fair and reasonable amounts.

(*v*) **Disclosure** - Liabilities are classified and disclosed in the financial statements in accordance with recognised accounting principles and relevant statutory requirements.

Audit procedures for verification of liabilities

8.3 The audit procedures to be adopted for verification and valuation of various liabilities are discussed in subsequent sub-paragraphs.

8.3-1 Loans and borrowings

(*i*) **Verify existence, obligation and completeness**

(*a*) Examine whether the loans obtained are *within the borrowing powers* of the entity.

(*b*) Examine *relevant records and documentation* supporting the transactions to assess the validity and accuracy of loans. The auditor should keep the following into consideration while doing so—

- The loans and borrowings are valid and have been properly authorised. *For example,* in case of a limited company the auditor should examine board of directors' *authorisation.* In case the enterprise has accepted deposits, the auditor should ensure compliance with *directives* issued by the Reserve Bank of India.
- In case of loans and advances from banks, financial institution and others, whether balance as per books and statement of lenders tally. In case of difference between the two amounts, *reconciliation statement* prepared by the client should account for the reasons.
- Examine *loan agreements* to gain knowledge about important terms affecting the financial statements and ensure their compliance. *For example,* restrictions as to dividend payment, maintenance of debt-equity ratio, retained earning restrictions, restrictions on the issuance of additional debt, etc. should be adhered to.
- Examine *documents* to ensure that statutory requirements, if any, *for creation and registration of charges* in respect of loans and advances have been met.

(*c*) *Confirm* loans and borrowings outstanding and interest payable on them *directly* with the lender.

(*d*) In case the enterprise has *acquired* assets under *hire-purchase agreements,* the auditor should ensure that future instalments have been shown as secured loans.

(*ii*) **Verify valuation and disclosure**

(*a*) The auditor should examine whether liabilities are *classified and disclosed* in the balance sheet in accordance with recognised accounting principles and relevant statutory requirements, if any.

(*b*) Examine whether instalments of long-term loans falling due within next twelve months have been disclosed in the balance sheet as a footnote or in parentheses.

(c) Where the market value of an asset offered as a security against loan has fallen below the amount of loan outstanding, the auditor should ensure that the loan is classified as secured only to the extent of market value of security.

8.3-2 Trade creditors

(i) **Verify existence, obligation and completeness**

(a) Obtain the *schedule of creditors* and examine it with reference to *individual creditors' accounts.* While examining creditors' accounts, the auditor should pay special attention to aspects such as whether adjustments on account of rebates, discounts, returns, etc. appear to be usual, whether there are amounts which remain outstanding beyond the normal credit period granted by suppliers, and so on.

(b) Inspect documents underlying purchases such as *invoices, receiving reports, etc.* and verify individual creditors' accounts balance against these documents.

(c) Vouch *subsequent payments* to trade creditors. Such payments following the end of the period provides a strong evidence to confirm the amount payable at the balance sheet date.

(d) The adequacy of *cut-off procedures* adopted by the business for separating credits and debits to creditor accounts for the year under audit and subsequent year should be checked carefully to know the unrecorded liabilities. It was held in *Westminster Road Construction and Engineering Co. Ltd.* case that the auditor has a duty to determine unrecorded liability in respect of goods received prior to the end of the period under audit which though included in stock, did not have a corresponding entry under liabilities.

(e) The auditor may communicate directly with the creditor so as to obtain *confirmations* of the amount due from them either on the date of balance sheet or as at any other chosen date which is reasonably close to the date of the balance sheet. Further, they may be chosen to be confirmed either by using judgment or statistical sampling.

(ii) **Examine valuation and disclosure -** Ensure that the creditors have been disclosed properly in the financial statements as per the recognised accounting principles and relevant statutory requirements, if any.

8.3-3 Contingent liabilities

(i) **Concept -** Contingent liabilities refer to obligations relating to past transactions or other events or conditions, that may arise in consequence of one or more future events which are presently deemed possible but not probable. The possibility of a contingent liability crystalling into an actual liability, thus, depends upon happening/non-happening of an event. Example of contingent liabilities include the following :

(a) pending or threatened litigation against the entity;

(b) guarantees of third party obligations;

(c) discounted bills receivable; and

(d) membership of a company limited by guarantee.

(ii) **Audit procedures** - The primary auditing objective in case of contingent liabilities is to verify their existence. The following auditing procedures are designed to accomplish that objective:

(a) Obtain a *letter of representation* from the client containing a statement that management is aware of no undisclosed contingent liabilities.

(b) Review the *minutes* of meetings of board of directors and their committees to discover contingency commitments, if any.

(c) Review *contracts, loan agreements* and similar documents for evidence of liabilities.

(d) Review list *of pending legal cases* and analyse the legal expense account and examine documentation (*e.g.*, invoices of attorney). This analysis is directed towards the discovery of possible law suits and tax assessments associated with legal fees paid by the client.

(e) Review *terms and conditions of grants and subsidies* under various schemes to discover the possibility of existence of any contingent liability due to non-compliance with them.

(f) Review *records relating to contingent liabilities* such as relating to bills receivable discounted or loan guarantees.

(g) Ensure that contingent liabilities do not include items such as product warranties, service contracts, etc. on which their is a probability of loss. In such cases, the board should provide for a provision against contingent loss in the financial statements.[1] The auditor should assess the reasonableness of amount of such provision with reference to relevant agreements and his past experience.

Provision for income-tax

8.3-4 Various audit procedures adopted for verifying provision for income-tax are given below—

(i) Recalculate the provision for tax liability for the year as per the provisions of the Income-tax Act, 1961 and rules made thereunder.

(ii) Examine records and documents such as *receipted challans, bank statements* and *demand notices* to gain knowledge about payment of advance tax, self-assessment tax and any other demand raised by Income-tax department during the year.

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1. Accounting Standard (AS) 4, *Contingencies and Events Occurring after the Balance sheet Date*, issued by ICAI, states that a contingent loss should be provided for if—

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

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

(*iii*) Review the *assessments* completed, revised or rectified upto the time of audit and ensure suitable adjustments have been made in respect of additional demands or refunds.

(*iv*) In case of disputed liability with regards to demands raised, examine whether there is a positive evidence of action by the enterprise to show that it has not accepted the demands, *e.g.*, it has gone to *appeal* against the demand or had made an *application* for rectification of a mistake.

(*v*) The auditor should also examine whether disputed tax liability requires a provision or suitable disclosure. The probability of such a provision can be assessed after making appropriate *enquiries* of management, examining the *correspondence* relating to dispute and obtaining management *representation.*

(*vi*) Ensure proper disclosure alongwith accounting policy adopted.

Debentures

8.3-5 The auditor may adopt the following procedures to verify debentures—

(*i*) Examine the memorandum and articles of the company to ascertain the borrowing powers of the company and limitation thereon, if any.

(*ii*) Vouch the cash received from the issue of debentures with the cash book, bank statement, application and allotment book and register of debenture holders.

(*iii*) Examine the list/register of debenture holders and ensure that the total amount received from debenture holders agrees with the total amount of debentures shown in the balance sheet.

(*iv*) Examine debenture trust deed in order to ascertain the terms and conditions of the issue.

(*v*) Ensure compliance with provisions of section 71 of the Companies Act, 2013, SEBI guidelines and listing requirements, if any.

(*vi*) Examine register of charges to ensure that charge created has been properly registered.

(*vii*) Ensure that the provisions regarding redemption of debentures have been adhered to.

TEST YOUR KNOWLEDGE

QUESTIONS WITH BRIEF ANSWERS

1. How will you verify/vouch :—

(*i*) Contingent liabilities *(D.U., B.Com. (H.), 1996) (D.U., B.Com. (H.), 1994)*

(*ii*) Loans and advances

[Hint : Refer paragraphs (*i*) 8.3-3, (*ii*) 8.3-1]