Chapter 6 VERIFICATION OF LIABILITIES

EWUS6K

Learning Objectives

- To understand the various forms of liabilities.
- To define the auditors duty with regard to verification of various liabilities.

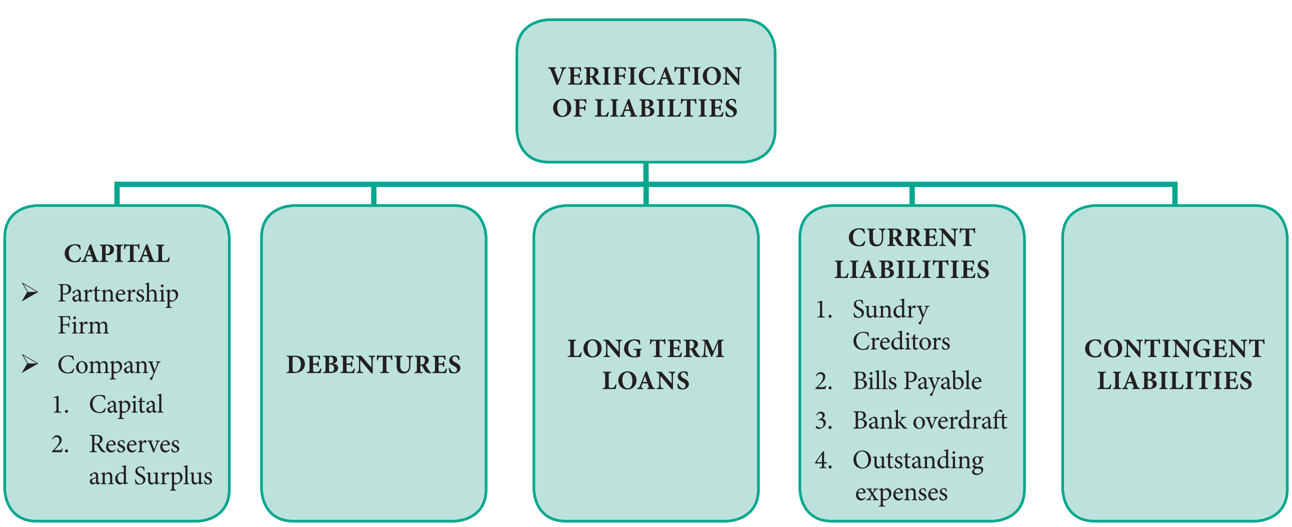
POINTS TO RECALL

RECAP

From the previous chapter, we have studied the meaning and classification of assets and procedures for verification and valuation of fixed assets, investments, current assets and intangible assets.

6.1 Introduction

Liabilities are legal obligations of the organization to third parties. It is in the form of Capital, Debentures, Long term loans, payment to suppliers against goods and expenses, contingent liabilities etc. Verification of liabilities is as important as 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. The main objective of verifying liabilities is to ensure that all the liabilities are properly disclosed, valued, classified and presented in the Balance Sheet. The diagram given below shows the various types and classifications of liabilities.



6.2 Verification of Capital

The amount invested by the owner in a business concern is called as Capital. The owner may be a sole proprietor or partner or shareholder. It is an internal liability of the business concern and the auditor is required to verify the genuineness and correctness of it in the Balance Sheet.

6.2.1 Verification of Capital in a Partnership Firm

The auditor should take into consideration the following while verifying capital of a partnership firm.

1. **Verify Partnership Deed:**

   The auditor should verify the partnership deed to find out the original capital contributed by each partner and the rate of interest payable on capital.

2. **Verify Capital Accounts:**

   He should verify all the transactions affecting the capital accounts of the partner.

3. **Examine Books of Accounts:**

   He should examine the cash book, pass book and withdrawals of the partners.

6.2.2 Verification of Capital in a Company

While verifying the capital of a company, the auditor should verify the share capital and the level of reserves and surplus maintained by the company.

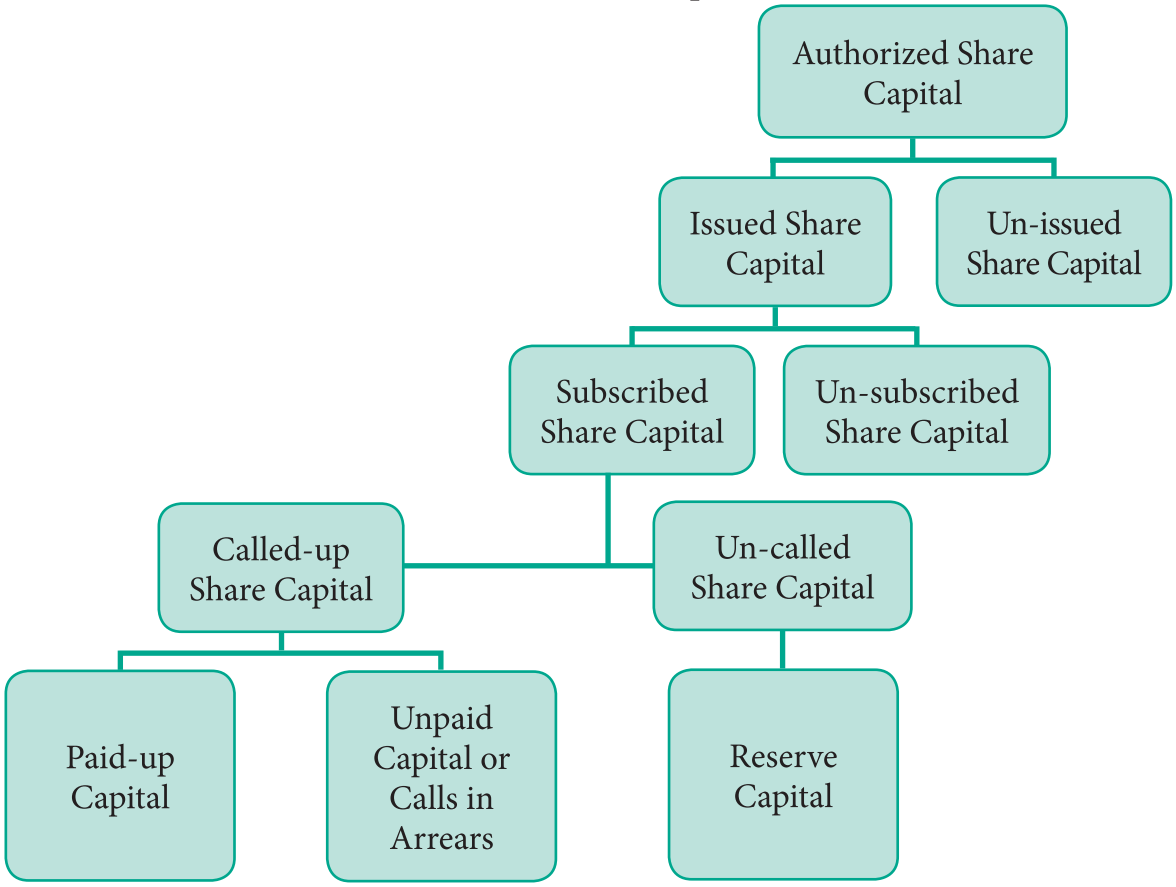
Meaning of Share Capital

Share capital means the capital raised by issue of shares. It is the amount invested by shareholders towards the face value of shares are collectively known as Share Capital.

Sub-Divisions of Share Capital

- **Authorised Capital:** It is the maximum amount of capital which a company is authorised to raise and is stated in the Memorandum of Association. It can also be called as "Registered Capital" or "Nominal Capital".
- **Issued Capital:** This represents a part of the authorized capital, which is issued to the public for subscription.
- **Unissued Capital:** The difference between authorised capital and the issued capital represents unissued capital.
- **Subscribed Capital:** It refers to that part of the issued capital which has been subscribed by the public.
- **Unsubscribed Capital:** The difference between issued capital and subscribed capital represents unsubscribed capital.
- **Called-up Capital:** This refers to that part of the subscribed capital which has been called up by the company for payment.
- **Un-called Capital:** The difference between subscribed and called-up capital is called as un-called capital.
- **Paid-up Capital:** It is that part of called-up capital which has been actually paid-up by shareholders.
- **Unpaid Capital:** The un-paid balance in the called-up capital

Sub-Divisions of Share Capital



is known as "calls in arrears" or "un-paid capital".

- **Reserve Capital:** A company can reserve part of its un-called capital and will be called only at the time of winding up. A special resolution has to be passed for this purpose. It is not disclosed in the company's balance sheet.

Auditor's Duty in Verification of Share Capital

The auditor's role in verifying the Share Capital is listed below:

1. **Verify Memorandum of Association and Register of Members:** In case of first audit, the auditor should check the Memorandum of Association, list of share holders and register of members for verification of share capital.
2. **Vouch Entries:** He should examine the pass book, cash book, and Minute book of directors in order to find out the number of shares issued, different types of shares issued and the amount received on each shares.
3. **Compliance with the Provisions of Companies Act:** In case of subsequent audits, the auditor should ensure that the share capital balance is the same as at the end of last year. If he finds that the capital stands altered by fresh issue of shares, the auditor should ensure that relevant provisions of the Companies Act have been complied with.
4. **Disclosure in Balance Sheet:** He should ensure that 'authorised capital' and each class of issued and subscribed capital has been shown separately in the Balance Sheet.
5. **Examine Rights of Shareholders:** He should examine the rights attached

to various shares in the Articles of the company.

6. **Issue at Premium:** Where the shares are issued at premium, he should verify that they are shown separately in the Balance Sheet.
7. **Issue of Shares for Consideration other than Cash:** Where the shares were allotted for consideration other than cash, he should examine the contract constituting with the vendor share and minutes book of the board.
8. **Verify RBI's Approval:** Where shares are allotted to foreign nationals, the auditor should verify RBI's permission in this regard.
9. **Forfeiture and Reissue of Shares:** The auditor should ensure that Articles of Association permit for forfeiture shares of and check the entries regarding forfeiture and reissue of shares.
10. **Transfer of Capital Profit:** He should verify that capital profit if any on reissue of forfeited shares has been transferred to Capital Reserve.

6.2.3 Verification of Reserves and Surplus

Meaning

Reserves and Surplus is that portion of current profits or of accumulated profits which is not distributed as dividend, but is kept separate for purposes of meeting some known or unknown liabilities or for fulfillment of future needs.

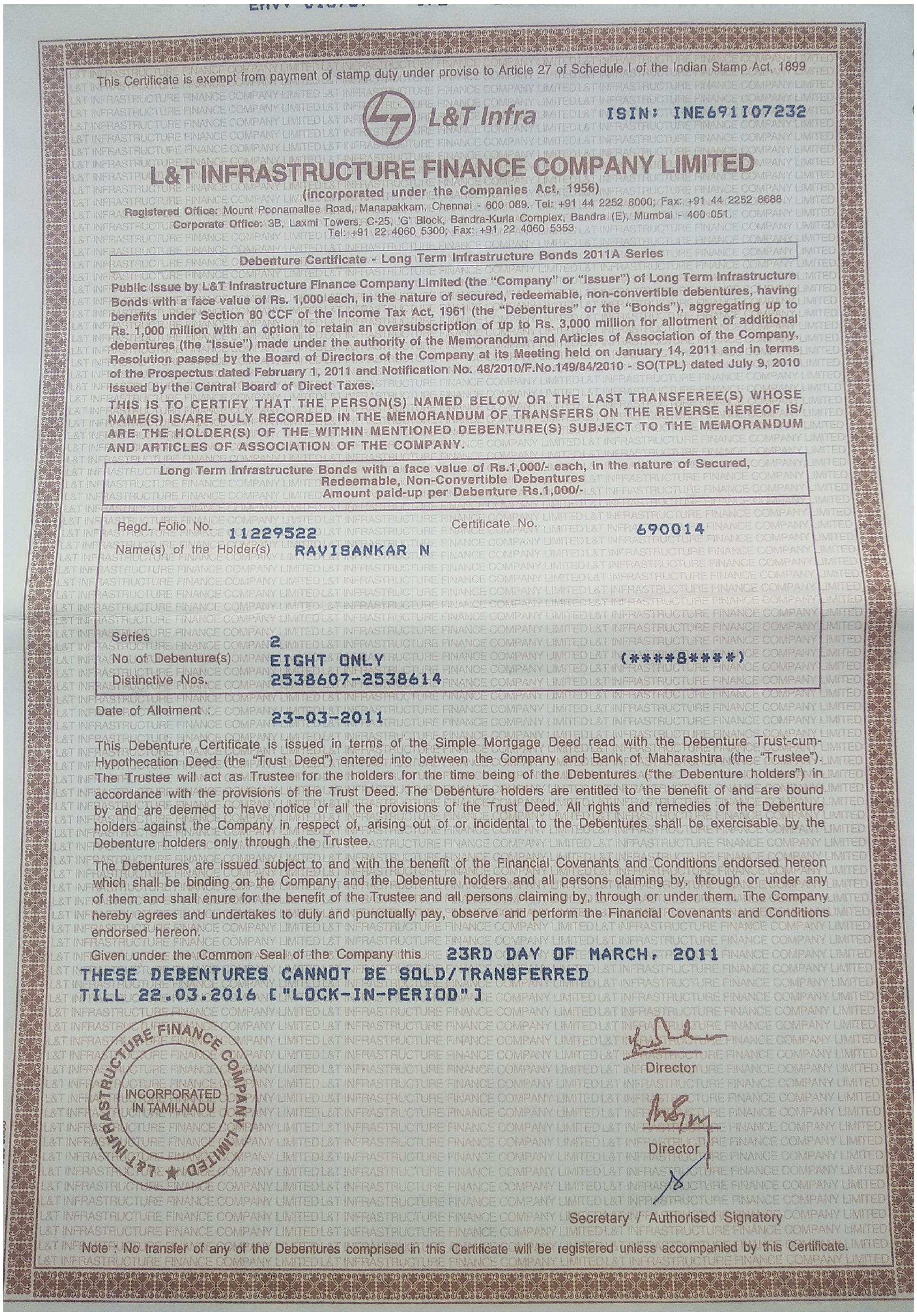
Auditor's Duty

Reserves and surplus are appropriation out of profits. The auditor should verify that the reserves and surplus are shown on the liability side of Balance Sheet with footnotes and verify entries in the Profit and Loss Appropriation Account.

6.3 Verification of Debentures

6.3.1 Debentures - Meaning

Debenture means a document issued by a company to raise finance. It is an acknowledgement of a debt which is given under the common seal of the company.



This Certificate is exempt from payment of stamp duty under proviso to Article 27 of Schedule I of the Indian Stamp Act, 1899

L&T Infra

ISIN: INE691I07232

L&T INFRASTRUCTURE FINANCE COMPANY LIMITED

(incorporated under the Companies Act, 1956)

Registered Office: Mount Poonamallee Road, Manapakkam, Chennai - 600 089. Tel: +91 44 2252 6000; Fax: +91 44 2252 8688

Corporate Office: 3B, Laxmi Towers, C-25, 'G' Block, Bandra-Kurla Complex, Bandra (E), Mumbai - 400 051. Tel: +91 22 4060 5300; Fax: +91 22 4060 5353

Debenture Certificate - Long Term Infrastructure Bonds 2011A Series

Public Issue by L&T Infrastructure Finance Company Limited (the "Company" or "Issuer") of Long Term Infrastructure Bonds with a face value of Rs. 1,000 each, in the nature of secured, redeemable, non-convertible debentures, having benefits under Section 80 CCF of the Income Tax Act, 1961 (the "Debentures" or the "Bonds"), aggregating up to Rs. 1,000 million with an option to retain an oversubscription of up to Rs. 3,000 million for allotment of additional debentures (the "Issue") made under the authority of the Memorandum and Articles of Association of the Company, Resolution passed by the Board of Directors of the Company at its Meeting held on January 14, 2011 and in terms of the Prospectus dated February 1, 2011 and Notification No. 48/2010/F.No.149/84/2010 - SO(TPL) dated July 9, 2010 issued by the Central Board of Direct Taxes.

THIS IS TO CERTIFY THAT THE PERSON(S) NAMED BELOW OR THE LAST TRANSFEREE(S) WHOSE NAME(S) IS/ARE DULY RECORDED IN THE MEMORANDUM OF TRANSFERS ON THE REVERSE HEREOF IS/ARE THE HOLDER(S) OF THE WITHIN MENTIONED DEBENTURE(S) SUBJECT TO THE MEMORANDUM AND ARTICLES OF ASSOCIATION OF THE COMPANY.

Long Term Infrastructure Bonds with a face value of Rs.1,000/- each, in the nature of Secured, Redeemable, Non-Convertible Debentures
Amount paid-up per Debenture Rs.1,000/-

Regd. Folio No. 11229522 Certificate No. 690014

Name(s) of the Holder(s) RAVISANKAR N

Series 2

No of Debenture(s) EIGHT ONLY (****8*****)

Distinctive Nos. 2538607-2538614

Date of Allotment : 23-03-2011

This Debenture Certificate is issued in terms of the Simple Mortgage Deed read with the Debenture Trust-cum-Hypothecation Deed (the "Trust Deed") entered into between the Company and Bank of Maharashtra (the "Trustee"). The Trustee will act as Trustee for the holders for the time being of the Debentures ("the Debenture holders") in accordance with the provisions of the Trust Deed. The Debenture holders are entitled to the benefit of and are bound by and are deemed to have notice of all the provisions of the Trust Deed. All rights and remedies of the Debenture holders against the Company in respect of, arising out of or incidental to the Debentures shall be exercisable by the Debenture holders only through the Trustee.

The Debentures are issued subject to and with the benefit of the Financial Covenants and Conditions endorsed hereon which shall be binding on the Company and the Debenture holders and all persons claiming by, through or under any of them and shall enure for the benefit of the Trustee and all persons claiming by, through or under them. The Company hereby agrees and undertakes to duly and punctually pay, observe and perform the Financial Covenants and Conditions endorsed hereon.

Given under the Common Seal of the Company this 23RD DAY OF MARCH, 2011

THESE DEBENTURES CANNOT BE SOLD/TRANSFERRED TILL 22.03.2016 ["LOCK-IN-PERIOD"]

L&T INFRASTRUCTURE FINANCE COMPANY LIMITED ★ INCORPORATED IN TAMILNADU

Director

Director

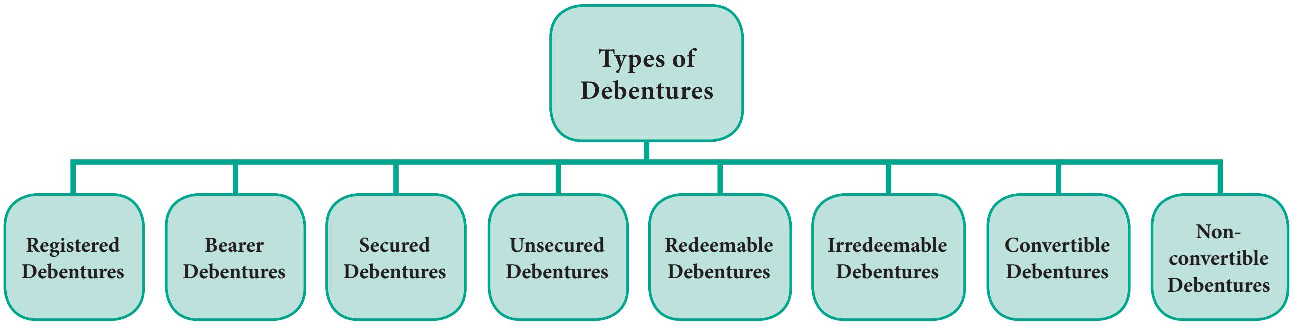
Secretary / Authorised Signatory

Note : No transfer of any of the Debentures comprised in this Certificate will be registered unless accompanied by this Certificate.

6.3.2 Types of Debentures

1. **Registered Debentures:** Registered Debentures are those which are transferable only by transfer deed names, address and particulars of the debentures possessed by holders are entered in the register. Interest is paid to one whose name appears in the register.

2. **Bearer Debentures:** Bearer Debentures are those which are transferred by mere delivery and company does not keep any record of debenture holders name and address. Payment of interest is made on submission on coupons attached to the debentures.



3. **Secured Debentures or Mortgage Debentures:** Mortgage debentures are those debentures that are secured either on a particular asset called fixed charge or on general assets of the company called floating charge. Mortgage debentures are also called collateral debentures. In this case, debentures may also be issued to banks and financial institutions as addition or subsidiary security along with certain principal security. Lending institutions can exercise their right as debenture-holders, if the company does not pay its loan and the principal security falls short.
4. **Un-secured or Naked Debentures:** Naked debentures are those which are not secured, companies of very good standing are able to issue Debentures of this type. They are not very common.
5. **Redeemable Debentures:** Redeemable Debentures are those debentures which are redeemed or the payment of which is made after a specified Period.

   Debentures are redeemable in the following manner:

   (i) At the expiry of a specified period at par or at a premium.

   (ii) Through purchase in the open market any time, at the price prevailing in the market.

   (iii) By annual drawings.
6. **Irredeemable Debentures:** Irredeemable Debentures are those for which the issuing company does not fix any date by when they should be redeemed and the holders of such Debentures cannot demand payment from the company so long as it is going concern. Usually such Debentures are repayable after a long period of time or when the company is winding up.
7. **Convertible Debentures:** Convertible Debentures are those whose holders are given the option to convert the debentures fully or partly into equity shares after a specified Period. Those which are fully convertible are called fully Convertible Debentures and those which are partly Convertible are called partly convertible debentures.
8. **Non-convertible Debentures:** Non-convertible debentures are those whose holders have no right to convert them into equity shares.

6.3.3 Auditor's Duty in Verification of Debentures

The auditor should note the following points while verifying debentures:

1. **Verify Borrowing Powers:** The auditor should verify the Memorandum and Articles of Association of the company and verify whether the company has got the power to issue debentures and ascertain the borrowing limits of the company.

2. **Verify Terms of Issue:** He should ensure that the terms of the issue have been complied with.
3. **Examine Debenture Trust Deed:** He should examine the Debentures Trust Deed to know the amount of debentures issued and securities offered and he should obtain a certificate from the debenture holder to confirm the debenture amount.
4. **Redemption of Debentures:** He should make an inquiry regarding Debenture redemption and verify the Articles of Association for the Debenture redemption fund.
5. **Issue at Premium or Discount:** He should examine whether premium or discount on issue of Debentures are properly disclosed in the Balance Sheet.
6. **Compare Register of Charges and Register of Debenture Holders:** He should compare the register of charges and register of debenture holders and check whether it is recorded correctly and verify that the assets mortgaged or charged are clearly indicated in the Balance Sheet.

6.4 Verification of Long Term Loans

Loans or Borrowings of a concern may be either secured or unsecured or may be for a short or long period.

6.5 Verification of Current Liabilities

Auditor's Duty

The auditor while verifying loan in general has the following duties:

1. **Verify Loan Agreement:** The auditor should verify the loan agreement and refer to the correspondences for getting the loan.
2. **Enquire Purpose of Loan:** He should enquire the purpose or purposes for which loan has been raised and also confirm that the loan raised are being utilized for the specific purpose for which it is being obtained.
3. **Examine Borrowing Powers:** He should examine the borrowing powers of the company by referring to the Memorandum and Articles of Association of the company.
4. **Disclosure in Balance Sheet:** He should verify that secured loans are shown separately from unsecured loans and any interest due but not paid is treated as a current liability in the Balance Sheet.
5. **Obtain Confirmation Letter:** He should obtain confirmation letter from the parties who have advanced loans and should verify the balances with the books.

Current liabilities are those liabilities which are payable within one year. This includes bank overdraft, sundry creditors, bills payable and outstanding expenses.

6.5.1 Sundry Creditors

MEANING

A person who gives a benefit without receiving money or money's worth immediately but to claim in future is a creditor. The creditors are shown as a current liability in the Balance Sheet.

AUDITOR'S DUTY

1. **Verify Books of Prime Entry:**

   The postings in purchase ledger are to be checked by verifying the books of prime entry. The postings may be checked for part of a year.
2. **Verify Statement of Accounts:**

   The balances shown in credit of suppliers account are to be verified with the statement of accounts obtained from the creditors.
3. **Verify Credit Entries:**

   The credit entries relating to discounts, returns, rebates etc. made in the suppliers account are to be verified with the statement of accounts obtained from them.

4. **Accounting of Purchase Returns:**

   The return outwards book is to be compared with the ledger accounts and confirm that all the returns are supported by the credit notes of the suppliers.

5. **Purchases of Subsequent Year:**

   The purchase invoices relating to the period immediately following the close of the year, are to be verified to ensure that they do not relate to the period under audit.

6. **Obtain Reasons for Outstanding Balance**

   The balances outstanding for a long period is to be probed and reasons for the same are to be found out.

7. **Comparison of Gross Profit:**

   Percentage of gross profits of the previous years is to be compared with the gross profits of the year under audit. Variation if any, found to be unreasonable or omission of purchase or inclusion of fictitious purchases are to be considered.

8. **Confirmation from Management**

   The auditor shall obtain from the management a certificate that all liabilities that had accrued till the close of the accounting year are carefully accounted for.

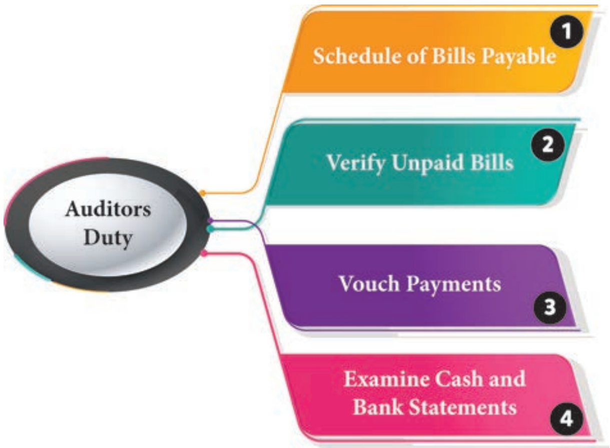
6.5.2 Bills Payable

MEANING

Bill refers to bill of exchange. Bills payable means bills acccepted for the credit purchases made. The amounts on bills are payable at its due dates. It is a current liability.

AUDITOR'S DUTY

1. **Schedule of Bills Payable:** The auditor should get a schedule of bills payable and compare with the Bills Payable Book and Bills payable Account.
2. **Verify Unpaid bills:** He should verify unpaid bills and check the subsequent payments with the cash book.
3. **Vouch Payments:** He should vouch the payments made against bills payable.
4. **Examine Cash and Bank Statements:** He should examine cash and bank statements for the bills which are met after the date of Balance Sheet but before the date of audit.



6.5.3 Bank Overdraft

MEANING

It is a line of credit extended by a bank to its account holder to withdraw money in excess of the balance in his account up to a specified limit. It is a current liability as the business concern, being an account holder is liable to repay the amount to the bank.

AUDITOR'S DUTY

1. **Verify Borrowing Powers:** The auditor should examine the Memorandum and Articles of Association to know the borrowing powers of the company.

2. **Verify Details of Contract:** He should study the loan contract, terms and conditions of loan, rate of interest, nature of security, type of pledge etc.
3. **Proper Authorisation by Directors:** He should refer the minuts book of directors to know that bank overdraft is duly authorised.
4. **Confirm Overdraft Balance:** He should confirm the amount of overdraft from the bank at the close of the year.

6.5.4 Outstanding Expenses

MEANING

Expenses which have been incurred but not yet paid during the accounting period for which the final accounts are being prepared are called as Outstanding Expenses.

AUDITOR'S DUTY

1. **Verify list of Outstanding Expenses:** The auditor should ask for a list of outstanding expenses certified by a responsible officer from the client with classification as per the nature of expenses.
2. **Verify Cash Book:** He should check the next year cash book to confirm that they have been paid off by the time of audit.
3. **Compare Expenses with Previous year:** He should compare the list of outstanding expenses of the current year with that of the previous year to identify deviations, if any.
4. **Verify Provision Created:** He should see whether necessary provision for all outstanding expenses has been made by checking relevant receipts and vouchers.

6.6 Verification of Contingent Liabilities

6.6.1 Meaning

Contingent liabilities are those liabilities, which may or may not arise in the future for payment. The auditor should ensure that all known and unknown liabilities

have been accounted in the books of accounts and have been shown in the Balance Sheet.

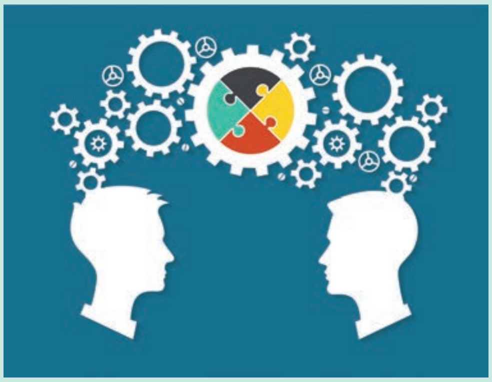
The following are the examples of Contingent Liabilities:

1. Liabilities on Bills Receivable discounted and not matured.
2. Liability on account of partly paid calls.
3. Liability on arrears of dividend on Cumulative Preference Shares.
4. Liability under a guarantee.
5. Liability for penalties under forward contracts
6. Liability that arises on account of litigation in respect of labour suits, trademarks, copyrights etc.

6.6.2 Auditor's Duty in Verifying Contingent Liabilities

1. **Ensure Creation of Adequate Provision:**
   The auditor should ensure that proper provision has been made for certain liabilities, for example, liability which arise on account of litigation and if he is not satisfied, the fact should be stated in the report.
2. **Disclosure in Balance Sheet:**
   In respect of certain liabilities for which no provision has been made in the books for example, Bills Receivable which has been discounted, arrears of accumulated fixed dividend etc. The auditor should verify that such liabilities are disclosed as foot note in the Balance Sheet.

STUDENTS ACTIVITY



1. Discuss long term liability, short term liability and current liability of an industry
2. Discuss the financial arrangements made to meet the unforeseen expenses in your institution

SUMMARY

- The auditor should take into consideration the following while verifiying liabilities: (1) whether proper records are maintained, (2) whether liabilities are actually payable and properly disclosed in balance sheet.
- Auditor should verify Share Capital with reference to the following - Memorandum of association and register of member, Vouch entries in cash and pass book,

Examine contracts with promoters and vendors, Properly disclosed in balance sheet and comply with provisions of Companies Act.

- Auditor should verify Reserves and Surplus with reference to the following - Creation of reserve, Utilisation of reserve, Disclosure in balance sheet, Confirm the rate of premium, Examine prospectus, articles of association and minutes of directors and Transfer of premium to securities premium account.
- Verification of debentures: Borrowing powers of the company, Terms of issue, Examine the debentures trust deed, Verify articles with regard to redemption of debentures and Compare register of charges and register of Debenture holders.
- Verification of Creditors: Schedule of creditors Vouch entries and postings, Verify goods inward register, Verify discounts and Verify hire purchase agreement.
- Verification of outstanding expenses: Verify statement of outstanding expenses, Provision for expenses, Compare balance with last year and Subsequent payment of expenses.
- Verification of contingent liabilities: Contingent liabilities are a liability which may or may not arise in the future for payment. The auditor has to check that all the known and unknown liabilities are shown in the balance sheet.

KEY TERMS

- **Shares:** It is a part of the share capital.
- **Debentures:** It is a credit bond issued by a company.
- **Share Capital:** A capital raised by the company by issue of shares.
- **Bearer Debenture:** A bearer debenture is an unregistered unsecured bond and are not recorded in the company's debenture-holders register with full details of every debenture holder.
- **Secured Debenture (or) Mortgage Debenture:** The debenture secured by a charge on the fixed asset of the issued company.
- **Un-secured (or) Naked Debentures:** Debentures that are not supported by a collateral security.
- **Contingent Liability:** A liability which may or may not occur in the future.

EVALUATION

I. Multiple Choice Questions:

1. The liability which may or may not arise in the future for payment is ______________.
   a. Certain liability
   b. Contingent liability
   c. Expenses
   d. Revenues

2. While verifying the capital of a partnership firm, the important document to be verified is __________.
   a. Memorandum of Association
   b. Partnership Deed
   c. Both
   d. None of the above

3. While verifying the share capital of joint stock companies, the important document to be verified is __________.
   a. Memorandum of Association
   b. Partnership Deed
   c. Both
   d. None of the above

4. ______________ denotes the verification made by the auditor to know whether the liabilities are properly valued.
   a. Valuation
   b. Assessment
   c. Computation
   d. None of the above

5. Creditors and Bank over draft are ______________
   a. Current Assets
   b. Fixed Assets
   c. Current Liabilities
   d. Fixed Liabilities

6. In ______________ side of the balance sheet, outstanding wages, salaries, rent, tax and interest etc. have to be shown.
   a. Assets
   b. Liabilities
   c. Both
   d. None of the above

7. The difference between the subscribed capital and called-up capital is called ______________
   a. Calls-in Arrears
   b. Calls-in Advance
   c. Paid-up Capital
   d. Reserve Capital

8. ______________ is created out of capital profits of the company.
   a. Capital Reserve
   b. Reserve Capital
   c. Subscribed Capital
   d. Calls-in Advance

9. ____________ is an acknowledgement of a debt received by the company.
   a. Shares
   b. Debentures
   c. Bonds
   d. Fixed Deposits

10. ______________ are those debentures for which repayment is made after a specified period.

a. Redeemable Debenture

b. Irredeemable Debenture

c. Convertible Debenture

d. Secured Debenture

Answers: 1. (b), 2. (b), 3(a) 4(a), 5.(c), 6.(b), 7.(a), 8.(a), 9.(b), 10.(a)

II. Very short answer questions:

1. What do you mean by verification of liabilities?
2. What is calls-in advance?
3. What is a debenture?
4. What is calls-in arrears?
5. What is Bank Overdraft?

III. Short answer questions:

1. What do you mean by share capital?
2. What is contingent liability?
3. What do you understand by authorised capital?
4. What is reserve capital?
5. What are the kinds of Debentures?

IV. Essay type questions:

1. Explain the types of share capital
2. Explain the auditor's duty with regard to share capital
3. Explain the auditor's duty in respect of capital reserve
4. Explain the auditor's duty in relation to contingent liability?
5. As an Auditor, how will you verify loans taken by a business concern?

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