

Technical Guide on Stock and Receivables Audit

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Internal Audit Standards Board
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Glossary

Cash Credit

A credit facility under which a customer draws up to the preset limit, subject to availability of sufficient security with the bank. The difference between an overdraft and cash credit account is that while the former is extended more to individuals, and less for business, the latter is extended only to business bodies. The cash credit facility is unique to India, as in most of the countries it is called overdraft.

Further the cash credit facility is more or less on a permanent basis so long as the business is going on. Internationally, at the end of specific period the overdraft facility is withdrawn and the customer is required to pay back the amount lent by the bank. The purpose of cash credit is for working capital. The operations are similar to overdraft.

Cash credit facility is of two types (depending upon the type of charge on goods taken as security by bank.)

- (i) *Cash Credit - Pledge*: when the possession of the goods is with the bank and drawings in the account are linked with actual movement of goods from/to the possession of the bank. The physical control of the goods is exercised by the bank.
- (ii) *Cash Credit - Hypothecation*: when the possession of the goods remains with the borrower and a floating charge over the stocks is created in favour of the bank. The borrower has complete control over the goods and the drawings in the account are permitted on the basis of stock statements submitted by the borrower.

Causes of NPA

NPA arises due to a number of factors or causes like:-

- (i) *Speculation*: Investing in high risk assets to earn high income.
- (ii) *Default*: Willful default by the borrowers.

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- (iii) *Fraudulent Practices*: Fraudulent Practices like advancing loans to ineligible persons, advances without security or references, etc.
- (iv) *Diversion of Funds*: Most of the funds are diverted for unnecessary expansion and diversion of business.
- (v) *Internal Reasons*: Many internal reasons like inefficient management, inappropriate technology, labour problems, marketing failure, etc. resulting in poor performance of the companies.
- (vi) *External Reasons*: External reasons like a recession in the economy, infrastructural problems, price rise, delay in release of sanctioned limits by banks, delays in settlements of payments by government, natural calamities, etc.

Charge on Assets of a Company

A charge means an interest or right which a lender or creditor obtains in the property of the company by way of security that the company will pay back the debt. Charges are of following two types:

- (i) *Fixed charge*: Such a charge is against a specific clearly identifiable and defined property. The property under charge is identified at the time of creation of charge. The nature and identity of the property does not change during the existence of the charge. The company can transfer the property charged only subject to that charge so that the charge holder or mortgagee must be paid first whatever is due to him before disposing off that property.
- (ii) *Floating charge*: Such a charge is available only to companies as borrower. A Floating charge is attached to any definite property but covers the property of a fluctuating nature such as, stock-in-trade, debtors, etc. It attaches to the property charged in the varying conditions in which happens to be from time to time. Such a charge

remains dormant until the undertaking charge ceases to be a going concern or until the person in whose favor charge created takes steps to crystallize the floating charge. A floating charge on crystallization becomes a fixed charge.

Consortium Lending

This approach to lending was introduced by the RBI in 1974. Accordingly, more than one bank finances, a single borrower requiring large credit limit. It (a) enables banks to spread risk of lending, (b) broke the monopoly of big banks to have large accounts, (c) enables banks to share experience and expertise, (d) introduces uniformity in approaches to lending, (e) enables banks to pool resources, and (f) checks multiple financing of the same account.

Each consortium has a lead bank, which has the largest share in the loan, which processes the loans low rates proposal, which calls the meetings of the consortium for sanction of limits and review of accounts, which obtains RBI permission for credit limits, and which conducts joint inspection of the borrowers activities. The borrower executes a single set of documents with the lead bank. It obtains the letter of authority from member banks and releases the initial requirements of the borrower. Thereafter it obtains reimbursements from the member banks to the extent of their shares in advance. If the member banks delays the reimbursement beyond a week, the lead bank was entitled to charge a penal interest for the period of delay. This arrangement was also called a Single Window Lending.

Creditors

An entity (person or institution) that extends credit by giving another entity permission to borrow money with a stipulation for repayment at a later date.

**Debtors/
Receivables**

A person or entity that owes an amount of money or favor to.

Drawing Power

It is the limit up to which the borrower can utilize the cash credit. Drawing power is required to be arrived at based on the stock statement which is current. If

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the outstanding exceeds the drawing power, it will attract penal interest. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. While calculating drawing power based on stock and debtors statements, care must be taken to exclude old, obsolete and non-moving stock and long outstanding debtors.

Inventories	<p>Inventories denotes tangible property held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or services for sale, including maintenance supplies and consumables stores and spare parts meant for replacement in the normal course.</p> <p>Paid inventories refers to the inventories which is fully paid, i.e., excluding Sundry creditors.</p>
Limit Sanctioned	<p>This refers to the extent of facility granted to the borrower based on his working capital requirements and securities offered. In the case of cash credit, it is the limit up to which the borrower can withdraw from his borrowal account. The extent to which the borrower draws up to his pre set limit depicts the utilized amount.</p>
Margin Money	<p>Margin money is like a security deposit retained by the bank till the loan is fully settled.</p> <p>The credit limit is sanctioned by the banks after retaining a margin on the value of the security offered. The percentage of margin requirements varies as per RBI guidelines.</p>
Memorandum of Satisfaction	<p>A company must make a report to the Registrar of payment of satisfying in full of any charge registered under this act. The satisfaction of charges must be filed with the Registrar within 30 days from the date of such a payment of charge. On receipt of intimation to the company, the Registrar gives notice to the charge-holder calling upon him to show cause within</p>

time not exceeding 14 days as why the payment of satisfaction should not be registered. If no cause is shown within the time stipulated above the Registrar must enter the satisfaction of the payment of charge. If some cause is shown, the Registrar must record note to that effect in the register and inform the company accordingly.

Mortgage

A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability. The transferor is called a mortgagor, the transferee a mortgagee; the principal money and interest of which payment is secured for the time being are called the mortgage-money and the instrument (if any) by which the transfer is effected is called a mortgage-deed.

Non Performing Asset

A debt obligation where the borrower has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time. The non performing asset is, therefore, not yielding any income to the lender in the form of principal and interest payments.

If the customers do not repay principal amount and interest for a certain period of time then such loans become non-performing assets (NPA). Thus non-performing assets are basically non-performing loans.

In India, the time frame given for classifying the asset as NPA is 180 days as compared to 45 days to 90 days of international norms.

Out of Order/ Irregular Account

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases, where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for six months as on the date of Balance Sheet or

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	credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.
Overdue Account	Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.
Pledge	It is a bailment of property as a security for debt/ amount borrowed.
RBI's Non-performing Asset Projections for March' 12	RBI projected banks' balance sheets for 2011-12 and finds that at end-March 2012, the level of gross non-performing assets (NPAs) will rise to 2.92% of advances, assuming the tighter provisioning requirements made by the central bank and 30% of standard restructured assets turning into NPAs.
Stock Statements	<p>It is a statement (normally in a prescribed format of the lending bank) showing the details of the various items of stock. It should clearly indicate the movement of the stock during the period. Stock which has not been paid for has to be excluded. Stock statements are to be signed by an authorized signatory and submitted to the banks at intervals stipulated in the sanction letter.</p> <p>Non- submission of stock statements on time will attract penal interest.</p>
Types of NPA	<p>NPA have been divided or classified into following four types:</p> <ul style="list-style-type: none">(i) <i>Standard Assets</i>: A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPA in the real sense. So, no special provisions are required for Standard Assets.(ii) <i>Sub-Standard Assets</i>: All those assets (loans and advances) which are considered as non-performing for a period of 18 months are called as Sub-Standard assets.

- (iii) *Doubtful Assets*: All those assets which are considered as non-performing for period of more than 18 months are called as Doubtful Assets.
- (iv) *Loss Assets*: All those assets which cannot be recovered are called as Loss Assets.

Working Capital

There are two measures of working capital: gross working capital and net working capital. *Gross working capital* is the total of the current assets. *Net working capital* is the difference between the total of current assets and the total of current liabilities.

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Chapter 1

Introduction

1.1 The most essential components, which form a significant portion of the total assets of an entity, in general, and current assets, in particular are Inventories and Debtors. They are considered as the lifeblood of every business activity since they are the indicators of good health of the company. The basic objective of verification of the assets is to indicate their physical existence and safety aspects.

In view of such magnitude entities obtain loans from banks in the form of cash credit against hypothecation of inventories and debtors. Consequently, the importance of the physical verification of inventories, their valuation and security aspects is not overemphasized, but rightly stated. The banks would like to get an assurance that the loans that have been made are backed by security that have a proper repaying capacity. Audit in banks is useful not only from the point of view of the management, who is the appointing authority but also from the point of other equally interested parties, who are interested for their different objectives, *viz.*, the Government, Public, RBI, Investors, Depositors and Analysts.

1.2 In order to get an assurance that the norms stated in the loan sanction form have not been disregarded, the bank appoints an external auditor, who is an independent person. The auditor undertaking such responsibility should take care that the requirements of the banks are met with and an early detection of the lapses and inconsistencies is done.

1.3 The main purpose of conducting the inventories audit in banks is to get an assurance that the security against which the loan is sanctioned represents the quality and quantity it claims to possess. With this assurance, the purpose of the inventories audit as required by the bank is served. The examination of the securities against which the loan has been sanctioned consists of not only physical verification of the securities but also includes verification of aspects, such as Ownership, valuation and proper storage. The auditor's role assumes great significance, in this regard as his report is considered as veritable and neutral. He is, therefore, expected to be objective and unbiased while undertaking the inventories audit.

1.4 Inventory and debtors, usually, account for a major part of the assets of an entity. Not only that, more than any other asset they indicate the

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financial health of the company. Hence, it becomes essential that a proper management control and accounting exists for these items.

1.5 Audit of inventory is undertaken for two major purposes:

- (i) Audit of stocks of entity for financial reporting -Verification as part of existence of assets and maintenance of records.
- (ii) Stock audit from the view point of the lender/ banks.

The difference in objective of the audit makes the process of audit different for both purposes hence they are discussed separately below.

Stock Audit

1.6 Working capital investment is the lifeblood of a company. Without it, a company cannot stay in business. The most critical use of working capital is providing the ongoing investment in short-term assets that a company needs to operate. A business requires a minimum cash balance to meet basic day-to-day expenses and to provide a reserve for unexpected costs. It also needs working capital for prepaid business costs, such as, licenses, insurance policies, or security deposits. Furthermore, all businesses from a professional firm's stock of office supply to the large inventories needed by manufacturers, retail and wholesalers invest some amount in inventory. Without some amount of working capital finance, businesses could not open and operate.

1.7 A second purpose of working capital is addressing seasonal or cyclical financing needs. Here, working capital finance supports the build-up of short-term assets needed to generate revenue, but which come before the receipt of cash. Since most businesses do not receive prepayment for goods and services, they need to finance these purchase, production, sales, and collection costs prior to receiving payment from customers.

1.8 The major forms of debt used to finance working capital are as follow:

Overdraft

This is an open-ended loan with a borrowing limit that the business can draw against or repay at any time during the loan period. This arrangement allows a company flexibility to borrow funds when the need arises for the exact amount required. Interest is paid only on the amount borrowed, typically, on a monthly basis. This can be either unsecured, if no specific collateral is pledged for repayment, or secured by specific assets such as accounts receivable or inventory. The standard term is 1 year with renewal subject to the lender's annual review and approval.

Factoring

It is a financial transaction where an entity sells its accounts receivable to a third party, collector (factor at a discount) in exchange for immediate money. Factoring differs from a bank loan in three main ways. First, the emphasis is on the value of the receivables, not the firm's credit worthiness. Secondly, factoring is not a loan – it is the purchase of a financial asset (the receivable). Finally, a bank loan involves two parties whereas factoring involves three. Factor bears collection risk. Company is made payment based on average collection period less a collection fee. Collection amount can be paid in advance with an interest charge.

Term Loan

Principal repaid over several years based on a fixed schedule. Loan amount tied to collateral value. Can be fully amortized or a balloon loan. Typical term is three to seven years.

Inventory Loan

Loan secured by inventory. The loan amount is based on a percentage of inventory value. Lender receives security interest in inventory and may take physical control. The inventory is released on loan repayment.

This is a common form of working capital finance. It is in the form of cash credit against the security of hypothecation of stock and debtors. Also, borrowers have to submit the details of stock and debtors every month on the basis of which Drawing Power after reducing the prescribed margin is calculated by the banks. Stock and debtors being the primary security, bankers need to ascertain the genuineness & correctness of such statements. The auditor has to conduct stock audit at specified intervals specifically, where the exposure exceeds the predetermined threshold limit.

Appointment of Stock Auditors and Periodicity of Audit

1.9 The appointment of stock auditors is generally, made by the regional or zonal offices, in case of nationalized banks, while in case of co-op banks sometimes concurrent auditors only are asked to conduct stock audit of select borrowers of the branch. Terms of appointment are prescribed by such offices which sometimes involves conducting of stock audit as one time exercise only while in others it may be a contract for two half yearly visits during a particular financial year, of which first visit to be conducted before September and second visit before March. The stock audit involves audit of

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latest stock and debtors information of the borrower and the report should give the position of stock and debtors ideally on the date of visit. Further it will also make examination of past data submitted by the borrower to the bank and appearing in the books of accounts of the borrower, to check reliability of information submitted by the borrower.

Steps Involved in Stock Audit

1.10 Stock audit is necessarily required to be conducted at the borrowers place for obvious reasons. But before visiting the borrower, understanding the entity, its banking operations and financial affairs is must.

Therefore, it is advisable to visit the respective branch where the borrower is having the account so as to gather the information relating to sanction, account operations, nature of business, performance of the borrower and other fundamental information along with the comments/ observations noted by other auditors (like Internal Inspectors, Concurrent Auditors, etc.) to have a brief understanding about the borrower and its financial affairs.

(i) Visit to Borrower's Branch

- Banks, generally, has the system of maintaining two folders (in few cases only one folder) for each borrower of which one is used for keeping original documents executed by the borrower (*viz.* Demand Promissory Note, Hypothecation Deed, Guarantee Bond, etc.) while other folder contains Application Form, Project Report, Sanction Letter, Audited Financial Statements, Previous Stock Audit Report, etc. Stock statements submitted each month by the borrower are filed with the correspondence file or may be kept in a single file meant for keeping stock statements of all the borrowers. Scrutiny of both the files along with the account operations and DP Register with reference to terms of Sanction helps stock auditor to gain insight about the borrower's affairs and conduct of the account.

(ii) Visit to borrower and verification of stock

- Once the basic information is collected from the bank branch, it is time to visit the borrower. It is advisable to carry audit questionnaire at the time of visit so that no important point / area is missed out. Visit to borrower involves verification of stock and debtors, inquiry about MIS and internal control, future projections and financial plans of the borrower and analysis of past results and bank operations.

- Although audit is related to stock and debtors only, understanding of overall financial scenario and inquiry as to sister concerns & their businesses may also help the stock auditor to finalize the report in a better manner.
- (iii) Preparation of Audit Report and discussion about audit findings
 - After conclusion of visits, stock audit report in the prescribed format, if available is to be prepared. In the absence of format, questionnaire prepared can itself also act as a report format. However, at the end of the questionnaire or in the covering letter itself (where auditor has to report in bank specified format) summary of major adverse findings (or points for future action) must be submitted by the auditor. Before submission of audit report, discussion about audit findings with the monitoring branch as well as borrower may be a good practice which may bring further clarity in reporting. But, it should be done depending upon the circumstances of case in hand.

Format for Stock Audit

1.11 Format for stock audit report may vary from bank to bank. Some banks have customized stock audit report formats while others may hint only the important areas to be reported by stock auditors. Irrespective of the formats, it is good to have questionnaire to be prepared by stock auditor covering following important areas of stock audit:

- (i) Compliance with terms and conditions of sanction.
- (ii) Timely and adequate submission of stock statements & other important financial information.
- (iii) Account operations – overdrawing, credit summation and cash withdrawals.
- (iv) Drawing power calculations by banks and by the auditors & discrepancies, if any along with the reasons.
- (v) Physical maintenance and storage of stock and adequacy of facilities at the borrowers place.
- (vi) Systems/ procedures implemented by borrower to identify the slow and non-moving stock items.
- (vii) Borrower's Management information system, its adequacy and Internal controls to safeguard stock.

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- (viii) Method of valuation of stock, time interval for valuation and adequacy and sufficiency of procedures thereof.
- (ix) Insurance of stock.
- (x) Verification of Debtors.

The list of common irregularities/ observations given below will give the better idea about preparation of stock audit questionnaire on above stated areas.

Common Irregularities/ Observations in Stock Audit

1.12 The common irregularities that may be observed during stock audit can be summarized as follows:

Observations about Statement Submission & Scrutiny	Observations About Account Operations	Observations about Insurance Coverage
<ul style="list-style-type: none"> • Stock Book Debts statements not submitted / no t submitted in time. • Inadequate details viz. rate, quantity and amount of different type of stock items not stated in the statement. • Scrutiny of stock statements not done. • DP Register not written up to date. • Age wise analysis of Debtors n ot given/ done. Debtors over 90 	<ul style="list-style-type: none"> • Operations in the accounts not scrutinized with reference to projections, QIS statements, audited accounts, etc. • Defects pointed out by the Internal Auditors/ Inspectors/ Concurrent Auditors are not complied with. • No/ belated review/ renewal of A/C. • All sales as per financial statements not 	<ul style="list-style-type: none"> • Under insurance of stock. • Insurance expired and not renewed. • Premium for renewal policy paid but policy no t on record. • Insurance Policy without Bank Clause. • No coverage of all risks as per sanction. • Wrong items/ description of goods on insurance policy. • Location of goods

<p>days (or as per sanction) considered for drawing power.</p> <ul style="list-style-type: none"> • Drawing power not correctly calculated. • Latest visit report by branch official not on record. 	<p>routed through account.</p> <ul style="list-style-type: none"> • Account not operated actively. • Cash withdrawal during current period is abnormal. • Frequent overdrawing in the account. • Balance over drawing power although within Sanctioned Limit. 	<p>wrongly stated.</p> <ul style="list-style-type: none"> • All locations of stock not covered.
<p>Observations about Verification of Stock and Creditors</p>	<p>Observations about Verification of Sundry Debtors</p>	<p>General Observations</p>
<ul style="list-style-type: none"> • Stock book not maintained/ not updated. • Obsolete stock not excluded from stock figures submitted to bank. • Deteriorating stock turnover ratio. • Stock figures submitted at the year end and as per financial statement not matching. • Stock debtors as per statements submitted and as per books not 	<ul style="list-style-type: none"> • Existence of long pending debtors. • Long pending debtors shown as below 90 days debts to bank. • Increase in the average collection period of debtors. • Dispute with debtors and pending court cases. • Amount receivable from Sister concern considered for calculation of 	<ul style="list-style-type: none"> • Diversion of funds and inter account transfers are not properly monitored. • Borrower having operations with other bank for which permission of lender not obtained. • Bank name plate not displayed.

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<p>matching.</p> <ul style="list-style-type: none"> • Confirmation for inventory with third party not obtained or physical verification of Inventory not done. • Material received from third parties for job work not excluded while calculating drawing power. 	<p>drawing power.</p> <ul style="list-style-type: none"> • Advances received from debtors not reported resulting into lower D P than calculated by bank. 	
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Above list is illustrative only and not the exhaustive one. In actual practice, there may be other observations/ irregularities over and above stated in the list.

Findings of Stock Audit

1.13 Stock audit is one of the important tools of credit monitoring for the bank. Apart from ensuring safety of realizable security, it also helps the bank to discipline the borrower or may act as a warning signal against probable future NPA. It may aid the bank to take timely remedial measures to avoid substantial future losses. It also highlights the weaknesses, if any, in the existing monitoring system of the branch through comments about maintenance of DP register, scrutiny of statements, review of accounts and compliance of audit findings.

Over and above, stock audit also has the utility for the borrower. Comments about insurance inadequacies, wrong product description and locations stated in the policies, if rectified timely may save the borrower from avoidable future losses.

Therefore, Statutory Audit where there is thrust only on the compliance under respective statute, the Stock Audit is a knowledge value addition exercise for both – bankers as well as borrowers.

Chapter 2

Inventories and Receivable Audit

Meaning of Inventories

2.1 Inventories denotes tangible property held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or services for sale, including maintenance supplies and consumables stores and spare parts meant for replacement in the normal course.

Inventories, thus, normally comprises of:

- (a) stores,
- (b) spares parts,
- (c) loose tools,
- (d) Maintenance supplies,
- (e) raw materials including components,
- (f) work in process,
- (g) finished goods including by-products,
- (h) Waste or by-products, etc.

Meaning of Debtors

2.2 A debt represent the amount due to an entity for goods sold or a service rendered or in respect of other similar contractual obligations but amount includes such amounts which are in the nature of loans and advances. Debtors are represented only by documentary evidence in the form of invoices and they don't have any physical existence.

Cash-credit Facility

2.3 A major part of working capital requirement of any unit would consist of maintenance of Inventories of raw materials, semi finished goods, finished goods, stores and spares, etc. In trading concern, the requirement of funds will be to maintain adequate inventories in trade. Finance against such inventories by banks is, generally, granted in the shape of cash credit facility where drawings will be permitted against Inventories of goods. It is a running account facility where deposits and withdrawals are permitted.

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2.4 Cash credit facility is of two types (depending upon the type of charge on goods taken as security by bank.):

- (i) **Pledge:** When the possession of the goods is with the bank and drawings in the account are linked with actual movement of goods from/to the possession of the bank. The physical control of the goods is exercised by the bank.
- (ii) **Hypothecation:** when the possession of the goods remains with the borrower and a floating charge over the inventories is created in favour of the bank. The borrower has complete control over the goods and the drawings in the account are permitted on the basis of Inventories statements submitted by the borrower.

Inventories/ Receivables Audit

2.5 The term 'Inventories Audit' in the context of banks refers to verification and valuation of the entire amount of current assets, current liabilities, loans and advances, diversion of funds, application of funds, accuracy of Inventories statements, arriving at the revised drawing power and any other matter connected with the credit administration by the banks.

2.6 The main thrust in inventories audit, therefore, is towards authentication of the quantity, quality, composition and valuation of the inventories and debtors.

Chapter 3

Mortgage

Meaning of Mortgage

3.1 Mortgage is a transfer of interest in specific immovable property for the purpose securing payment of money advanced, or to be advanced by way of loan, an existing or future debt, or the performance of an engagement, which may give rise to a financial liability.

3.2 The transferor is called a Mortgagor and the transferee is a Mortgagee, the principal money and interest of which payment is secured for the time being are called mortgage money, and the instrument, if any, by which the transfer is effected is called a Mortgage Deed.

3.3 *Section 58* of the Transfer of Property Act, 1882 deals with mortgage. Accordingly, the necessary ingredients of a mortgage are as follows:

- (i) Transfer of interest in specific immovable property
- (ii) Transfer is for the purpose of securing the payment of money advanced or to be advanced by way of loan.
- (iii) It may be existing and future debt.
- (iv) It may be also for performance of an engagement, which may lead to financial liability.

Types of Mortgage

3.4 Mortgage are of following types:

- (i) Simple Mortgage,
- (ii) English Mortgage,
- (iii) Equitable Mortgage or Mortgage by deposit of title deeds,
- (iv) Usufructuary Mortgage,
- (v) Mortgage by Conditional Sale,
- (vi) Anomalous Mortgage

Simple Mortgage

Where, without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage-money, and agrees,

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expressly or impliedly, that in the event of his failing to pay according to his contract, the mortgages shall have a right to cause the mortgaged property to be sold and the proceeds of sale to be applied, so far as may be necessary, in payment of the mortgage-money, the transaction is called a simple mortgage and the mortgagee a simple mortgagee.

English Mortgage

Where the mortgagor binds himself to repay the mortgage-money on a certain date, and transfers the mortgaged property absolutely to the mortgagee, but subject to a proviso that he will re-transfer it to the mortgagor upon payment of the mortgage-money as agreed, the transaction is called an English mortgage.

Equitable Mortgage or Mortgage by Deposit of the All Deeds

Where a person in any of the following towns, namely, the towns of Calcutta, Madras and Bombay, and in any other town which the State Government concerned may, by notification in the Official Gazette, specify in this behalf, delivers to a creditor or his agent documents of title to immovable property, with intent to create a security thereon, the transaction is called a mortgage by deposit of title-deeds.

Mortgage by Conditional Sale

Where the mortgagor ostensibly sells the mortgaged property:

- on condition that on default of payment of the mortgage-money on a certain date the sale shall become absolute, or
- on condition that on such payment being made the sale shall become void, or
- on condition that on such payment being made the buyer shall transfer the property to the seller,

The transaction is called a mortgage by conditional sale and the mortgagee a mortgagee by conditional sale.

Provided that no such transaction shall be deemed to be a mortgage, unless the condition is embodied in the document which effects or purports to effect the sale.

Usufructuary Mortgage

Where the mortgagor delivers possession or expressly or by implication binds himself to deliver possession of the mortgaged property to the mortgagee, and authorizes him to retain such possession until payment of the mortgage-money, and to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same in lieu of interest, or in payment of the mortgage-money, or partly in lieu of interest or partly in payment of the mortgage-money, the transaction is called an usufructuary mortgage and the mortgagee an usufructuary mortgagee.

Anomalous Mortgage

A mortgage which is not a simple mortgage, a mortgage by conditional sale, a usufructuary mortgage, an English mortgage or a mortgage by deposit of title-deeds within the meaning of this section is called an anomalous mortgage.

Difference between Mortgage and Pledge

3.5 Mortgages are dealt as per Transfer of Property Act, 1882 whereas Indian Contract Act, 1872 deals with pledge.

Pledge is the bailment of goods, as security for payment of debt, performance of promise. The creditor holds the possession of goods as security, but has no right of foreclosure; as there is no transfer of ownership. The right of enjoyment of property is not given to the pledgee.

While, transfer of possession is very important in case of pledge it is not necessarily so in case of mortgage (depending upon type of mortgage).

In mortgage there is transfer of interest, whereas in case of pledge, the pledgee has only special right of detaining the goods till repayment of loan.

Mortgagor has right of redemption and mortgagee has right of foreclosure, whereas the pledgee does not have right of foreclosure.

Charge

3.6 The word Charge is not defined in the Companies Act. *Section 124* merely states the expression 'charge' includes mortgage. However, *Section 100* of the *Transfer of Property Act, 1882* defines "charge". These two provisions give a fair idea that Charge is nothing but security of its property, etc. by the Company in favour of creditor with the intent of securing his debt.

Difference between Mortgage and Charge

3.7 In *Raja Sri Shiva Prasad v. Beni Madhab AIR 1922 Pat. 529*, Das J. stated that the broad distinction between a “mortgage” and “charge” is:

“Whereas a charge only gives a right to payment out of a particular fund or particular property without transferring that fund or property, a mortgage is in essence a transfer of an interest in specific immovable property.”

In other words:

- A “mortgage” effectuates transfer of property or an interest therein but there is no such transfer in “charge”.
- In every “mortgage” there is “charge” but in “charge” there is no “mortgage”.

Chapter 4

Charge

Charge as Defined in Section 100 of Transfer of Property Act, 1882

4.1 *Where immovable property of one person is by act of parties or operation of law made security for the payment of money to another, and the transaction does not amount to a mortgage, the latter person is said to have a charge on the property; and all the provisions hereinbefore contained which apply to a simple mortgage shall, so far as may be, apply to such charge.*

Nothing in this section applies to the charge of a trustee on the trust-property for expenses properly incurred in the execution of his trust, and, save as otherwise expressly provided by any law for the time being in force, no charge shall be enforced against any property in the hands of a person to whom such property has been transferred for consideration and without notice of the charge.

Important Provisions contained in Section 125 of the Companies Act, 1956

4.2 Certain charges to be void against liquidator or creditors unless registered:

- (1) Subject to the provisions of this Part, every charge created on or after the 1st day of April, 1914, by a company and being a charge to which this section applies shall, so far as any security on the company's property or undertaking is conferred thereby, be void against the liquidator and any creditor of the company, unless the prescribed particulars of the charge, together with the instrument, if any, by which the charge is created or evidenced, or a copy thereof verified in the prescribed manner, are filed with the Registrar for registration in the manner required by this Act within thirty days after the date of its creation.

Provided that the Registrar may allow the particulars and instrument or copy as aforesaid to be filed within thirty days next following the expiry of the said period of thirty days on payment of such additional fee not exceeding ten times the amount of fee specified in Schedule X as the Registrar may determine, if the company satisfies the Registrar that it

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- had sufficient cause for not filing the particulars and instrument or copy within that period.
- (2) Nothing in sub-section (1) shall prejudice any contract or obligation for the repayment of the money secured by the charge.
 - (3) When a charge becomes void under this section, the money secured thereby shall immediately become payable.
 - (4) This section applies to the following charges:
 - (a) A charge for the purpose of securing any issue of debentures;
 - (b) A charge on uncalled share capital of the company;
 - (c) A charge on any immovable property, wherever situate, or any interest therein;
 - (d) A charge on any book debts of the company;
 - (e) A charge, not being a pledge, on any movable property of the company;
 - (f) A floating charge on the undertaking or any property of the company including Stock-in-trade;
 - (g) A charge on calls made but not paid;
 - (h) A charge on a ship or any share in a ship;
 - (i) A charge on goodwill, on a patent or a license under a patent, on a trade mark, or on a copyright or a license under a copyright.
 - (5) In the case of a charge created out of India and comprising solely property situated outside India, thirty days after the date on which the instrument creating or evidencing the charge or a copy thereof could, in due course of post and if dispatched with due diligence, have been received in India, shall be substituted for thirty days after the date of the creation of the charge, as the time within which the particulars and instrument or copy are to be filed with the Registrar.
 - (6) Where a charge is created in India but comprises property outside India, the instrument creating or purporting to create the charge under this section or a copy thereof verified in the prescribed manner, may be filed for registration, notwithstanding that further proceedings may be necessary to make the charge valid or effectual according to the law of the country in which the property is situated

- (7) Where a negotiable instrument has been given to secure the payment of any book debts of a company, the deposit of the instrument for the purpose of securing an advance to the company shall not, for the purposes of this section, be treated as a charge on those book debts.
- (8) The holding of debentures entitling the holder to a charge on immovable property shall not, for the purposes of this section, be deemed to be an interest in immovable property.

Registration of Charge

4.3 A transaction or an arrangement that amounts to a charge, requires registration under the Companies Act only if it satisfies the conditions laid down in *Section 125*.

Such charge should be one among the kinds enumerated in Sub-section (4) of *Section 125*. Needless to state, a mortgage of every kind is a charge that requires registration.

Objective of Registration

4.4 The objective of Registration of a charge is to give public notice which can be achieved:

- (i) By requiring the companies to maintain record of charges and make it available for inspection to the members of the public.
- (ii) By requiring the registrar of companies to maintain record of the Charges filed by the companies and make it available for public inspection.

The registration of a charge thus, is intended to give notice to people who may not otherwise be aware of it, particularly, to persons who may advance money to the company, and it may also serve the purpose of preventing a fraudulent and belated claim of a charge in the event of liquidation.

Charge Requiring Registration

4.5 Charges which require registration are as follows:

- (i) *Section 125* enumerates the following charges which require registration.
 - (a) A charge for the purpose of securing any issue of debentures;
 - (b) A charge on uncalled share capital or the company;

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- (c) A charge on any immovable property, wherever situated, or any interest therein;
 - (d) A charge on any book debts of the company;
 - (e) A charge, not being a pledge, on any movable property of the Company;
 - (f) A floating charge on the undertaking or any property of the company including stock in trade;
 - (g) A charge on calls made but not paid;
 - (h) A charge on a ship or any share in a ship;
 - (i) A charge on goodwill, on a patent or license, on a trade mark, or on a copy right or a license under a copyright.
- (ii) A charge created without executing any instrument also requires registration.

Execution of an instrument for creating a charge is not a condition precedent for the requirement of registration.

- (iii) A resolution of the Board of Directors can be taken to be fact of creation of a Charge.
- (iv) A charge created by operation of law or by an order of the court and not by a contract is not a charge created by the company. It therefore does not need registration as *Section 125* is applicable only to the charges created by the company itself.
- (v) A charge on any movable property also requires registration (except a charge by way of pledge of movable property) *vide* Clause (e) of Sub-section (4). Thus, hypothecation of movable property is a charge that requires registration so long as it is not a pledge.
- (vi) A charge on book debts requires registration *vide* clause (d).
- (vii) Pledge of promissory notes by endorsement thereof by a company in favour of its creditor does not require registration. If a transaction satisfies all the requirements of a valid pledge, it would be eligible for exemption from registration under Clause (c) of Sub-section (4) of *Section 125*; even it is also in the nature of mortgage. The reason for exempting pledge from registration is that in pledge the debtor parts with the possession of the property and passes it on to the creditor which is a sufficient notice of creation of a charge and, therefore, no registration of such a charge is necessary

- (viii) A pledge of fixed deposit receipts with a Bank for obtaining a loan does not require registration. The Department of Company Affairs is of the view that registration of pledge, though not mandatory, is permissible at the instance of the company or of any interested person
- (ix) A charge on future debts will be void if it is not registered. However, absolute assignment of a future debt is not a charge and a document making such assignment does not require registration.

Consequences of Non-Filing

4.6 The consequences of non-filing are as follows:

- (i) Charge requiring registration is void against the liquidator and any creditor of the Company if prescribed particulars are not filed with the Registrar of Companies (RoC) within thirty days of the date of creation of Charge.
- (ii) The words “Filing” and “Registration” are not synonymous and interchangeable. Filing is the delivering of particulars of Charges to the ROC. The term Registration denotes the registration of the Charge by the ROC office in its records as per provisions of Companies Act, 1956.
- (iii) It is only the omission to file the particulars of a charge within 30 days. Charge void or within next 30 days with the permission of ROC.
- (iv) Charge is valid even if RoC does not register it or makes unreasonable delay in registering it, provided the particulars thereof have been filed duly within thirty days.

Filing Defective Particulars

4.7 *Regulation 17 of the Companies Regulations, 1956* provides that:

- (i) RoC shall examine, or cause to be examined, every document received in his office.
- (ii) If any such document is found to be defective or incomplete in any respect, the RoC shall direct the company to rectify the defect or complete and no such document shall be registered and recorded until the defect has been so rectified or the document has been completed as the case may be.
- (iii) RoC is, thus under an obligation to inform the Company about the defects.

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- (iv) However, the document shall be treated as filed on the date on which it was initially filed and not on the date it was rectified.

Date of Creation of Charge

4.8 The date mentioned in the instrument being the date of execution thereof would be taken to be the date of creation of Charge. The period of 30 days would start from such date.

In the cases of mortgage of deposit of title deeds, it is the date on which the title deeds are actually deposited and not the date of the Memorandum of the deposit, even if the date of the memorandum is subsequent to the date of deposit of the title deeds.

Procedure for Filing of Particulars of Creation of Charge

4.9 *The Companies (Central Government's) General Rules and Forms, 1956 read with Sections 125, 127, 128, 130, 132, 135 and 138 of the Companies Act, 1956 provides the procedure to file the documents. The Ministry of Company Affairs vide its Notification No.GSR 56 (E) dated 12.2.2006 has issued the Companies (Central Government's) General Rules and Forms (Amendment) Rules, 2006. Accordingly, in place of physical filing of documents, the e-filing has been made mandatory to all incorporated companies whether private or public, listed or unlisted without any sectoral preferences.*

- (i) The prescribed particulars together with copy of the instrument creating the charge or Modification thereof or satisfaction of charge the following Forms shall be filed with the ROC through electronic media or through any other computer readable media:

Form No. 8: Creation of original Charge and Modification of charges.

Form No.10: Particulars for registration of charges for debentures. (Both creation and modification covered).

Form No.13: Register of charges [merged with Form No.8 in the new system].

Form No. 17: Memorandum of complete satisfaction of charge.

- (ii) A copy of every instrument evidencing any charge or modification of charge and required to be filed with the Registrar in pursuance of Section 125, 127, 128 or 135 shall be verified as follows:

- (a) Where the instrument or deed relates solely to property situate outside India, a copy shall be verified by a certificate either under the seal of the company, or under the hand of a responsible officer of the company, or under the hand of some person interested in the mortgage or charge on behalf of any person other than the company, stating that it is a true copy.
- (b) Where the instrument or deed relates, whether wholly or partly, to property situated in India, the copy shall be verified by a certificate of a responsible officer of the company stating that it is true copy or by a certificate of a public officer given under and in accordance with the provisions of *Section 76 of the Indian Evidence Act, 1872*.
- (iii) *Form 8 or Form 10 or Form 17* as the case may be, shall be signed on behalf of the company and the charge-holder. The electronic-form shall be authenticated by authorized signatories using digital signatures, as defined in the Information Technology Act, 2000.

Certificate of Registration

4.10 As per *Section 132 of the Companies Act, 1956* The Registrar shall give a certificate under his hand of the registration of any charge registered in pursuance of this Part, stating the amounts thereby secured; and the certificate shall be conclusive evidence that the requirements of this Part as to registration have been complied with.

Penalties under Section 142 of Companies Act, 1956

4.11 If default is made in filing with the Registrar for registration the particulars:

- (a) Of any charge created by the company;
- (b) Of the payment or satisfaction of a debt in respect of which a charge has been registered under this Part; or
- (c) Of the issues of debentures of a series.

Requiring registration with the Registrar under the provisions of the Act, then, unless the registration has been effected on the application of some other person, the company, and every officer of the company or other person who is in default, shall be punishable with fine which may extend to five thousand rupees for every day during which the default continues.

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Subject as aforesaid, if any company makes default in complying with any of the other requirements of this Act as to the registration with the Registrar of any charge created by the company or of any fact connected therewith, the company, and every officer of the company who is in default, shall, without prejudice to any other liability, be punishable with fine which may extend to ten thousand rupees.

Significance of MCA 21 for Banks and Financial Institutions

4.12 The Charge Registration information is an invaluable input for credit evaluation. MCA 21 serves the interests of the Banks and Financial Institutions through the process of "Registration of Charges".

Steps already taken by the Ministry of Company Affairs

4.13 With an Endeavour to improve and refine the charge registration process and enhance the value that can be derived by the financial services industry, following measures have been implemented by the Ministry of Company Affairs:

- (i) Digitization of more than 10 million pages related to all subsisting charges and established inter-linkage between the charge data within a given company (including creation of an Index of charges);
- (ii) Simplification and unification of charge related forms including adapting the same for electronic filing. These have been duly notified and have come into force from 28th Feb, 2006;
- (iii) Facility of authenticating these e-forms using digital signatures in accordance with the Information Technology Act, 2000;
- (iv) Cross-referencing of charge creation document at the time of filing anew charge document involving subsequent modification or satisfaction;
- (v) Introduction of concise, structured yet comprehensive Instrument of Charge containing/ evidencing basic information in place of diverse elaborate contracts.

Steps to be taken by the Banks and Financial Institutions

4.14 The following are the guidelines given by the Ministry of Company Affairs to the Banks and financial institutions:

- (i) Ensure that newly notified e-forms are used henceforth. Copies of the new e-forms and procedures for e-filing can be obtained from MCA portal www.mca.gov.in.
- (ii) Ensure that all e-forms that will henceforth be used for filing, are authenticated using a digital signature.
- (iii) Ensure that the authorized officers of your Bank or institution obtain Digital Signature Certificates authenticating all relevant e-forms for the purposes of registration of a charge with the ROC.
- (iv) Encourage the borrowers to register creation/modification/satisfaction of charges in a timely manner. In particular, encourage the charges to be satisfied as there are a number of cases which are probably closed and the same has not been done.
- (v) While Ministry has taken due care to ensure completeness and accuracy of data; it is very likely that there could be errors of omission and commission in an exercise of this enormity. Please review the existing charge data and highlight any discrepancies/errors to the concerned ROC, so that the same can be corrected to ensure the reliability of data.
- (vi) Proactively support the enhancement of the Instrument of Charge and enforce this as a standard across all charge transactions this will facilitate us not only collation of data, but also explore the possibility for use of sophisticated data mining technology/ tools (the current data is largely unstructured and unfit for analysis).
- (vii) Disseminate this information widely within your enterprise and facilitate quick adoption.

Chapter 5

Need, Scope and Applicability of Stock Audit

This chapter throws light on the procedure of stock/ inventory audit, its objectives and utility.

Objectives of Stock Audit

5.1 The various purposes expected to be achieved through stock audit may be summarized as follows:

- (i) To ensure proper preservation/ storage and handling of stock.
- (ii) To identify whether there exist any obsolete stock and if yes, whether it has been segregated and written off.
- (iii) To verify whether the stock is adequately insured against fire and other natural calamities (in appropriate cases against other risks like, theft, burglary, marine, riots, etc. as per sanction).
- (iv) To ascertain whether physical stock tally with the stock statement submitted to the banker.
- (v) To ascertain whether hypothecated stock is realizable.
- (vi) To confirm that stock is owned by the borrower and finance is made against value of paid stock only.
- (vii) To examine the age wise debtors outstanding as per books and as per statement submitted by the bank, steps taken for recovery of long pending debtors and likely instances of debtors turning bad, if any.

Like any other audit, the rationale for conducting inventories audit also lies in prevention and early detection of frauds and errors. Inventories audit acts as a safeguard against occurrence of both internal and external frauds.

Scope of Stock Audit

5.2 The scope of the audit covers all the aspects that have a direct impact on the working capital of the unit as well as the aspects relating to Inventories that have a bearing on the bank finance. In other words, it deals with the matters that have an effect on the security and liquidity in view of the banker.

Need, Scope and Applicability of Stock Audit

It encompasses the following aspects:

- (i) Physical verification of inventories.
- (ii) Verification of condition of storage.
- (iii) Valuation of inventories and pointing out variances.
- (iv) Valuation of obsolete/ non-moving Inventories.
- (v) Age-wise categorization of inventories.
- (vi) Evaluation of the Inventories management by the company.
- (vii) Reconciliation of Inventories statements submitted with the accounting records maintained by borrowers particularly, relating to quantity, rate, value of inventories, age, marketability, etc.
- (viii) Verification and evaluation of sundry creditors indicating separately those relating to Inventories and their relationship with bank finance.
- (ix) Commenting upon the sources of the raw materials, i.e., whether any credit is available for the material and which of the items are available against cash payments.
- (x) Review of the Inventories valuation system.
- (xi) Age-wise and value-wise qualification of debtors.
- (xii) Determination of the drawing power.
- (xiii) Determining adequacy of the insurance cover.
- (xiv) Verification of documents/ securities.
- (xv) Commenting upon the comparative Profitability and Inventories ratio.
- (xvi) Ensuring that the compliance of the terms and conditions of limit sanctioned.
- (xvii) Verification of transactions with sister concerns, unsecured Loans to Directors and others.
- (xviii) Any other matters of interest to the bank.

Purpose of Stock Audit

5.3 Stock audit is essential for the following purposes:

- (i) To give the bankers an assurance regarding the following:
 - (a) That a suitable environment for preservation of Inventories exists.

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- (b) That a responsible person for safeguarding the inventories is always present.
- (c) That degraded inventories have been written off.
- (d) That adequate safeguards exist against fire and natural calamities.
- (e) That physical inventories tally with the inventories statements submitted to bank.
- (f) That the pledged/ hypothecated inventories is realizable.
- (g) That inventories is owned by the borrower.
- (h) That all sanction terms have been adhered to.
- (i) That inventories are not stagnating and becoming obsolete.
- (ii) To investigate wherever the party is not submitting periodic Inventories statements regularly.
- (iii) To investigate, where the accounts have been marked as substandard.
- (iv) To find out reasons when there are many qualifying remarks about inventories and receivables in the Auditor's report of the borrower.
- (v) To find out suspect dealing in lending procedure.
- (vi) To make the banks aware of their right of enforcement of the security interest provided in the Securitization and Reconstruction of Financial Assets and enforcement of Security Interest Act, 2002.
- (vii) To fulfill Head Office requirement.

Need of Stock Audit

5.4 Under the following circumstances, it is advisable for banks to get annual stock audit done by the independent agencies:

- (i) Where there are over dues in term loans or other accounts, where the banks' stake is high.
- (ii) Where there is evidence of pressure on the borrower from the creditors.
- (iii) Where the inventories are stagnating.
- (iv) Where party is not submitting inventories statements regularly.
- (v) Where there are grounds to suspect that the position of chargeable current assets indicated may not be correct.

Need, Scope and Applicability of Stock Audit

- (vi) Where there are too many qualifying remarks about inventories and receivables in the Auditor's report of a borrower.
- (vii) Where the accounts is marked as sub-standard.
- (viii) Suspect dealings in lending procedure, jeopardizing advances given.
- (ix) An errant borrower, where Inventories audit is need ed to supplement actions of the branches for recovery.
- (x) Any other valid reason, such as, mismanagement, heavy losses, lockout, strikes, etc.
- (xi) Fulfilling the criteria fixed by the head office to get done stock audit.

Special Consideration while Conducting Stock Audit

5.5 Following should be considered while conducting stock audit:

- (i) If the stock statement as shown in the hypothecation statement does not tally with the stocks as in the balance sheet , then appropriate action should be taken to find reasons for the differences.
- (ii) It should be seen that the stocks have been properly valued.
- (iii) It should be seen that Current Assets are not over-stated.
- (iv) It should be seen that the Turnover is not over-stated.
- (v) It should be seen that the stocks that are genuinely owned by the borrower are shown in the accounts.

Chapter 6

Responsibility of the Auditor

6.1 The responsibility of an auditor lies towards the employing authority and the authority, which regulates the profession. In case of stock audit, the bank or the financial institution employs the auditor. They place reliance on the audit report and acts accordingly, due to which the auditors are responsible. The reports issued by the auditor also cater to the needs of others including the investors, society, creditors, etc.

6.2 The importance of stock audit is not limited only to compliance and discharge of responsibility. Stock audits also acts as a warning signal to those accounts, which are expected to turn into Non-performing assets (NPA). It may be possible that certain advances are prospective NPAs and their timely detection may prevent them from turning into actual NPAs. The auditor should try to detect such inconsistencies and plug these loopholes so as to prevent the misuse of funds. Thus, the stock audit assists the bank in the process of early detection and prevention of NPAs, so that appropriate action can be taken and such instances a voided. Auditors can perform this function in view of their expertise in this area and help banks to make a judgment. The auditor, thus should see to it that the purposes for which the stock audit is undertaken are served satisfactorily.

Composition of NPAs of Public Sector Banks - 2002 To 2011

(Amount in ₹ crore)							
Bank Groups / Years	As on March 31						
	Priority Sector		Non-Priority Sector		Public Sector		Total
	Amount	Per cent share	Amount	Per cent share	Amount	Per cent share	Amount
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
A. Nationalised Banks							
2002	16173	45.78	18742	53.05	413	1.17	35328
2003	16886	47.10	18402	51.33	561	1.57	35849
2004	16705	47.74	17895	51.14	390	1.12	34990
2005	16381	49.81	16225	49.33	283	0.86	32888
2006	15124	53.66	12845	45.58	216	0.76	28185

Responsibility of the Auditor

2007	15779	60.58	9965	38.26	302	1.16	26046
2008	16385	66.80	7941	32.38	202	0.82	24528
2009	15871	60.65	10001	38.22	297	1.13	26169
2010	19908	56.13	15283	43.09	280	0.79	35470
2011	25678	59.84	16957	39.52	273	0.64	42907
B. State Bank of India & its Associates							
2002	8977	47.01	9628	50.42	490	2.56	19095
2003	8053	47.49	8379	49.41	526	3.10	16958
2004	7136	47.07	7803	51.48	220	1.45	15159
2005	7017	47.39	7624	51.48	168	1.13	14808
2006	7250	54.95	5819	44.10	125	0.95	13193
2007	7175	57.15	5193	41.36	188	1.50	12556
2008	8902	58.49	6222	40.88	97	0.63	15220
2009	8447	47.26	9250	51.75	177	0.99	17874
2010	10940	50.11	10646	48.77	244	1.12	21831
2011	15567	55.32	12567	44.66	6	0.02	28140
Public Sector Banks (A+B)							
2002	25150	46.21	28371	52.13	902	1.66	54423
2003	24938	47.23	26781	50.72	1087	2.06	52807
2004	23840	47.54	25698	51.24	610	1.22	50148
2005	23397	49.05	23849	50.00	450	0.94	47696
2006	22374	54.07	18664	45.11	341	0.82	41378
2007	22954	59.46	15158	39.27	490	1.27	38602
2008	25287	63.62	14163	35.63	299	0.75	39749
2009	24318	55.21	19251	43.71	474	1.08	44042
2010	30848	53.83	25929	45.25	524	0.91	57301
2011	41245	58.05	29524	41.56	278	0.39	71047
<i>Source</i> : Off-site returns (domestic) - Latest updated database, Division of banking Supervision, RBI.							

Chapter 7

ICAI Pronouncements

7.1 As there is no Guidance Note or Standards prescribed for Stock audit, the auditors should conduct the audit based on the generally accepted auditing practices and to the best of his judgment and ability.

Relevant Engagement Standards

7.2 The auditor should apply the relevant Engagement Standards that will facilitate him in the process of giving the assurance of repaying ability that the bank seeks. The auditor should approach the audit with a perspective, which enables him in the process of preventing and in the process, taking corrective measures, for the probable frauds and errors that exist.

7.3 The audit may be conducted in five stages keeping in mind the relevant Standard as Auditing (SAs).

The five stages in audit are:

1. Pre-commencement
2. Understanding the entity
3. Audit planning
4. Substantive procedures
5. Reporting

Pre-Commencement

SA 210 [earlier AAS 26]	Agreeing the Terms of Audit Engagement	The auditor and the client should agree on the terms of engagement.
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Understanding the Entity

SA 315 and	Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its	The auditor should obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.
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SA 330 [earlier AAS 6, 20 and 29]	Environment The Auditor's Responses to Assessed Risks	
SA 250 [earlier *AAS 21]	Consideration of Laws and Regulations in an Audit of Financial Statements	When the auditor believes that there is a non-compliance, he should document the same and report it.
SA 550 [earlier AAS 23]	Related Parties	The auditor should obtain sufficient audit evidence regarding the transactions of related parties that are material to the financial statements.
SA 402 [earlier AAS 24]	Audit Considerations Relating to an Entity using a Service Organization	The auditor should consider how a service organization affects the accounting and internal control system of the borrower.

Audit Planning

SA 200 [earlier AAS 2]	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	The scope of an audit will be based on the terms of engagement, relevant laws and the pronouncements of the Institute.
SA 300 [earlier AAS 8]	Planning an Audit of Financial Statements	Auditor should plan his work based on the client's business to enable him to conduct an effective audit in an efficient and timely manner.
SA 299 [earlier AAS 12]	Responsibility of Joint Auditors	The division of work should be adequately documented and matters of relevance may be communicated to the joint auditors in writing.

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SA 530 [earlier AAS 15]	Audit Sampling	The auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.
SA 570 [earlier AAS 16]	Going Concern	The auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.
SA 220 [earlier AAS 17]	Quality Control for an Audit of Financial Statements	The audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with Standards on Auditing.

Substantive Procedures

SA 200 [earlier AAS 1]	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	Auditor should comply with certain basic principles whenever an audit is carried out.
SA 230 [earlier AAS 3]	Audit Documentation	Auditor should have proper working papers that will enable him to substantiate his results.
SA 240 [earlier AAS 4]	The Auditor's Responsibilities Relating to Fraud in Audit of Financial Statements	The auditor should approach the audit with a perspective, which enables him in the process of preventing and in the process, taking corrective measures, for the probable frauds and errors that exist.
SA 500 [earlier AAS 5]	Audit Evidence	The auditor should evaluate whether he has obtained sufficient appropriate evidence

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		before he draws his conclusions.
SA 610 [earlier AAS 7]	Using the Work of Internal Auditors	The auditor should evaluate the internal audit function and accordingly adopt less extensive procedures than otherwise required.
SA 620 [earlier AAS 9]	Using the Work of an Auditor's Expert	Auditor should carefully direct, supervise and review work delegated to a ssistants and should obtain reasonable assurance that work done is adequate for his purpose.
SA 600 [earlier AAS 10]	Using the Work of Another Auditor	In the process o f giving an assurance that the bank requires, the auditor may have to rely on the work of the other auditors like the Internal auditor, the Inspectors appointed by the RBI, etc. The principal auditor should discuss with the other auditor the audit procedures applied.
SA 580 [earlier AAS 11]	Written Representations	The auditor should use his professional judgment in determining matters on which he wishes to obtain representations by management.
SA 320 [earlier AAS 13]	Materiality in Planning and Performing an Audit	The auditor should consider materiality and its relationship with audit risk when conducting the audit.
SA 520 [earlier AAS 14]	Analytical Procedures	The auditor should apply analytical procedures at the planning and overall review stages of the audit.
SA 560 [earlier AAS 19]	Subsequent Events	The auditor should consider the effect of subsequent events on the audit report.
SA 505 [earlier	External	The auditor should determine

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AAS 30]	Confirmations	whether the external confirmations are necessary to support certain assertions in financial statements.
SA 501 [earlier AAS 34]	Audit Evidence-Specific Considerations for Selected Items	The auditor should perform audit procedures designed to obtain appropriate audit evidence during his presence in physical checking.

Reporting

SA 260 [earlier AAS 27]	Communication with those Charged with Governance	The engagement letter should describe the form in which any communication on audit matters of governance interest will be made.
SA 700 [earlier AAS 28]	Forming an Opinion and Reporting on Financial Statements	The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

Chapter 8

Audit Process

8.1 The audit process can be discussed in detail under the following stages:

- 1 Pre-commencement
- 2 Understanding the entity
- 3 Audit planning
- 4 Substantive procedures
- 5 Reporting

Pre-commencement

8.2 Before commencement of any audit, the auditor should obtain the following documents/ details from the client:

- (i) Engagement letter from the bank.
- (ii) All relevant details of the borrower including:
 - (a) Name of the unit and of the key persons.
 - (b) Address of both the registered office and factory of the unit.
 - (c) Nature of business.
 - (d) Sanction terms and conditions.
 - (e) Bank Account No, banking facilities enjoyed by the borrower.
 - (f) If the advance is a consortium lending, names of lead bank and other banks and their participation.
 - (g) Last three months bank statements.
 - (h) Last three months Inventories statements.
 - (i) Latest inspection report of the account, Annual report or any available audit reports.
 - (j) Insurance particulars.
- (iii) An appointment before visiting the borrower's office.
- (iv) Wherever applicable, he should communicate with the previous stock auditor.

Understanding the Entity

8.3 The auditor should have the following information to understand the entity:

- (i) The nature of business.
- (ii) The nature of goods, especially, with regard to the storage:
 - (a) whether stored at multiple locations,
 - (b) whether they are of deteriorating nature, etc.
- (iii) The processes involved in manufacturing, production and ascertaining whether any part of the work is to be sent out of the entity for further processing.
- (iv) The key personnel involved in preparation and submission of Inventories statements and financial statements to the bank.
- (v) The business of the entity in order to identify the events and risks that may have an impact on the audit report.
- (vi) The transactions of related parties that are material to the financial statements. The auditor should obtain sufficient audit evidence in this regard.
- (vii) Effect of a service organization on the accounting and internal control system of the borrower.
- (viii) Effect of a CIS environment on the audit. The auditor should have sufficient knowledge of the CIS to proceed with the audit.

Audit Planning

8.4 In planning the inventories and receivables audit, the auditor should consider the following:

- (i) The nature of the accounting and internal control systems used regarding Inventories.
- (ii) Inherent, control and detection risks, and materiality related to Inventories.
- (iii) Whether adequate procedures are established and proper instructions issued for physical Inventories counting.
- (iv) The timing of the count.
- (v) The locations at which Inventories is held and its nature.
- (vi) Whether an expert's assistance is needed.

8.5 When inventories is situated at various locations, the auditor would decide, the location to be checked, taking into account the materiality of the inventories and the risk of material misstatement and the assessment of inherent and control risk at different locations.

Inventories are usually located at the following locations:

- (i) Borrower's premises
- (ii) At the borrower's plant.
- (iii) In transit.
- (iv) On Consignment.
- (v) In a public warehouse.
- (vi) For processing.

Substantive Procedures

8.6 The following steps are to be taken by the auditor for an effective stock audit:

Before making Visit to Party

The auditor may obtain the following information before making visit to party:

- (i) Obtain the Name, Address, Telephone No., and Fax No of the party.
- (ii) Obtain the bank account numbers and full banking details of the party.
- (iii) List down the various kinds of facilities enjoyed by party and the limits thereof.
- (iv) List down the date of sanction, sanction limit, drawing power & current balance in the account. Obtain a copy (Xerox) of the original sanction letter and the latest review note.
- (v) Check whether the party is regularly submitting the statement of inventories and book debts
- (vi) Check whether the insurance policy has been issued in the favour of bank or not.
- (vii) Check the amount of insurance policy and date of expiry.
- (viii) Go through previous visit record made by branch manager, advance officer or any other officer of the branch.
- (ix) Check whether the interest on overdraft or cash credit facility has been regularly paid, same is the case of installment payments of term loan.

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- (x) Check whether the operation of account is satisfactory or not.
- (xi) Get an appointment before visiting the party's office.
- (xii) Check the due diligence certificate in the case of Lending under Consortium Arrangement/ Multiple Banking Arrangements. [Refer RBI/2008-2009/379 DBOD. No. BP.BC.110/08.12.001/2008-09 dated February 10, 2009]

At the Borrower's Office

The auditor may check the following at the borrower's office:

- (i) Check whether the party has maintained the inventory register.
- (ii) Check whether other books of account have been maintained by the party, i.e., cashbook, bank passbook, purchase book, sales book, debtors ledger and creditor ledger, etc.
- (iii) Check all statutory dues have been paid.
- (iv) Check whether prescribed particulars of charges as detailed in Section 125(4) of this Companies Act along with the instrument by which the charge is created has been filed with the Registrar for registration within 30 days after the date of its creation.
- (v) Check the sales and purchase invoices.
- (vi) Bank name plate stating "Hypothecated to Name of Bank/ Financial Institution" should be affixed on the wall of Inventories premise, e.g. "Hypothecated to Corporation Bank".
- (vii) If there is damaged Inventories, then it should not be taken into account for calculation of drawing power.
- (viii) Inventories must be in sufficient quantity to cover the advance given by the bank.
- (ix) Inventories should be kept in proper condition
- (x) Inventories must be kept in the premises, which should be free from water leakages, fire, and other hazards, etc., so that damage to inventories does not occur.
- (xi) Fire-fighting equipment must be available in inventories premises and it should be regularly checked to preserve its utility.
- (xii) Specify the name of the person who has attended the auditor.

Documents to be Obtained from the Borrower

The auditor may obtain the following documents from the borrowers:

- (i) The auditor should obtain a written representation from management regarding.
 - (a) The completeness of information provided regarding the Inventories; and
 - (b) Assurance with regard to adherence to laid down procedures for physical Inventories count.
- (ii) Insurance premium receipt with respect to the insurance policy.
- (iii) Bank/ Financial Institutions original sanction letter and the latest review note.
- (iv) Balance Sheet and Profit and Loss Account of the borrower for last 3 years.
- (v) Inventories Statement & Book Debts Statement as on the last day of the quarter and for the year and preceding 3 months before the date of inspection.
- (vi) Copy of Memorandum of Association, Articles of Association along with Form No. 32 and 18, partnerships deed, Trust deed and its byelaws as may be applicable.
- (vii) Copy of audited financial statements.

Procedure for Verification of Pledged Inventories

The auditor may perform the following procedures to verify the pledged inventories:

- (i) Ensure that a board is prominently displayed at the entrance and within the godown, clearly stating that the goods are hypothecated or pledged with the respective bank or financial institution.
- (ii) Examine the lock to ensure that bank's/ financial institution's name is engraved there on.
- (iii) Examine the layout of the godown where inventories are stored.
- (iv) If the godown is rented, inspect the rent receipt and ensure that it is in the name of the borrower. Also ensure that the rent is not in arrears. If the godown is in ownership, verify the ownership agreement and ensure that it is in the name of the borrower.

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- (v) Ensure that there is no other gate or entrance to the godown and if it is there, it is properly locked from inside.
- (vi) Ensure that the godown is located at the address given to the bank and as mentioned in the insurance policy and other documents.
- (vii) Ensure that the ventilators are covered by grills.
- (viii) Ensure that no hazardous material is stored nearby the godown. If so, it should be specifically mentioned in the insurance policy.
- (ix) Ensure that no other Inventories other than those pledged to the bank are stored in the godown without the specific prior authority and if they are stored, then adequate insurance cover is taken.
- (x) Ensure that the godown is in a good condition without and leakage or Seepage of water and dampness.
- (xi) Ensure that the bin cards are signed by the godown keeper and by all inspecting officers.
- (xii) Ensure that there is proper stacking of goods.
- (xiii) Ensure that the deteriorated goods are not stored in the godown.
- (xiv) Ensure that the goods are not re-pledged.

Procedure for Verification of Hypothecated Inventories

In the case of hypothecation accounts, there will always be some difference between the inventories shown in the Inventories Statements and the actual inventories on the date of inspection due to the time lag involved. Hence the figures appearing in the Inventories statement and the borrower's books should be reconciled by making necessary adjustments for sales, purchases, production and consumption since the date of Inventories Statement. The audit should be designed in such a manner that if the inventories is large, an extensive check should be made of the material control system.

The auditor may perform the following procedures to verify the hypothecated inventory:

- (i) Verify the actual inventories in the godown physically with that declared in the Inventories Statement.
- (ii) Verify that the record keeping is proper and that there are no indications of dishonest or inefficient management.
- (iii) Verify that there are adequate internal control systems commensurate with the size of the concern.

- (iv) The auditor should review management's instructions regarding:
 - (a) The application of control procedures, for example, collection of used stock-sheets, accounting for unused stock-sheets, tagging and count and re-count procedures;
 - (b) Accurate identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, Inventories owned by a third party, for example, on consignment and Inventories in transit; and
 - (c) Appropriate arrangements made regarding the movement of Inventories between areas and the shipping and receipt of Inventories before and after the cut-off date.
- (v) The auditor should also consider cut-off procedures including details of the movement of inventories just prior to, during and after the count to ensure that such movements are appropriately included and/ or excluded, as applicable from such inventories. For example:
 - (a) Goods purchased but not received are included in the inventories;
 - (b) Goods sold but not dispatched are excluded from the inventories.
- (vi) Verify whether consistent and accepted accounting principles are adopted for valuation of Inventories.
- (vii) Evaluation of the security measures for prevention of theft and pilferage.
- (viii) Costing system in operation to ensure the value of the system in use
- (ix) Go through the "Purchase register", "Sales register", "Goods received note", and "Goods returned note" and verify with the invoices. If these registers are not prepared, then examine the books, which serve as a record of the things made as in these registers.
- (x) If there is any difference between the physical verification of the inventories and the records, the same should be jotted down.
- (xi) In case the inventories are lying with processors, verify whether the branch has obtained a letter of no-lien from the processors.
- (xii) Scrutinize at least 20 % of the total raw material and 85 % of the total finished goods and semi-finished goods lying in the godown.

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- (xiii) Prepare the age-wise list of the inventories in the following manner:
 - (a) more than 12 Months.
 - (b) more than 6 Months Old and Less than 12 Months Old.
 - (c) more than 3 Months Old and Less than 6 Months Old.
 - (d) more than 1 Month Old and Less than 3 Months Old.
 - (e) less than 1 Month Old
- (xiv) Bifurcate the inventories into paid and unpaid and ensure that only paid inventories are taken for the purpose of calculation of drawing power.
- (xv) In case of unpaid inventories, the bank/ financial institution should not provide any assistance or credit facility to the extent the insurance policies cover the following risks:
 - (a) Fire.
 - (b) Marine
 - (c) Other Natural Calamities
- (xvi) The inventories hypothecated should be within the norms as suggested by the Tandon/ Chore committee. If the borrower is keeping excess inventories than the prescribed norms, the borrowers should give a time-bound program to reduce the level of inventories.
- (xvii) A written declaration from the borrower about his existing credit facilities with other banks, if any, and an undertaking that the inventories will not be hypothecated to any other banks without the prior consent of the bank is taken on record.
- (xviii) Also verification of register should be done.
- (xix) Details of the inventories as regards to quantity, quality, life, date of purchase and price must be verified.
- (xx) Check whether goods require any specialized preservation, and if so, then proper arrangement should be made for facilitating such storage.
- (xxi) Check the method, which has been employed for ascertaining the final value of closing inventories.
- (xxii) Check whether borrower follows the method consistently or not.
- (xxiii) Verify the movement of inventories.
- (xxiv) Check the work in progress and its basis of valuation and percentage of completion.

Procedure for Verification of Hypothecated Book Debts

The auditor has to ensure that the book debts charged to the bank have arisen out of genuine trade transactions. Hypothecation of book debts, to be precise, is more like clean advances. Their safety depends upon the quality of checks the branch exercises over the book debts statements, submitted from time to time. Following checks, however, should be done by the auditor:

- (i) The debts shown as outstanding should be shown in the respective ledger account in the books of the borrower.
- (ii) Few invoices/ excise gate passes should be checked to ensure actual movement of Inventories.
- (iii) Sundry Debtors may be classified as sound, i.e., fully realizable or doubtful.
- (iv) Prepare the age-wise list of the Book debts in the following manner:
 - (a) more than 12 Months Old
 - (b) more than 6 Months Old and Less than 12 Months Old
 - (c) more than 3 Months Old and Less than 6 Months Old
 - (d) more than 1 Month Old and Less than 3 Months Old
 - (e) less than 1 Month Old

The age of the book debts should not be more than stipulated in the sanction. The debts of over a period of 3 months (or as stipulated in sanction) should be excluded while estimating the drawing power.

- (v) The debt should represent sales and service transactions only.
- (vi) Ledger of sundry debtors and sales-register should be pursued.
- (vii) Bad or doubtful debts should be excluded while calculating the drawing power.
- (viii) The advances have been allowed to reputed corporate borrowers after a careful assessment of the creditworthiness of debtors, besides that of the borrowers.
- (ix) Examine the statement of Debtors to ascertain whether there is undue concentration of debts involving large amount from a few parties. If so, examine whether limits for individual debtors have been fixed and whether the limits are adhered to.
- (x) Compare the statement of book debts with the debtors ledger to ascertain the genuineness of the debt, aging of debt and cases of non-realization of long outstanding debts.

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- (xi) All realizations are duly deposited in the account and the borrower furnishes realization statement of book debts.
- (xii) The drawing power is revised from time to time on the basis of statements and the required margin is maintained in the account.

While valuing debtors, it should be seen that the bad and doubtful debts have been written off so as to reflect their correct value.

The following are the indicators that the debts are doubtful and uncollectible:

- (i) Terms of credit have been repeatedly ignored.
- (ii) Stagnation or lack of healthy turnover.
- (iii) Payments have been received but balances are increasing continuously.
- (iv) Cheques are repeatedly dishonored.
- (v) Debt under litigation, arbitration or dispute.
- (vi) Collection becomes time barred.
- (vii) Debtor is unable to repay the due amount due to insolvency or disowns the debt.

Confirmations

Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are entitled to hold the stocks of the entity. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. In the process of audit, external evidence is considered to be more reliable than internal evidence. Therefore, confirmation of Accounts Receivables, which are hypothecated for the purpose of loans from financial institutions or bank, is a generally practiced auditing procedure to obtain such evidence. This establishes reliably the existence and the value of the debts as is reflected in the accounts.

The entire process is as follows:

- (i) Select the parties for obtaining confirmation.
- (ii) Design the confirmation request.
- (iii) Communicate the confirmation request to the third party.
- (iv) Obtain response from the third party.

- (v) Evaluate the information provided by the third party and scrutinize the same for reliability.

The date of request of confirmation is also very important.

The date may be as follows:

- (i) Year end date
- (ii) Date prior to year-end.

Generally, the confirmation request should be sent approximately a week before the date specified in the request, if the debtor is in a foreign country. The auditor should first obtain a schedule of accounts receivable. The auditor should also determine that there are no totaling errors. He should investigate the credit balances and compare all or a selected sample of account balances with the account balances in the ledgers.

The auditor may verify the following accounts:

- (i) All accounts with a balance over a pre-determined amount. The predetermined amount is based on the auditor's assessment of materiality.
- (ii) All accounts having zero balances.
- (iii) Accounts with old unpaid balances especially when subsequent sales have been paid off.
- (iv) Accounts written off during the year under review.
- (v) Certain accounts that had appeared on the prior year's accounts receivable schedule but not on the current year's schedule.
- (vi) All accounts with credit balances.

Drawing Power

The auditor may perform the following procedure regarding drawing power:

- (i) Ensure margin requirements as per sanction terms are considered.
- (ii) Check for arithmetical accuracy.
- (iii) Check that old and obsolete inventories are excluded.
- (iv) Check that debtors greater than 90 days are excluded.
- (v) Check that unpaid stock [Sundry Creditors] has been excluded.
- (vi) Check that the statement is submitted as per bank's format only.

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- (vii) Drawing power is required to be arrived at based on the Inventories statement which is current.
- (viii) The outstanding in the account based on drawing power calculated from Inventories statements older than three months, would be deemed as irregular.
- (ix) The account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

Verification of Insurance Coverage

The auditor may perform the following procedures to verify the insurance coverage:

- (i) Check whether the Inventories hypothecated is adequately insured.
- (ii) Check whether the policy is in force.
- (iii) Check whether inventories with third parties are also covered.
- (iv) Check whether bank clause is included in the policy.
- (v) Check whether the Inventories is covered against all major perils.
- (vi) Check whether the collateral security is also insured adequately.

Documents to be taken as Working Papers

The auditor should comply with the requirements of the SA 230 [Earlier AAS 3] regarding documentation and gather the following records as documentary evidence for the purpose of facilitating him in the process of audit:

- (i) Auditor's report on Inventories for the previous three years.
- (ii) Bank statements of the last 3 months.
- (iii) A statement showing previous years Opening Inventories, Purchases, Sales, Work in progress and Finished Goods.
- (iv) Details of Installed capacity, licensed capacity and Actual production with documentary evidence.
- (v) Copies of sales invoices for last 12 months, taking on an average at least 3 entries per month and checking the process of collection.
- (vi) Copies of purchase invoices for last 12 months, taking on an average at least 3 entries per month and checking the process of collection.
- (vii) A certified copy of the constitution of entity represented by either the

- Partnership Deed or the Memorandum and Articles of Association or the Trust deed for Trust, etc.
- (viii) In case of a company, the following copies: (a) a copy of Form No.18 along with filing fees receipt for registered office address (b) A copy of Form No 32 along with filing fees receipt for directors. (c)A copy of Form No. 8 and 13 along with filing fees receipt and charge registration certificate (d) a copy of Form No.8 and 17 along with filing fees receipt & certificate for registration of charge and balance sheet.
 - (ix) The Profit and Loss Account for the last 3 years.
 - (x) Month-wise Inventories statement of the last one year.
 - (xi) Month-wise book debt statement of the last one year.
 - (xii) In case of a manufacturing concern, a brief summary of the manufacturing process.
 - (xiii) A list of books and records maintained for the purpose of Inventories, debtors and security.
 - (xiv) An organization chart giving an overview of the organizations' hierarchy, along with their respective responsibility.
 - (xv) A flowchart depicting the movement of raw materials, work in progress and finished goods.
 - (xvi) The credit policy as is employed by the company.
 - (xvii) A detailed statement of debtors showing the date of the bill and age-wise classification of debtors.
 - (xviii) An Inventories statement as on the date of physical verification along with date of purchase with the detailed breakup of its components.
 - (xix) A copy of agreement of ownership / Lease agreement / Rent agreement for office / Factory / Godown.
 - (xx) A list of sundry creditors with date of bill for goods purchased on date of physical verification.
 - (xxi) A certified copy of the Insurance policy in force.
 - (xxii) A certified copy of loan sanction letter.
 - (xxiii) Comprehensive management representation letter.
 - (xxiv) A certified copy of Excise Return (RT-12), Sales tax return and Income tax return of the previous year.
 - (xxv) Copy of registration certificate under Shops and Establishment Act,

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Register of Firms, Pollution control Board, Food and Drugs Approval Authority – other laws as applicable.

(xxvi) A note specifying the accounting policies that are employed.

(xxvii) A detailed note on accounting system for purchases, sales and inventories.

The auditor should verify the documents that are available with the bank branch and satisfy him about the adequacy of such documents. As far as possible the auditor should not call for these documents, if they are insufficient since the borrower may be hesitant to divulge his trade documents to a third party. Instead the banks should be asked to call for these documents.

Reporting

8.7 The auditor may consider the following while reporting:

- (i) The report has to be submitted to the authority appointing the auditor.
- (ii) It should be in the prescribed format and should be exhaustive and inclusive of all facts and summaries.
- (iii) It should include the date, time, location of visit and the name of the officials conducting the audit and the official of the entity present at the entity at the time of conducting the audit.
- (iv) Copies of confirmations, management representations, etc should be submitted along with the report.
- (v) If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of Inventories or adequacy of procedures adopted by the management in respect of physical inventories count, the auditor should make a reference to a scope of limitation in his audit report.
- (vi) If the inventories is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.

Chapter 9

Significant Observations in Cash-Credit Accounts

9.1. The significant observations made by the auditor in cash-credit accounts are as follows:

- (i) Inventories / Book Debts / QIS statements not furnished in time.
- (ii) Inventories Statement received from borrower are filed without scrutiny. Non moving inventories and not identified.
- (iii) Age wise analysis of debtors are not done. Debtors more than 90 days are considered for drawing power.
- (iv) Drawing power not correctly calculated.
- (v) Inadequate insurance or insurance is not available, Policy without Bank Clause/coverage of all risk.
- (vi) Operations in the accounts are not scrutinized with reference to projections, QIS statements, audited accounts, etc.
- (vii) In case of consortium advances and account is not monitored in close coordination with the member bank.
- (viii) Physical verification of assets and inventories are not done as per stipulation. Defects pointed out by the Inspectors are neglected.
- (ix) Valuation of inventories are not verified.
- (x) Confirmation for Inventories with third party are not obtained or physical verification of inventories are not done.
- (xi) Material received from third parties for job work is not excluded while calculating drawing power.
- (xii) Diversion of funds and inter account transfers are not properly monitored.
- (xiii) Accounts are not reviewed/renewed at regular interval.
- (xiv) Monitoring of account where sub-limit is transferred to branches.
- (xv) Borrower having operations with other bank.
- (xvi) To cover the valuation of security, revaluation of assets may not be genuine.

Chapter 10

Inadequacy of Stock Audit

10.1 Conducting Stock Audit does not necessarily guarantee absolute veracity of the stock records or even the healthy financial position, for that matter. There are certain inherent deficiencies that are inevitably there. They take place in the following ways:

- (i) The auditors appointed for the purpose of Stock Audit cannot be expected to be aware of the industry scenario precisely. If the risk assessment and demand analysis is done without taking into consideration the future industry prospects, then it will undoubtedly reveal a wrong picture and hence a futile report as a result.
- (ii) The scope of the auditor's work is limited; in the sense that he is not allowed to delve deep in the technical aspects. Also it is not humanely possible for him to be conversant with the technical details and this prevents him from judging the concept of technological obsolescence, which is a critical aspect as far as stocks are concerned.
- (iii) Since the system of allocation of stock audit is not based on a well-worked out methodology, it is sometimes allocated without considering the proper evaluation of the competence, manpower or experience. As a result, it fails to serve the purpose it was meant to serve.
- (iv) Several banks resort to window dressing for the purpose of reflecting a healthy financial position than it actually is. This may be in the form of certain liabilities which are not reflected in the books. This is particularly true in cases where the borrower has various group companies.

Remedies

10.2 It is not possible to deal with all the inconsistencies in a fool-proof manner. However the following can be done:

- (i) The appointment procedure of the Stock auditors can be more scientific and should be based on merit.
- (ii) As required by SA 310 [Earlier AAS-20], the auditor should acquaint himself with the Knowledge of the business, before he starts the audit, both technical as well as financial aspects, to give him a better understanding.

10.3 Special considerations while conducting Stock Audit:

- (i) If the stock statement as shown in the hypothecation statement does not tally with the stocks as in the balance sheet, then appropriate action should be taken to find reasons for the differences
- (ii) It should be seen that the stocks have been properly valued, after considering the relevant accounting principles, Standards on Auditing.
- (iii) It should be seen that current assets are not over-stated.
- (iv) It should be seen that the turnover is not over-stated.
- (v) It should be seen that the accounting policies with regard to stock and debtors is employed.
- (vi) It should be seen that the stocks that are genuinely owned by the borrower are shown in the accounts.

Chapter 11

Physical Verification of Inventories

11.1 The auditor should check the following regarding the inventories.

- (i) Ensuring whether the entity is maintaining proper records of inventories.
- (ii) Conduct of physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification.
- (iii) whether any material discrepancies were noticed on physical verification.
- (iv) if so, whether the same have been properly dealt with in the books of accounts.

Maintenance of Records

11.2 What constitutes “proper records” is a big question. However, in general, records relating to inventories should contain, *inter alia*, the following:

- (i) Particulars of the item like nomenclature, nature, etc.
- (ii) Identification code of the item.
- (iii) Details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner.
- (iv) Relevant document number and department identification, if any.
- (v) Location.
- (vi) If priced stores ledger is maintained, the records of the inventory should also disclose the prices at which the recording of the issues and receipts is made.
- (vii) The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents.

Physical Verification of Inventories

- (viii) The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained.
- (ix) In cases where a company is maintaining stock records for work-in-progress, say, for compliance with the requirements of the section 209(1)(d) of the Companies Act, 1956, the auditor would normally be able to obtain relevant information in respect of work-in-progress from such records. However, in many cases, it might be impracticable to maintain stock records for work-in-progress. In such cases, the auditor should consider the fact whether the company, at any point of time, can arrive or calculate the quantity and amount involved in the work-in-progress. Some of the factors that might be used in arriving at the value of work in progress include the production cycle, input/ output ratio analysis, production and stock records for the immediately following period. If the company is able to do so, the auditor may form an opinion that proper records relating to the work-in-progress have been kept and, accordingly, no adverse comment of the auditor under this clause would be required. However, before adopting this as an audit procedure, the auditor should satisfy himself as to the impracticability of maintenance of stock registers of work-in-progress.
- (x) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping (manual or computerized), the number of operating locations, the systems of control, etc.

Conducting Physical Verification

11.3 Physical verification of inventories would mean verification with regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement.

There are two principal methods of physical verification of inventories: periodic and continuous.

Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a

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year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.

Frequency of Counts

11.4 Count frequency should be calculated to meet your previously stated objectives. Factors such as the effects on customer service and manufacturing operations, and the potential for inaccuracy within the specific product group will affect the frequency of your counts. Even factors such as manufacturing and supplier lead times should be considered in prioritizing counts. Certain key raw materials critical to your operation that are highly prone to variances due to high scrap factors or variation in manufacturing processes may need to be counted every week (or day) while some very slow-moving finished goods may only need to be counted once a year. As your count program evolves, the frequency of counts will change based upon the accuracy levels achieved.

Process of Verification

11.5 Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. The auditor has to use his professional judgement regarding the nature, timing and extent of the procedures to be applied in forming his opinion.

- (i) The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.
- (ii) The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock

Physical Verification of Inventories

- records and other corroborative evidence, e.g., inventory statements submitted to banks.
- (iii) Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:
 - (a) maintains adequate stock records that are kept up-to-date;
 - (b) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and
 - (c) investigates and corrects all material differences between the book records and the physical counts.
 - (iv) The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.
 - (v) The auditor may determine the reasonableness and adequacy of the procedures of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The documents which can be examined by the auditor would include
 - (a) written instructions given by the management to the concerned staff engaged in the verification process;
 - (b) physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;
 - (c) summary sheets/consolidation sheets duly authenticated by the responsible officials;
 - (d) internal memos etc., with respect to the issues arising out of physical verification of inventory;
 - (e) any other relevant documents evidencing physical verification of inventory.
 - (vi) In case where the inventories are material and the auditor is placing reliance on the records, documents, information and explanations provided by the management, it would be desirable that the auditor, in order to substantiate the fact that the physical verification is carried out in accordance with the procedure explained by the management, attends the physical verification. Where the auditor is present at the

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time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories.

- (vii) While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable or adequate.

Discrepancies on Verification of Inventory

11.6 The auditor needs to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies.

Chapter 12

Valuation of Inventories

12.1 If the inventories are not valued properly then it projects a wrong picture of the financial statements of the company. The valuation of inventories therefore is an important area that needs to be addressed well by the auditors.

12.2 There cannot be a universal principle to be applied for the purpose of valuation. Different methods of valuation are adopted, depending upon the type of Inventories, in particular and the type of the business, in general. The auditor is, therefore, required to ascertain the method of valuation that best suits the requirement.

12.3 However, it should be borne in mind that he should adopt the principle of conservatism while valuing the inventories. The inventories should be valued at cost or market price, whichever is lower. The fundamental concept is that provision for losses should be made and unrealized profits should not be considered. This helps the accounts to project the true value in the real sense.

12.4 An auditor is, therefore, expected to do the following regarding the valuation of inventories:

- (i) Find out the cost price of the inventories.
- (ii) Determine the market value of the inventories.
- (iii) Since different types of inventories require different methods of valuation, ascertaining the appropriate method of valuation and valuing it, accordingly.
- (iv) Value the obsolete inventories/ non-moving/ scrap inventories

I Actual Cost of the Inventories

12.5 Two aspects need to be addressed while arriving at the cost price:

- (a) The method of valuation and
- (b) Compliance of the Section 145A of the Income Tax Act, 1961

Method of Valuation

12.6 The term, cost price is elusive since it is not well defined anywhere. The auditor has to use his discretion to decide which method of ascertaining

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the cost price best suits his requirement. There are various methods that can be adopted. However, the Institute of Chartered Accountants has prescribed the methods that are mandatory for the valuation of inventories, by means of the Accounting Standard 2, which deals with the valuation of inventories.

These methods are specific identification method, First-in-First-out method and Weighted Average Method. It is the duty of the auditor to verify that the inventories have been valued by either of the above methods. The auditor should report any variance from the same.

A brief idea of these methods is given as under:

1. **Specific Identification Method:** If the materials that have been purchased are utilized for a particular job, the actual purchase price can be charged as the cost of the Inventories. This method is appropriate when there are minimum fluctuations in the prices.
2. **First in First out Method (FIFO):** This is the most widely used method adopted for valuing the Inventories. Here the Inventories is valued on the basis of the principle that the Inventories is utilized in the order in which it is received. Hence the Inventories remaining is from the latest purchase.
3. **Weighted Average Method (WAM):** This is a relatively practical method of valuation .As per this method; the Inventories is valued at an average price which is arrived at every time a purchase is made. The simple principle of average should be applied .In other words the total value of the Inventories should be divided by the quantity to arrive at the weighted average price.

Any of the above methods can be employed for the purpose of valuation of inventories. If any other method is employed, the auditor should take note of it and report the discrepancy in the report that is submitted.

Compliance with the Section 145A of the Income Tax, 1961

12.7 The Income Tax Act, 1961 has inserted Section 145A from Accounting Year 1998-99. This section requires that while valuing Inventories the method employed should be:

- In accordance with the method regularly employed by the assessee.
- Further adjusted to include the amount of any cess, tax, fee (by whatever name called) actually paid or incurred or fee by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

While valuing the Inventories, it should be ensured that the above requirement of the statute is complied with. The auditor should obtain a satisfaction to the effect that the value of the Inventories is inclusive of any cess, tax or fee that has been either incurred or paid on such Inventories. The auditor should bring any lapse on this account to the notice in the report.

II Market Price of the Inventories

12.8 After having arrived at the cost price of the Inventories, on the basis of the aforementioned parameters, the auditor has to find out the market price of the inventories. As the inventories is to be valued at cost or market price whichever is lower, it is an important step in the process of valuation. The market price may seem to be a very simple term, in the sense that it is the price of the inventories that prevails in the market. However, in order to arrive at the market price, the purpose for which the inventories is held is to be found out. If it is held for use then the market value is the value arrived at net of selling expenses. Similarly, if the inventories is required to be replaced, then the cost of replacement as on the date of balance sheet should be taken as the market price.

Thus, after arriving at the market price on the above basis, the auditor can quantify the value of the inventories.

III Valuation of Different Types of Inventories

12.9 The Institute of Chartered Accountants of India defines Inventories to include, stores, spare parts, loose tools, raw materials, materials in process, finished products, waste or by products, etc. Each type of Inventories entails different methods of valuation depending on their unique characteristics. The following points should be kept in mind while arriving at their value:

- (i) *Stores*: Stores have been defined as that component of Inventories that is not held for sale. They are in fact, consumed in the manufacturing process. Examples of stores would include, oil, tallow, grease, dyes, fuel, etc. Since they are not Inventories in the real sense of the term, they should be shown as a separate item in the balance sheet and the amount of stores consumed should be debited to the Manufacturing Account, so as to arrive at the true cost of manufacture. The stores should be shown at cost price only. However, any deterioration in the price should be incorporated to arrive at their true value.
- (ii) *Spare Parts*: It refers to the parts that form part of any Plant and Machinery. If an y such spare part is consumed, they should be

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capitalized as part of the asset they have been used for. Spare parts should be valued at the cost price only. It is the duty of the auditor to get a list of these spare parts from the Works Manager so that he can verify their existence.

- (iii) *Raw Materials:* It consists of the Inventories that is consumed in the process of manufacture. Raw material is valued at the invoice price, i.e. the cost price plus a reasonable proportion of freight, duty, etc that has been paid with regard to the Inventories. Either the actual cost or the average price can be taken as a method of valuation of raw material, depending upon the availability of data. For any diminution in the value of the raw materials, sufficient provision of the fall in the value should be made.
- (iv) The raw materials should be valued at a price, which is never higher than the market price. In case of the goods, whose value appreciates with the passage of time, they are valued at a price higher than the cost price. It is the auditor's duty to see to it that they are not valued at a price that is higher than the price of the similar goods.
- (v) *Materials in Process:* The goods which are not completed on the date of the balance sheet, some process needs to be carried out thereon, are called materials in process or semi-manufactured goods. These should be valued at cost plus a proportionate amount of wages and other charges, on the basis of percentage of completion. The auditor should verify that the percentage of completion has been worked out properly and hence valuation is in order.
- (vi) For this purposes, the auditor should or may examine the production / costing records (e.g. cost sheets), hold discussion with the personnel concerned, and obtain expert opinion, where necessary.
- (vii) In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work-in-process may be impracticable. In such cases the auditor should lay greater emphasis on ascertaining whether the system from which the W- I- P is ascertained, is reliable.
- (viii) *Finished Goods:* The Finished goods are valued at the cost price. The cost price is arrived at after adding all the expenses incurred in the process of manufacture. The auditor should verify that the expenses have been appropriately apportioned.
- (ix) *Goods on Consignment:* It may happen sometimes that the goods are sent on a consignment basis and they do not arrive till the date of the

balance sheet. In this case, the goods should be valued at the cost price plus proportionate expenses like, freight, dock dues, etc. the auditor should insist on the consignee to verify the quantity of Inventories lying with him. Any expenses incurred during the process of sale, it should be allocated only to the goods sold and not added to the unsold Inventories. Here again the principle of conservatism should be followed, a price higher than the market price should not be taken, while provision for losses should be done. If the Inventories is valued at selling price, when sent as a consignment, it should be ascertained that the Inventories should be valued after making the adjustments, or else the Inventories will be over-valued.

For computing accumulation of huge inventories, the number of days holding of Inventories etc, the following methods may be followed:

- 1) For Raw Material:
$$= \frac{\text{Holding of raw material stock}}{\text{Annual raw material consumed}} \times 365$$
- 2) For Inventories in Process:
$$= \frac{\text{Holding of inventories in process}}{\text{Annual cost of production}} \times 365$$
- 3) For Finished Goods:
$$= \frac{\text{Holding of finished goods}}{\text{Annual cost sales}} \times 365$$
- 4) For sundry debtors:
$$= \frac{\text{Holding of sundry debtor's}}{\text{Annual sales}} \times 365$$
- 5) For sundry creditors
$$= \frac{\text{Holding of sundry creditor's}}{\text{Annual purchases}} \times 365$$

IV Valuation of Obsolete/ Dormant/ Slow-Moving/ Excess Inventories

12.10 The term obsolete inventories refers to the inventories that has become unsalable due to following reasons:

- (a) Discontinuation of the product in the market

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- (b) Physical Deterioration
- (c) Change in the design of the product
- (d) Substitution by a better material in lieu of the existing one.

The auditor should make an effort to find out the inventories that have become obsolete due to any of the above reasons. After preparing a list of them, they should be presented to the management who can decide whether they should be disposed off or kept. Obsolete inventories should be valued at net realizable value.

Dormant inventories mean the Inventories whose movement is temporarily hampered due to a variety of reasons, but they are expected to be consumed in the days to come. One such reason for their slow movement is that the Inventories is consumed in the manufacture of goods that are sold seasonally and hence their production is stopped during off-season. Slow moving Inventories means the Inventories with a low turnover rate. In other words, they move at a slow rate.

The dormant and slow moving Inventories should be valued at net realizable value, cost or replacement price, whichever is the lowest. The auditor should make a list of these items also and speed up their disposal, if necessitated by the management.

Excess Inventories, as the name suggests, is the excess of Inventories that has accumulated due to either unwarranted purchase of goods, lapse in the forecast of sales leading to excess Inventories than can be consumed, unhealthy practices in the Inventories management, etc. The question whether any Inventories is in excess is subjective and depends on the discretion of the company. In general any Inventories that is in excess of three years usage will be considered as excess Inventories. The auditor should see to it that the excess Inventories is sold and unless there is any possibility of its usage in the production process.

The auditor should bear in mind the fact that either of the above kind of Inventories necessitates additional blockage of funds, mis-utilisation of space, maintenance cost, Storage cost and fear of pilferage and further deterioration. This has an adverse impact on the bottom line of the company. He should therefore make an effort to see that proper controls are in force so as to ensure that such inventories are kept under check and as far as feasible avoided.

Controls

12.11 The controls that should be exercised by the auditor are as follow:

A) Controls with regard to the Scrap, Waste and Spoilage

The term scrap refers to that Inventories that arises due to the manufacturing process and has very small value. Waste, on the other hand means goods that have no recovery value. While, spoilage refers to those goods that do not meet the quality standards and hence have to dispose off at less than their actual value.

The auditor should bear the following points in mind while exercising control over the scrap, waste and spoilage:

- (i) The management should establish normal rates of scrap at which scrap is generated after having taken into account the past records and experience.
- (ii) Proper documentation of the scrap records should be done.
- (iii) The actual scrap realized should be compared with the standard set and the variance should be reported.
- (iv) The scrap should be considered as good units for the purpose of valuing the Inventories. Any sale proceeds derived from the sale of such scrap should be deducted from the cost of production.
- (v) An important area for the auditor to keep a check is that of sale proceeds of the scrap. He should satisfy himself that the sale proceeds are properly accounted and they have not been misappropriated.
- (vi) The scrap units should be properly stored in the stores department.
- (vii) Top management should be aware of the scrap generated and hence a periodic report should be generated.

B) Controls with regard to Stores Maintenance

Raw material forms the most important component in the cost sheet and hence an effort should be made that optimum Inventories is maintained. An auditor should see that the following points have been considered and any deviation from these should be immediately reported:

- (i) It should be seen that the Inventories requirement has been properly planned so as to avoid a problem of either excess Inventories or shortage of Inventories. If the Inventories is more than which is

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required, it will lead to excess blockage of funds, in the other scenario if the Inventories is short, it will hamper the production process.

- (ii) The Inventories should be properly handled and stored so as to prevent deterioration in value.
- (iii) The stores department should be well located so as to minimize the transportation cost.
- (iv) There should be an effective system for recording the movement of Inventories. Any movement should be well documented.
- (v) The system of First-in-First-out should be adopted so as to prevent obsolescence of old Inventories
- (vi) Any non-moving item should be identified and written off, if necessitated.
- (vii) The principle of re-order point should be followed so as to ensure continuous supply of goods at any point of time.
- (viii) A system of Continuous Inventories-taking should be in force

Auditor's Duty with regard to the Valuation of Stock

12.12 The cost of Inventories includes:

- (i) Cost of purchases.
- (ii) Cost of conversion comprising of cost of direct labor and allocated Fixed and variable overheads.

While valuing the Inventories, the auditor has to consider the following:

- (i) He should ascertain the accounting policy adopted for valuation of stocks and consider the appropriateness as per AS-2.
- (ii) He should verify that the cost of Inventories does not include:
 - (a) Abnormal waste material, labor or other production costs.
 - (b) Storage cost unless necessary in the production and manufacturing process.
 - (c) Administrative overheads not contributing to bringing the Inventories to the present location.
 - (d) Selling and distribution expenses.
 - (e) Interest cost.

Valuation of Inventories

- (iii) He should check the basis for Net realizable value determination.
- (iv) He should ascertain that the cost of damaged and obsolete item is written off.
- (v) He should check the arithmetic accuracy of stock valuation.
- (vi) He should check the consistency of the basis of valuation.
- (vii) He should review Inventories records for identifying slow moving and obsolete items.
- (viii) He should review the system of overheads allocation.

Chapter 13

Verification of Securities

Securities - Definition

13.1 According to *Section 2 (h) of Securities Contracts (Regulation) Act, 1956*, the term 'Securities' include:

- (i) shares, scrips, inventories, bonds, debentures, debenture Inventories or other marketable securities of a like nature in or of any incorporated company or other body corporate;
- (ii) derivatives;
- (iii) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- (iv) government securities;
- (v) such other instruments as may be declared by the Central Government to be securities; and
- (vi) Rights or interests in securities.

13.2 The physical as well as demat securities shall be in the form of:

- (i) Scrips or Certificates.
- (ii) Safe Custody Receipts (SCR).
- (iii) Letter of Allotment.
- (iv) Either Scrips or Allotment Letter.
- (v) Certificate of holding.

Scope of Audit

13.3 The scope of audit in this regard is as follows:

- (i) To verify physically the certificates of the securities held by the branch.
- (ii) To see that the registers for the securities held physically are maintained properly.
- (iii) To verify that securities held by the branch are tallying with Security Holding Register.

- (iv) To obtain the state ment showing the securities sent for demat and cross tally with the records maintained in the register.
- (v) To check vault and other registers with the Inventories Holding Register to see the reconcilia tion between physically verified scrips and total investments made by the bank. This scrutiny will reveal major queries relating to demat, redemption, withdrawals, re-deposits, call/put options.
- (vi) To give the report on the following lines.

Reporting

13.4 Reporting should be done on the following:

1. Statement showing primary market holding.
2. Statement showing the securities in the secondary market.
3. Statement showing the securities held in physical form.
4. Statement showing the certificates withdrawn permanently from Vault for redemption or for the purpose of demats.
5. Statement showing the investments neither where allotment letters are received nor the certificates.
6. Statement showing certificates of the investments held by ot her branches of the bank and for which there is Safe Custody Receipts.
7. The statement showing investments held by the other branches of the bank where the Safe Custody Receipts are not received by the Bank's Investment Section.
8. Statement showing certifica tes withdrawn from the Vaults for the interest collection.
9. Statement showing the certificates of the investments by the R.B.I.
10. Statements showing demat secondary market holdings.
11. Statement showing half yearly interest bonds.
12. Statement showing details of letters of allotment.
13. Statement showing the investment done in Regional Rural Banks.
14. Statement showing the certificates which are torn or mutilated.
15. Statement showing scrips lodged with branches (e.g. Custody).
16. Statement showing scrips pending for demat.

Audit of Securities

13.5 The auditor has to physically verify securities and check the following points:

(A) When the Original Securities are in Custody of Client

- (i) Whether the securities are in the name of the client. i.e. Ownership;
- (ii) Whether the securities are kept properly and in safe custody. i.e. Custodian;
- (iii) Whether the face value of the securities is properly mentioned. i.e. Valuation;
- (iv) Whether any security is missing, if so, investigate the reason thereto.

(B) When the Original Securities are in Custody of Another Person, i.e., Bank/ Financial Institution

In this case, the auditor will have to obtain a certificate from the holder of the securities that they are holding them on behalf of the client and the same are kept in safe custody.

(C) When the Original Securities are Sent Back to the Company for Surrender/ Transfer/ Change in Name, etc.

In this case, the auditor will have to check up the correspondence with the Company and the acknowledgement of the company that it has received the original security.

Chapter 14

Analytical Review Procedures

14.1 In addition to the audit procedures discussed earlier, an auditor has to apply certain analytical procedures to review the financial soundness of the business of the borrower. The auditor should carry on the following procedures:

- (i) Checking records of opening stock, purchases, production, sales and closing stock
- (ii) Comparison of closing stock with those of previous year quantity
- (iii) Comparison of composition of closing stock with the previous year
- (iv) Compare the current year Gross Profit with that of last year
- (v) Compare actual stock with budgeted figures
- (vi) Compare Inventories ratios with those of the industry and firms

14.2 The most common analytical procedure is Ratio Analysis. Ratios are useful tools for review of performance and state of affairs of the organization. Ratios calculated over a period of time can reveal trends based on which meaningful conclusions can be drawn.

At planning stage, ratios give a sense of direction to the auditor for areas to be covered for audit, during field work. They help him draw inferences and identify the main points to be dealt in report while after completion of the audit ratios help the auditor to re-enforce/establish his inferences and conclusions in his report. Ratios may be classified on the basis of their sources as follows:

1. Balance sheet ratios.
2. Income statement ratios.
3. Mixed ratios-these ratios contain figures from more than one financial statement.

Some of the more common ratios, their classification, method of computation, and the attribute measured are shown in the following list:

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Ratios	Formula	Purpose
Liquidity Ratios - Measures the entity's ability to meet its short-term obligations, and provide an indication of the Company's solvency.		
Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Indicates whether short-term creditors can be met with current assets
Quick Ratio or Acid Ratio	$\frac{\text{Current Assets}-\text{Inventory}}{\text{Current Liabilities}}$	Measures the entity's ability to pay off short-term creditors without relying on the sale of inventories
Leverage Ratios - Measure the extent to which the entity is financed by debt and provide a measure of the risk of the entity borne by the creditors.		
Debt Ratio	$\frac{\text{Total debt}}{\text{Total Assets}}$	indicates percentage of total funds provided by creditors; high ratios when economy is in downturn indicate more risk for creditors.
Times Interest Earned	$\frac{\text{Earnings before interest and taxes}}{\text{Interest Charges}}$	Measures extent to which earnings can decline and still provide entity with ability to meet annual interest costs, failure to meet this obligation may result in legal action by creditors, possibly resulting in bankruptcy
Long Term Debt to Equity	$\frac{\text{Long Term Debt}}{\text{Shareholder's Equity}}$	indicates the proportion of the entity financed through long-term debt Vs. owners' equity
Active Ratios - Measure how effectively an entity employs its resources.		
Inventory Turnover	$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$	Estimates how many times a year inventory is sold.
Age of Inventory	$\frac{360 \text{ days}}{\text{Average Accounts receivable}}$	Indicates number of days of inventory on hand at year-end,
Accounts Receivable	$\frac{\text{Net Credit sales}}{\text{Average account receivable}}$	Estimates how many times a year, account receivable are collected
Age of Accounts	$\frac{360 \text{ days}}{\text{Accounts receivable turnover}}$	Indicates the age of accounts receivable or number of days sales not collected
Total Asset Turnover	$\frac{\text{Net sales}}{\text{Total Assets}}$	Estimates volume of sales based on total assets

Analytical Review Procedures

Profitability Ratios – Measure how effectively the entity is being managed.		
Sales To Total Assets	$\frac{\text{Net sales}}{\text{Total assets}}$	Indicates the ability of an Entity to use its assets to generate sales.
Gross Margin	$\frac{\text{Gross margin}}{\text{Net sales}}$	Provide a percentage relationship based on sales
Profit Margin On Sales	$\frac{\text{Net income}}{\text{Net sales}}$	Indicates the return a Company receives on sales.
Net Operating Margin	$\frac{\text{Operating income}}{\text{Net Sales}}$	Indicates management's effectiveness at using Entity's assets to generate Operating income
Return On Total Assets	$\frac{\text{Net income} + \text{Interest income}}{\text{Total assets}}$	Indicates the return a company receives for its assets
Return On Common Shareholders Equity	$\frac{\text{Net income} - \text{Preferred dividends}}{\text{Average stockholders equity}}$	Indicates return on investment to common shareholders

Illustration 1:

Facts

A company has cost of sales for the year of ₹1, 08,000. Its Inventories amounted to ₹20, 000 at the beginning of the year and ₹16, 000 at the end of the year. Its Inventories turnover is determined as follows:

1. Average Inventories

Opening stock	₹20, 000
Closing Stock	₹16, 000
Average Inventories	$\frac{20000 + 16000}{2} = ₹18000$

NOTE: A better indication of the average Inventories may be obtained by using month-end inventories, if available.

2. Cost of sales ₹108,000

3. Inventories Turnover Ratio = Cost of sales/ Average Inventories

$$= \frac{₹ 108,000}{₹ 18,000} = 6$$

In the previous year, the inventories turnover was 6.

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Interpretation of the above ratio:

An increase in the Inventories turnover ratio may occur because of improved purchasing, production, and pricing policies. It may also be caused by one of the following:

1. Poor credit rating of client. If the client has a poor credit rating, it may not be getting the entire Inventories it requires. This will cause Inventories levels to decline, and if sales do not decline as rapidly, the Inventories turnover ratio will increase.
2. Unrecorded purchases.
3. Unusual Inventories shrinkage.
4. Extremely conservative Inventories valuation.
5. Error in computing the Inventories.

Audit Procedures:

The following audit procedures may be employed for taking corrective action. There are no specific auditing procedures when the high turnover is caused by insufficient Inventories because of a poor credit rating. In that situation, however, the auditor might want to obtain a credit report on the client and should approach the audit with more skepticism than usual.

If the auditor believes that the high turnover of Inventories is caused by other than a poor credit rating, he may take the following additional procedures:

1. Review debit balances in the accounts payable schedule. A debit balance might indicate a payment without the accompanying entry for a purchase.
2. Review Inventories controls to determine the possibility of theft. Also, if the company is a manufacturer, review production records to determine spoilage and waste.
3. Compare Inventories costs with Inventories values.
4. Review Inventories computations.

Illustration 2:

Facts

Following is the trend statement of selected income and expense item:

Year	1 st	2 nd	3 rd	4 th	5 th
Sales	100	116	133	151	168
Selling expenses	100	115	132	150	175

Analysis

Sales have increased at a steady rate over the 5-year period, and selling expenses matched this increase for the first 4 years. In the fifth year, however, the increase in selling expenses was disproportionate to previous years' increases and to the current year's increase in sales.

The increase may have been caused by one of the following:

1. Misclassification of expenses,
2. Classification of prepayments as expenses,
3. Recording of non-business expenses.

Auditing Procedures

The following audit procedures may be employed for taking corrective action:

If a trend statement indicates a disproportionate increase in an expense, the auditor should apply additional substantive tests to this expense. To determine the reason for the disproportionate increase in selling expenses in the preceding examples, the auditor may review invoices for major expense items in order to answer the following:

1. Were administrative or non-selling expenses classified as selling expenses?
2. At year-end, did the Company make advance payments for the subsequent year's selling program and classify these payments as an expense rather than as a prepayment?
3. Are expenses of executives, personal in nature, being charged to the company?

Thus, Ratio Analysis acts as a useful tool for the purposes of interpreting the figures and acts as a guiding light to the auditor for taking the required action.

Illustration 3:

Facts

A company had sales (all credit) for the year of ₹1, 20,000. Its accounts receivable at year-end amounted to ₹20, 000. Its day's sales in account receivable are computed as follows:

- | | |
|--|-----------|
| 1. Sales | ₹ 120,000 |
| 2. Accounts receivable | ₹ 20,000 |
| 3. Average daily sales (Sales ₹120,000/360 days) | ₹ 333 |

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4. Days sales in accounts receivable

[Accounts receivable / Average daily sales

(₹20, 000 / ₹333)]

60

In the previous year, the day's sale in account receivable was 45.

Analysis

The company is not collecting its receivables as rapidly as it did in the previous year. This increase in the day's sales accounts receivable indicates a possible problem in the collectibility of the receivables.

Auditing Procedures

The following audit procedures may be employed for taking corrective action.

The auditor may consider doing some or all of the following:

1. Review cash receipts and remittance advices for the subsequent period.
2. Obtain credit reports on significant past due accounts.
3. Analyze year-end sales to determine any unusually large sales. Determine the nature of these sales and ascertain that they were recorded in the proper accounting period.

Apart from the above ratios, the following ratios may act as a helping tool for the purposes of interpretation of the figures as stated in the books. The illustrative example of these ratios is as below:

Chapter 15

Planning of Physical Inventory

15.1 Planning a physical inventory is much like planning a fund-raising campaign. The logistics must be fully worked out in advance and every participant must be thoroughly briefed. The following checklist covers planning considerations which should be included in preparing for a physical count:

General Planning

1. Identify the company personnel responsible for the conduct of the count.
2. Make a preliminary tour of inventory locations.
3. Take steps to:
 - clean up the areas where inventory is located
 - accumulate like inventory items that are scattered about
 - stack, sort and clean inventory items
 - segregate defective and obsolete items
 - identify slow-moving items
 - identify consigned or other items on hand belonging to others
 - identify items that need not be counted
 - pre-count items (if practicable and controllable) order necessary recording materials and equipment to take counts, such as tags, extra tape measures, more scales, etc.
4. Consider the need to physically count inventory being held by others
5. In setting a date or period for taking the inventory, consider the timing of the count in relation to the balance sheet date, the low point in inventory quantities

Cut-Off Procedures

6. Establish the cut-off date and time. This requires procedures designed to stop the flow of inventory items to assure that transactions are recorded in the appropriate accounting period in which they occurred.

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7. Make plans for:
 - closing down production or suspending or controlling operations
 - segregating incoming inventory expected to be received during the count and establishing prenumbered receiving reports (or other means) to identify "pre-physical" and "post-physical" shipments of inventory.
 - accounting for inventory that must be shipped out during the count
 - controlling the movement of inventory in process
 - controlling intracompany shipments (to avoid double counting)
 - Identify and listing undelivered goods held by vendors for later delivery
8. Identify the forms for entering the physical inventory counts.
9. Make provision to control all count records (issued, returned, unused, and spoiled or voided) and to reconcile them at the end of the inventory count.
10. Determine that the count listing provides for identification of:
 - classifications of inventory (raw material, in process, finished goods)
 - condition (defective, obsolete, slow-moving, excess quantities)
 - location (building, floor, department, off premises, in transit)
 - ownership(inventory on hand belonging to others)

Most of the procedures to be followed during the physical inventory taking should be put into writing so as to guide all concerned.

Chapter 16

Stocktaking

Stocktaking

16.1 Stocktaking is an act of a physical counting process leading to the preparation of a detailed list of property assets and sources of their origin as of a specified date.

Stocktaking consists of the establishment by means of actual physical counting of all property, plant and equipment (fixed assets) and monetary assets; it also provides an explanation of a difference between actual balance established during the inventory and the balance resulting from books of accounts.

Objectives of Stocktaking

16.2 The main objective of a stocktaking process is to establish the actual balance of assets and liabilities. In particular, it consists of:

- (i) relating entries in books of accounts with actual state.
- (ii) clearing accounts with people responsible for entrusted with them property items.
- (iii) assessing business usefulness of property items undergoing the inventory.
- (iv) counteracting irregularities having been stated during the inventory (surplus, useless items).
- (v) establishing proper financial outcome.

16.3 Activities to be undertaken:

- (i) Inventory through a physical counting of all the property items that remain at a business entity disposal.
- (ii) Valuation of property items.
- (iii) Obtaining written information from a business entity's on :
 - o financial assets deposited in bank accounts..
 - o granted loans.
 - o receivables and liabilities.

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- the company's own assets entrusted to contractors.
- (iv) Comparing inventory records of some items (for instance land) with referential documents.
- (v) Establishing and explaining the causes of losses and discrepancies in quantities.
- (vi) Proposing and substantiating motions concerning methods of settlement of inventory differences.
- (vii) Indicating ways of removing irregularities in the management of a given entity's property.

Types of Stocktaking

16.4 Stocktaking are of following types:

- (i) Stocktaking through Physical Counting - performed by members of a stocktaking commission on the basis of direct observations and measurement of property items conducted in a given business entity. It comprises such accessible items as:
 - Fixed assets
 - Tangible current assets
 - Cash at the entity's cash desk
 - Securities
- (ii) Coordinating Balance with contractors comprises mainly:
 - State of financial assets deposited in bank accounts
 - Loans and credits
 - Receivables
 - Liabilities
- (iii) Verification of Records-concerns assets and liabilities the balance of which cannot be established through inventory or through the coordination of balance with contractors In particular it relates to:
 - Arable lands
 - State or local authorities' receivables and liabilities
 - Other items impossible to access

Methods of Stocktaking

16.5 Following are the method of stock taking:

1. Perpetual Inventory System

A method of controlling physical stock level by ensuring the amount of stock level of every item could be accounted at all times. This normally involves detailed recording of all receipts, issues and running balances for each item of stock.

Due to the detailed recording of all in and out, management does not need to do a physical stocktaking/ count. The stock level can be ascertained at any moment of time.

To ensure that the aforesaid stock level is accurate, physical stocktaking needs to be conducted.

Basically, there are two types of physical stocktaking:

2. Continuous Stocktaking

As the word continuous means the continual physical count of the quantity of the stock.

This is done at a FEW TIMES a year. The physical quantities counted are then compared to the stock recorded under the perpetual inventory system.

Stock discrepancies between physically counted and recorded might be due to:

- (i) Pilferage and falsification of documents;
- (ii) Natural wastage like evaporation or breaking in bulk;
- (iii) Warehouse's errors both physical and clerical;
- (iv) Clerical errors in the books recorded under the perpetual inventory system

3. Periodic Stocktaking

Unlike continuous stocktaking, the stocks are physically counted only at the end of the accounting year.

Advantages of Continuous Physical Stocktaking Compared to Periodic Stocktaking

16.6 Though the greatest disadvantage is the time and manpower factor as it involves more frequent stocktaking, there are many advantages of continuous over periodic stocktaking:

- (i) It improves the quality of the physical stocktaking as there are more frequent physical counting;
- (ii) It allows stock discrepancies to be more fully investigated;
- (iii) Maintain a higher work standards as the warehouse personnel know that they need to count the stock more frequently;
- (iv) Unauthorized changes in procedures are detected and
- (v) Production hold-ups, a common issue in periodic stocktaking is eliminated.

Purpose of Stocktaking

16.7 Physical stocktaking is the process of counting, weighing or otherwise measuring all items in stock and recording the results.

The reasons for doing this are as follows:

- (i) To verify the accuracy of the stock records.
- (ii) To support the value of stock shown in the balance sheet by physical verification.
- (iii) To disclose the possibility of fraud, theft or loss.
- (iv) To reveal any weakness in the system for the custody and control of stock.

The size and number of surpluses and deficiencies revealed by stocktaking is a good criterion of the efficiency of storekeeping, control and procedure generally.

Procedures for Stocktaking

16.8 For a satisfactory stock take, a good deal of preparation is necessary. First of all, a program should be drawn up and agreed with all concerned, including the customer's finance department, auditors, the customer's management and warehouse personnel. Secondly, proper cut off time, inventory report, stocktaking sheets or cards have to be prepared in

advance. Thirdly, all personnel concerned must be instructed and briefed before-hand on their respective duties come the day of the stock take.

- (i) Appoint one person to control the whole operation.
- (ii) While stocktaking is in progress, do not have the warehouse open for normal business or operations.
- (iii) After the end of the last working day before the stock take, no more issues (deliveries) should be made and no more receipts recorded into the Warehouse Management System until the stock take is complete. The number of the last receipt and issue should be noted, and all documents up to and including these numbers posted to the computer system or records. At this point, all the records can be ruled off and no further postings are made until the results of the stocktaking have been entered.

Ideally, the warehouse should be tidied and the number of items per pallet standardized to ease counting on the stock take day. For example, if there are 210 televisions to be counted and one pallet has twenty televisions then all pallets of the same model should have twenty televisions making ten pallets of twenty TV's each with one pallet of ten TV's. A common cause of wrong counts is random numbers of each item on separate pallets. Another common cause of errors is a mixture of items on pallets. Sometimes, TV Model A may be stacked at the front of the pallet and Model B at the back. If the stock taker is tired, they may not do a complete count of items on the pallet and assume the whole pallet only contains Model A and the Model B TV's will not be counted. This will lead to an excess of Model A in the count and a shortage of Model B.

Each row of racks in the warehouse should be numbered and the number marked in chalk on the floor. Each bay in the racking should be numbered to enable easy re counting if necessary. Count sheets should be issued to the staff doing the stock take. Count sheets should be carbonized with minimum three copies. One copy for the Client, one copy for the warehouse operator (ie Tamadam) and one copy for the Master File as backup. Have stocktaking sheets under the control of one person, consecutively numbered, and issued to the staff on duty as required. No duplicates should be allowed and at the end of the job, all stocktaking sheets must be accounted for.

- (iv) There should be count teams assembled on the day of the stocktake. Each team should consist of a forklift driver, a representative from the client and a representative from Tamadam. The number of items in

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each bay should be counted. The count sheet for each bay should be countersigned by the client's representative and Tamadam's representative. The object is to make each person taking stock responsible for a particular section or clearly defined area of the warehouse and record everything that is found in the area.

- (v) Count all normal stock including loose packages and items under inspection. Damaged stocks should be recorded separately.
- (vi) After the teams have completed their counts and handed the count sheets to the verifiers, the results of the count sheets should be entered into a computer and verified on the spot. The number of total items in the count and in the system should be compared to see if there are any shortages. If the number of items counted matches but there is a difference in individual models, there may have been cross counting or cross delivery of stock.

If the number items does not match or there is a large discrepancy, then the items which show large discrepancy have to be recounted immediately. This is where the numbered bays and allocated count sheets will be very useful as this will enable the count team to zoom in on the area where the goods for which there is discrepancy are kept.

- (vii) Normally it is only possible to match the total number of items in the system and that counted on the day of the count. A detailed item by item comparison will normally only be completed a few working days after the stocktake day in the case of counts with large numbers of items and many SKUs.

Conclusion

16.9 The carrying out of accurate stocktakes is of crucial importance both to the warehouse operator and for our clients. With the procedures outlined above, the stocktake should be fast and painless. In the case of discrepancy, the procedure should enable the physical location in the warehouse in which there is a discrepancy to be located as quickly as possible so that a recount can be done. Also, physical tally sheets are very important and these must be kept in their entirety in a safe location for future reference

Chapter 17

Relevant RBI Notifications

I. Master Circular - Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances (DBOD.No.BP.BC.12/21.04.048/2011-12 dated July 01, 2011)*

Para 4.2.4

The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with such deficiencies banks may follow the following guidelines:

- (i) Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

A working capital borrowal account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

- (ii) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and

* Refer Link :http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6530.

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other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA.

II Lending under Consortium Arrangement/ Multiple Banking Arrangements

RBI/2008-2009/427**

UBD.PCB.No. 59 /13.05.000/2008-09

April 9, 2009

Chief Executive Officers of
All Primary Urban Co-operative Banks

Dear Sir /Madam,

Lending under Consortium Arrangement / Multiple Banking Arrangements

Please refer to our circular UBD.PCB.No.36/13.05.000/2008-09 dated January 21, 2009 on the captioned subject.

2. The formats for declaration of information by the borrower at the time of applying for a credit facility to a bank (Annex I) and the format for exchange of information among the banks in respect of borrowers enjoying credit facilities from more than one bank (Annex II), enclosed to the aforesaid circular have been revised to reflect information relating to the derivative transactions entered into by banks with the borrowers and the unhedged foreign currency exposures of the borrowers.

3. Banks are advised to use the revised formats with immediate effect.

Yours faithfully,

(A.K.Khound)
Chief General Manager-in-Charge

Encl : Revised Formats

** Refer Link: http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?id=4919.

Part - I
Diligence Report

To,

The Manager,

_____ (Name of the Bank)

I / We have examined the registers, records, books and papers of _____ Limited (the Company) as required to be maintained under the Companies Act, 1956 (the Act) and the rules made thereunder, the provisions of various statutes, wherever applicable, the provisions contained in the Memorandum and Articles of Association of the Company as well as the provisions contained in the Listing Agreement/s, if any, entered into by the Company with the recognized stock exchange/s, as may be applicable for the half year ended on _____. In my / our opinion and to the best of my / our information and according to the examination carried out by me / us and explanations furnished to me / us by the Company, its officers and agents. I / We report that in respect of the aforesaid period:

1. (a) The management of the Company is carried out by the Board of Directors comprising the following persons :
(b) During the period under review the following changes took place:
2. (a) The shareholding pattern of the company is as under :
(b) During the period under review the following changes took place:
3. The company has altered the following provisions of
 - (i) the Memorandum of Association during the period under review and has complied with the provisions of the Act.
 - (ii) the following Articles of Association during the period under review and has complied with the provisions of the Act.
4. The company has during the period under review, entered into the following transactions with business entities in which directors are interested.
5. The company has during the period under review, advanced loans, given guarantees and provided securities amounting to ₹ _____ to its directors and / or persons or firms or companies in which directors are interested.

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6. The Company has during the period under review, made loans and investments; or given guarantees or provided securities to other business entities as under :
7. The amount borrowed by the Company from directors, members, public, financial institutions, banks and others during the period under review is / are within the borrowing limits of the Company. The break-up of the company's borrowings is as under:
8. The Company has during the period under review, not defaulted in the repayment of any public deposits or unsecured loans and the Company or its Directors are not under the Defaulter's list of Reserve Bank of India or in the Specific Approval List of ECGC.
9. The Company has during the period under review, created, modified or satisfied charges on the assets of the company as under :
10. The Forex Exposure and Overseas Borrowings of the company are as under
11. The Company has issued, offered and allotted all the securities to the persons entitled thereto and has also issued letters, coupons, warrants and certificates thereof to the concerned persons and also redeemed its preference shares / debentures and bought back its shares (wherever applicable) in compliance with the specified procedures and within the stipulated time.
12. The Company has insured all its assets including the secured assets.
13. The Company has complied with the terms and conditions, set forth by the lending institution at the time of availing the facility and also during the currency of the loan and has utilized the funds for the purposes for which these were borrowed.
14. The Company has declared and paid dividends to its shareholders as per the provisions of the Companies Act, 1956.
15. The Company has paid all its statutory dues and that there are no arrears.
16. The Company has complied with the provisions stipulated in Section 372 A of the Companies Act in respect of its Inter Corporate loans and Investments.
17. The Company has complied with the applicable and mandatory Accounting Standards issued by the Institute of Chartered Accountants of India.

Relevant RBI Notifications

18. The Company has credited and paid to the Investor Education and Protection Fund all the unpaid dividends and other amounts required to be so credited.

19. A list of prosecutions initiated against or show cause notices received by the Company for alleged offences under the Act and also the fines and penalties or any other punishment imposed on the Company in such cases is attached.

20. The Company has complied with the various clauses of the Listing Agreement, if applicable.

21. The Company has deposited both Employees' and Employer's contribution to Provident Fund with the prescribed authorities.

Note: The qualification, reservation or adverse remarks, if any, may be stated at the relevant place(s).

Signature :

Place :

Name of Company Secretary :

Date :

C.P. No.:

Technical Guide on Stock and Receivables Audit

Part - II

Certification of Borrowal Companies by Chartered Accountants / Company Secretaries

- (i) Terms of reference for stock audit are to be spelt out clearly by the Banks, so that the Chartered Accountants can give focused attention to such areas.
- (ii) End-use verification of funds lent, if certified by Statutory Auditors, will be a good comfort to the Banks.
- (iii) As Banks quite often deal with unlisted companies, disclosure requirements for such companies above a specific turnover may be made akin to those for listed companies, viz. consolidated balance sheet, segmental reporting etc. Information on large shareholding also will be useful
- (iv) Further, the following additional certification either from Chartered Accountant or Company Secretary may also be thought of :-
 - (a) Company Directors not figuring in defaulters list (RBI / ECGC) / willful defaulters list etc.)
 - (b) Details of litigation above a specified cut off limit.
 - (c) A specific certificate, probably from the Company Secretary, regarding compliance with Sec. 372 (a) of the Companies Act.
 - (d) Details of creation / modification / satisfaction of charges on the assets of the company, position regarding insurance, show cause notices received, finds and penalties awarded.
 - (e) As regards rotation of Auditors, for the sake of operational convenience, it is suggested they may be changed once every 5 years instead of every 3 years.
- (v) In order to avoid concentration, group companies may have different Statutory / Internal Auditors in case group turnover exceeds ₹100 crores.

ANNEXURES

Annexure I

Format for Stock Audit Report

Index

S.No.	Particulars	Page no.
A.	Particulars of Limit	
B.	Operations in the Account	
C.	Submission of Statements	
D.	Insurance	
E.	Unit Visit	
F.	Verification of Stock	
G.	Verification of Book Debts	
H.	General	
I.	Stock Auditor's Certificate	
J.	Conclusion	

Particulars of Limits

1. With our Bank:
 - Sanctioning Authority
 - Date of Sanction
 - Reason for Overdue position, and
 - Position & Non Renewal (if any)
2. Nature of Limit

	Amount (₹ in lacs)	DPN Date	Balance O/s. as	Overdue	ROI
FUND BASED					
TOTAL EXPOSURE					
NON-FUND BASED					
TOTAL EXPOSURE					

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3. Value of Collateral Securities:

Agriculture Properties

Non Agriculture Properties

Others

TOTAL VALUE

Date of Last Valuation (by the Panel Valuer / Manager)

4. Any transactions indicating diversions of funds noticed. (Random check 5% to 10% of the total debit)
5. Average daily balance (debit as well as credit) credit / debit summations in relative to utilization of the limit and the sales projections.
6. Whether the interest has been serviced within 7 days.
7. In case of Overdue Packing Credits:
Furnish the Amount and Last date of shipment.
8. Whether PC is adjusted by application of local rupee funds.
9. Whether bills are being realized as per tenor / terms.
10. Details of overdue bills both inland / foreign.
11. Details of bills returned.
12. Comprehensive ECGC coverage obtained as per terms of sanction or not.
13. Is there any devolvement of LC.

14. if yes, number of LCs devolvement and amount.
15. Whether any guarantee invoked. (if yes, number and amount).
16. No of guarantees expired but still outstanding with amount.
17. In case of term loan, whether repayment of installment is regular.
18. Whether purchase commitment is met by issue of cheque/ DD on Cash Credit account.

Operations in the Account

1. Operation/ Performance of the account of the branch.
(See the operation for full year)
2. Whether the account is being regularly/ actively operated.
3. Whether sales are being routed through the account.
Random check of 10 credits with sales realization including bill.
4. Number of times the account remained overdrawn.
Ascertain reasons for such overdrawals.
5. Whether cash withdrawals are regularly allowed.
Reasons for allowing withdrawals.
In your opinion such cash withdrawals are warranted or not.

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6. (a) Whether returned and discounted cheques have been adjusted on the date of return itself or subsequently with how much delay, (if so, mention the number and value)
- (b) Whether, is there any instance of cheque return issued by the borrower or keeping cheque under the CCO, (If so, mention the number and value)
- (c) Whether any cheque submitted by the party for collection is returned. (if so, mention the number and value)

Submission of Statements

1. (a) Whether stock statements are being submitted regularly.
Movement of Stock is found. Date of Last Stock Statement.
- (b) Present market rate.
- (c) Whether value is correctly given in the cost of price or the market price whichever is lower?
- (d) Quality and Marketability of good.

2. (a) Whether Book Debts statements are being submitted regularly.
Date of Last Book Debts statement.
- (b) Whether Book Debts statements show age-wise list of debtors.
- (c) Particulars of Long Outstanding debts included in the statement of the Book Debt.
- (d) Whether Auditor certificate is obtained once in 3 months.
- (e) Comments / Remarks, if any, made by the Auditor.
3. Whether DP is being calculated.
Check DP Register
(if not, maintained give remarks)
4. Statements of QTS, MSOD, etc,
5. Whether QIS/ MSOD /other relevant statement. Details should be given for QIS-I, QIS-II, QIS-IU (for the last one year).
6. Whether operating limits are fixed as per QIS-I.
7. Whether penal interest @ 1% p.a. charged for delay / no n submission of QIS statement.
8. Whether the information submitted in QIS is as per the books of account of the party.

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Insurance

S.No.	Description	Value	Amount insured (₹ In lacs)	Date	Whether Adequate (Yes/ No)	Expiry
1.	Stocks					
2.	Machineries					
3.	Vehicles					
4.	Building					
5.	Whether the goods are fully insured for all the industry specific risks					
6.	Extent of insurance cover available					
7.	Whether the policies are in force					
8.	Whether "Bankers Clause" included in the policy					
9.	Location of goods property stated in the policy with Door No. / Survey No. Municipal No. etc.,					
10.	Goods sent to the processing uruts / sub-contractors / whether insured / transit insurance obtained					
11.	Whether any location / godown is not covered in the insurance.					
12.	Whether any risk is excluded (if so, specify the reasons)					

(a) Drawing Power (stocks)

		(₹ in lacs)		
		Cash Credit	Packing Credit	Key Loan
i)	Value of the stock at the time of verification			
	Less			
ii)	Stock procured under			

FLCALC / BG + other credit purchases

Add

iii) Stock in transit-Inward
(to be covered under the Trust Loan)

Add

iv) Stock in transit-Outward but not yet Invoiced (mostly in the export business)

v) Value of paid Stock

Less Margin %

Drawing Power Outstanding as on the date of verification:

i. With our Bank

ii. With other Bank

Total Borrowings Stock Deficit / Surplus

b) Drawing Power for Cash Credit (Book Debts):

	(₹ in lacs)		
	Cash Credit	Packing Credit	Key Loan
(i) Total Receivables within tenor period			
Less			
(ii) Receivables emanated by sales of goods got under BG / ILC/PLC			
Net Receivables			
Less			
(iii) Margin			

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- (iv) Drawing power /limit
whichever is lower

Outstanding in Cash Credit (Book
Debts):

- i. With our Bank
(₹ in lacs)
- ii. With other Bank

Total Whether Deficit / Surplus

Unit Visit

1. Address of all godowns.
2. Storage place owned/ rented.
if it is owned whether upto date
tax paid.
if it is rented whether no lien letter
from owner is obtained
3. Whether storage places have
direct access.
4. System of stock records.
5. Safety of stocks.
6. Condition of stocks
7. Movement of stock (comments on
method of inventory control -
FIFO/ LIFO).
8. Name of the person contacted at
unit with designations.
9. Name of the official who had
verified the stock periodically and
the godown register is being
maintained update.
Date of the last verification and by
whom and the remarks, if any,
observed by the official.

Is there any remark which persists
for a few occasions and the
borrower had not set it right.

Whether bank's name board has been prominently displayed.

Whether letter of free access is obtained.

S.No		Last Year	This Year
A	Production Capacity of the Unit		
	1. Licensed capacity		
	2. Installed capacity		
	3. Actual capacity		
B.	Method of valuation of Stock		
	1. Raw material		
	2. Stocks in process		
	3. Finished Goods		
	If not in order, give details		

Physical Inventory (Stocks)

S.No	Particulars	Value of stocks as shown in Stock statements as on (₹ in lacs)
------	-------------	--

Value of Stocks as shown in Stock Statements as on

1.	Raw material	
2.	Stock in-process	
3.	Stores & spares	
4.	Stores & spares	
	Total Value	

Total

Add Purchases (from the date of stocks statement till the date of inspection)

Less: Material consumed / reduction on account of sales {from the date of stocks till the date of inspection)

Total Add Stocks given on job work

Total Less Stocks received on job work

Less Stocks belonging to sister concerns for which no payment has been made

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Stock Auditor's Certificate

1. We have inspected (physically) the stocks of goods as per the enclosed Stock statements from the borrowers in the case of OD/CC as per particulars furnished in case of Key Loan, etc., as onand found them correct.
2. The balance of Stock shown in the borrowers Stock shown in the borrowers Stock statements are enclosed and agree with that shown in the Bank's Godown Inspection Register or {In the case of Hypothecation advances) Drawing Power Register.
3. The stocks are in good and marketable condition and do not show any signs of deterioration in quality and that the storages is in a satisfactory condition.
4. The stocks are not outstanding beyond the stipulated period of months as per terms of sanction (Details of old stocks, if any value thereof are enclosed).
5. The godowns belong to borrowers / third parties in which case latest rent receipt / no lien letter from processors are verified.
6. The stocks are valued at manufacturing cost or ruling market value or invoice value whichever is lower.
7. The stocks under hypothecation have not been hypothecated to other banks.
8. The advances of the bank are fully safe / secured / liquid.
9. We further certify th at we have covered all the points indicated in terms of reference in the Assignment letter.

Signature of Auditor

Date: _____

Stock Audit Report

We have conducted the Stock Audit allotted by your Head Office and we furnish hereunder the above report:

Introduction

Name of the Branch
Name of the Region
Date of Commencement
Date of Completion
Date of Stock Verification
Status of Account as on date of visit
Date of Report

1. Name of the Borrower
2. Constitution
3. Address
 - a. Registered Office
 - b. Administrative Office
 - c. Factory
 - d. Godown
4. Name of the Partners/Directors and their net worth (Nature of relationship among partners/directors)
5. Name of the Guarantors and their net worth (Nature of relationship with partners / directors)
6. Enjoying credit facilities Since
7. Name of the Branch Officials contacted / discussed
8. Nature of activity (Trading / Manufacturing / Exporting, etc.)
9. Description of Stock declared (commodity dealt with)

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10. Nature of Banking arrangement (sole/multiple/consortium)
11. Banking with us Since
12. If advance if an Consortium basis or Sanctioned by more than one bank
The position of each bank share is to be given
 - a. Fund Based
 - b Non Fund Based

13. Terms & Conditions
Ascertain whether all terms & conditions of sanction are complied with (Yes / No)
If no, the terms & conditions which are yet to be complied with

14. Steps proposed for rectification of shortcoming / irregularities
15. Comment on accounts - conduct with other consortium banks/ banks under multiple banking arrangements

16. With other Banks / Institution:

Name of the bank / institution	Nature of Limit	Amount (₹ In lacs)	Balance O/s. as on	Status of the Account
--------------------------------	-----------------	--------------------	--------------------	-----------------------

17. Comments on accounts with any other banks / any diversion of funds(if no, diversion specific observation, specific comment should be made)

Verification of Stock

1. Value of Stock:

As per latest statement	As on the date of verification	O/s. as on date of verification
on.	on.	on.
₹	₹	₹

2. Particulars of Stock as on date of verification (₹ in Lacs)

Description of goods	Quantity	Total Value	Stored at	Amount Insured	Due on
----------------------	----------	-------------	-----------	----------------	--------

3 Stock Coverage - Drawing Power:

(For non-fund based facilities)

(₹ in lacs)

Limit availed under with	Our Bank	Other Bank	Bill Liability
--------------------------	----------	------------	----------------

1. a) BG issued for suppliers credit

b) ILC (DA) issued

c) FLC (DA) issued

TOTAL

2. a) Details of goods procured under the above non-fund based limits and net value thereof

(₹ in lacs)

Available as	Sale proceeds/ remitted kept in the account	Total	Goods procured under the above limits	Deficit/ Surplus
Stock	Receivable	(1+2+3)		

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Verification of Book Debts

1. Collect age-wise and party wise break up of book debts and party wise receivables be checked with Invoices / sales register comments on any discrepancy observed.
2. Whether receivables are routed through the account?
3. Average time taken for realization of book debts to be compared with the past trend / industry trend / trade trend. Reasons for any deviation to be analysed and commented upon.
4. Overall observations as to the quality of book debts.
5. Verify excise records / sales tax returns / assessment orders of sales tax.
6. Composition of value of stocks and book debts as on the balance sheet date should be compared with value of stocks as on the date of inspection.
7. Whether level of Sundry Creditors is commensurate with past trends.
8. Whether arrangement of goods is properly done so as to verify the goods easily.
9. Whether the borrower holds Stock received for processing (job work) and whether they are separately stored.

If so, whether it is so declared and deducted from the total Stock.

10. Whether Stock turnover is satisfactory.
11. Whether maintenance of Stock and accounting records are satisfactory.
12. Whether random physical inspection now conducted represent a correct position of the entire Stock.
13. Whether purchased / sale invoices are verified. Whether valuation of purchase is correct? Whether over valuation of product is done.
14. Whether there are any purchases from allied / sister concerns.
Whether all such transactions are genuine.
15. Whether there are cash purchases whether such cash purchases are proportionate.
16. Any other observation on
 - Verification of invoices
 - Physical verification of Stock
 - Stock held with processing / job work or outstation godowns
 - Old, obsolete, non moving Stock

General

1. a) The unrectified inspection/credit supervision / concurrent Audit comments made, if any, and latest progress report.

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- b) Reason for non-rectification
- 2. Whether the borrower account is subject to credit rating
- 3. Statutory dues (workers & govt.)
- 4. Details of pending litigations and its Present Status
- 5. Problems faced by the company in general and the plans to overcome these problem vis-a-vis bank's assistance
- 6. Summary of Features

Discussion with Branch Manager

It is hereby confirmed that we held discussions with Branch manager / Sub-Manager/ Assistant Manager on all the above observations before finalizing the report.

Signature of Auditor

Date:

Signature of Branch Manager

Conclusion

- 1. Any other matters in the Auditor's view.
- 2. Any features which contravenes the Bank's instructions which is likely to effect Bank's interest.
- 3. Any suggestions / comments to improve the system of cost audit by the borrowers.

Signature of Auditor

Date:

Annexure II

Checklist for Inventories and Receivables Audit

Bank: _____ Branch: _____ Zone: _____

Name of the account: _____

Address: _____

I) Office: _____

II) Factory & Go down: _____

Constitution: _____

Name of the Partners /directors: _____

Nature of business: _____

Latest Sanction : _____ Authority: _____ Date _____

Position of account: _____

Nature of Facility	Sanctioned Limit (₹)	Drawing Power (₹)	Outstanding as on (₹)	Overdue Excess, If any. (₹)
Term Loan Specify the assets a) Land & Building b) Plant & Machinery c) Others Cash Credit (Inventories & Book-Debts.)				

Remarks on the payment of interest and installments: _____

Inspected by: _____

Date of inspection: _____

Name and designation of Attendant: _____

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A) Before going for Physical Verification:

S. No.	Particulars	Yes/ No/Not applicable												
1	Have you sent an engagement letter?													
2	Have you verified the borrower's file at the branch to ascertain the following details:													
	a) Name of the borrower													
	b) Location of - Office - Godown / Factory													
	c) Constitution (Sole proprietor, Partnership, Pvt. Ltd)													
	d) Nature of Business													
	e) Date of establishment and date of commercial production													
	f) Particulars of credit limits													
	<table border="1"> <thead> <tr> <th>Loan A/c No</th> <th>Facility</th> <th>Sanctioned Limits</th> <th>D.P</th> <th>Balance O/S</th> <th>Overdue/excess</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>	Loan A/c No	Facility	Sanctioned Limits	D.P	Balance O/S	Overdue/excess							
Loan A/c No	Facility	Sanctioned Limits	D.P	Balance O/S	Overdue/excess									
	g) Particulars of security: A) Primary: B) Secondary													
3	What is the asset code: (Standard, Sub-standard, Doubtful or Loss Assets)?													
4	Whether advance is sanctioned on Consortium Basis? If so, the position of each of the banks?													
	<table border="1"> <thead> <tr> <th>Name of the Bank</th> <th>Limit sanctioned</th> <th>Value of security</th> <th>Balance Outstanding as on -----</th> <th>Overdrawn amount</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>	Name of the Bank	Limit sanctioned	Value of security	Balance Outstanding as on -----	Overdrawn amount								
Name of the Bank	Limit sanctioned	Value of security	Balance Outstanding as on -----	Overdrawn amount										

5	Insurance Particulars:				
	Policy No	Assets covered/ Location	Amount Insured	Date of expiry of Policy	Whether Bank clause exists in the policy
6	Whether additional risks like theft, earthquake, and machinery breakdown are included as per sanction terms and are complied with by the borrower?				
7	Whether the address/ location of goods is properly stated and includes Door No./ Survey No. Municipal no etc?				
8	Whether goods sent to the processing units, sub-contractors are insured/ transit insurance obtained?				
9	Whether all locations/ all industry specific risks are covered?				
10	Whether proper documents, including charging of primary and secondary securities have been obtained?				
11	What is the date of documentation?				
12	Whether documents are properly stamped?				
13	Whether equitable/ registered mortgage of property created?				
14	Whether search report has been got done up to the date of equitable/ registered mortgage?				
15	Wherever required whether charge has been registered with ROC within prescribed time?				
16	<p>Have you verified the periodical stock statements submitted by the borrower with reference to any conditions stipulated in the sanction regarding:</p> <p>a) Quantity of stocks,</p> <p>b) Place of storage,</p> <p>c) Value of stocks</p> <p>d) Composition of stocks- Proportion of raw material, work – in- process and finished goods</p>				
17	<p>Have you verified that the stock statements are?</p> <p>a) signed by authorized persons only</p>				

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	<ul style="list-style-type: none"> b) sent in bank's format c) sent within the stipulated time to the bank 	
18	Have you verified the Godown stock register in case of pledged accounts to ascertain the nature and quantity of stock pledged in each godown, age and turnover in the stocks?	
19	<p>Have you verified the operations in the account to ensure that the</p> <ul style="list-style-type: none"> a) Operations and utilization of the funds and turnover are satisfactory b) Drawings are allowed within the drawing power and sanction stipulations are complied with c) Sale proceeds of hypothecated stocks are routed through the account only 	
20	Have you verified the previous stock audit/ branch inspection reports to ascertain whether any steps have been taken to rectify irregularities pointed out?	
21	Have you obtained a representation letter from the borrower clearly indicating the places /branches where the goods are stored?	
22	<p>Have you obtained the following documents to from the borrower?</p> <ul style="list-style-type: none"> 1) A written representation from management concerning: <ul style="list-style-type: none"> (a) The completeness of information provided regarding the Inventories; and (b) Assurance with regard to adherence to laid down procedures for physical Inventories count. 2) Balance Sheet & Profit & Loss Account of the borrower for last 3 years 3) Inventories Statement & Book Debts Statement as on the last day of the quarter and for the year & preceding 3 months before the date of inspection 4) Copy of Memorandum of association, Articles of association along with form No. 32 & 18, partnerships deed, Trust deed & its byelaws as 	

	may be applicable 5) Copy of Audited financial statements	
23	Have you inquired about the Associations of which borrower party is member?	
24	Have you done documentary checking of ownership or lease? Have you taken a copy of the same?	
25	Have you taken phone numbers of CA's – Statutory Auditor, Tax Auditor etc?	
26	Have you made a comparison of previous 2 to 3 years financial position of the borrower?	
27	Have you checked whether the account is a suit filed account?	

B) Physical Verification of Stocks

I. Verification of Hypothecated Stock

Sr No	Particulars	Yes/ No/ Not applicable
1	Is there any difference between the stocks as shown in the stock statement and the actual stock?	
2	Whether any reconciliation for the difference has been made?	
3	Whether the stocks represent those reflected in the stock statements sent to the Banks?	
4	Is the level of Inventories held found to be too high?	
5	Is the material control system employed by the borrower proper?	
6	Whether the borrower has maintained up to date records?	
7	Whether the borrower is having adequate internal control system commensurate with the size of the concern?	
8	Whether borrower is following consistent and accepted accounting principles for valuation of stocks?	
9	Whether the quality and sale ability of the stocks are good?	
10	Whether the following records of the borrower have	

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	<p>been checked?</p> <p>a) Excise records</p> <p>b) Raw materials consumption, Production register, Purchase and sales records</p> <p>c) Purchase and sales invoice</p> <p>d) Cost records and order books</p> <p>e) Sales, Purchase, Sundry creditors and Debtors ledgers</p>	
12	Has the stock been stored properly?	
13	Is there a direct access to the godown?	
14	<p>What is the value of</p> <p>a) Obsolete stock</p> <p>b) Slow- moving stock</p> <p>c) Damaged/ Rejected stocks</p> <p>d) Unpaid stock</p>	
15	Whether Sundry creditors have been deducted as per policy of bank and as per sanction terms?	
16	Whether stipulated margin as per sanction terms has been deducted?	
17	Whether stocks received under usance L/C, co-acceptances and guarantees for purchase of raw materials have been reduced?	
18	Whether the Bank Hypothecation Board has been displayed?	
19	Whether stocks belonging to sister concerns, received for job- work etc are properly segregated?	
20	Whether the movement of stock in and out of the godown is properly accounted and monitored?	
21	What is the Work in progress and level of completion?	
22	Whether the goods which require any specialized preservation, are properly preserved?	
23	Whether rent/ property tax/ municipal tax receipts pertaining to godowns have been verified?	
24	Whether , in case of stocks which have expiry dates(such as drugs, food items) the same have been excluded for calculation of drawing power.	
25	Whether, stocks have been examined at	

	laboratories(in case of chemicals, dyes etc).	
26	Whether goods-in transit are included in the stock statements? Is the inclusion of such goods as per sanction terms? Whether the relative bills/ challans/ invoices have been verified?	
27	Whether goods sent to third parties for job work, finishing or machining, etc. have been inspected?	
28	Whether any written confirmation is on record for stock with third parties?	
29	Whether the sanction terms permit storage of goods with clearing agents?	
30	If so, whether the agents are in the approved list of the bank and within the limits fixed by the bank?	
31	Whether clearing agents charges and other dues have been paid?	
32	Whether any irregularities pointed out in the last Concurrent audit/ Inspection report have been rectified?	
33	Whether a written declaration has been obtained from the borrower that the stocks will not be hypothecated to other banks without the prior consent of the bank?	
34	Whether, in case of consortium advances, information is exchanged between the banks?	
35	Whether the hypothecated Plant & Machinery is maintained properly and found in working condition?	
36	Were there any instances of breakdown causing interruptions in the working of the unit in the recent past?	
37	Whether fire protection measures are satisfactory?	
38	Whether security arrangements at the godown/ Factory are satisfactory?	
39	Have you checked up the Sales Tax Provision?	
40	Have you checked Income Assessment Orders?	
41	Have you checked the provisions relating to ESIS Challans?	

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42	Have you checked provisions relating to PF – Challans, assessment order?	
43	Has the factory license been renewed?	
44	Have you received the details of no. of skilled and unskilled employees, office staff? Have you checked up the Salary register?	
45	Have you considered the inherent control and detection risks, and materiality related to Inventories?	
46	Whether adequate procedures are established and proper instructions issued for physical Inventories counting?	
47	Whether persons involved in stock taking differ from those responsible for store-keeping?	
48	Whether store procedures provide for the use of pre-numbered forms	
49	Whether a system of cross-checking exists for checking data generated by different departments?	
50	Whether controls exist for receipts and issues of stores?	

II) Hypothecation of Book-Debts

Sr. No.	Particulars	Yes / No/ Not applicable
1.	Are standard price lists maintained?	
2.	Are prices that are not based on a standard price list, required to be approved by a senior executive outside the sales department?	
3.	Are written orders received from customers?	
4.	If oral/ telephonic orders are received from customers, whether the same are recorded immediately in the standard forms?	
5.	Is there a numerical control over all customers' orders?	
6.	Are credit limits fixed in respect of individual customers? Does an official independent of the sales department approve these limits?	
7.	Are credit limits reviewed periodically?	
8.	Are customers' credit limits checked before orders	

	are accepted? Is this done by a person independent of the sales department?	
9.	If sales to employees are made at concessional prices: a) Is there a limit to the value of such sales? b) Are the amounts recovered in accordance with the terms of sale? c) Is there an adequate procedure to see that the limits are not exceeded?	
10.	Are dispatches of goods authorized only by Dispatch Notes/Gate Passes or similar documents?	
11.	Do such Dispatch Notes/Gate Passes or similar documents bear pre-printed numbers?	
12.	Are they under numerical control?	
13.	Are they prepared by a person independent of: a) The Sales Department? b) The processing of invoices?	
14.	Except when all documents are prepared in one operation, are the Dispatch Notes/Gate Passes matched with: a) Excise Duty Records? b) Sales invoices? c) Freight payable to carriers (where applicable).	
15.	Are unmatched Dispatch Notes/ Gate Passes reviewed periodically?	
16.	Are the goods actually dispatched checked independently with the Dispatch Notes/ Gate Passes and customer's orders?	
17.	Are acknowledgements obtained from the customers for the goods delivered?	
18.	Are the customer's orders marked for goods delivered?	
19.	Are shortages in goods delivered to the customers investigated?	
20.	Are credits to customers for shortages, breakage & losses in transit match the claim lodged against carriers/ insurers?	
21.	Are sales invoices pre-numbered?	

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22.	Are invoices checked for: a) Prices? b) Calculations (including excise duty and sales tax)? c) Terms of payment?	
23.	Are 'no charge' invoices authorized by a person independent of the custody of goods or cash?	
24.	Are invoices mailed direct to the customers promptly?	
25.	Are credits to customers for remittance posted only from the entries in the cash book (or equivalent record)?	
26.	Does cashier notify immediately: a) Sales Department, b) Debtors Ledger Section and c) Credit Controller; i) Of all dishonored cheques or other negotiable instruments? ii) Of all documents sent through bank but not returned by the customers?	
27.	Is immediate follow-up action taken on such notification?	
28.	Are the bills of exchange, etc. periodically verified with the bills on hand?	
29.	Is a record of customers claims maintained: a) Are such claims properly dealt with in the accounts?	
30.	Does the Receiving Department record them on sales Return Note?	
31.	Does the Receiving Department count, weigh or measure the goods returned?	
32.	Are copies of Sales Returns Notes sent to: a) Customer? b) Sales Department? c) Debtors' Ledger Section?	
33.	Are the returned goods taken into stock immediately?	
34.	Is a Credit Note issued to the customer for the	

	goods returned?	
35.	Are all Credit Notes pre-numbered?	
36.	Are Credit Notes numerically controlled?	
37.	Are Credit Notes authorized by a person independent of: a) Custody of goods? b) Cash receipts? c) Debtors' ledger?	
38.	Are Credit Notes: a) Compared with Sales Returns Notes or other substantiating evidence? b) Checked for prices? c) Checked for calculations?	
39.	Are corresponding recoveries of sales commissions made when Credit Notes are issued to customers?	
40.	Are units of sales (as per sales invoices) correlated and reconciled with the purchases (or production) and stock on hand?	
41.	Is the Sales Ledger balanced periodically and tallied with the General Ledger Control account?	
42.	Are ageing schedules prepared periodically?	
43.	Does a responsible person review them?	
44.	Are statements of accounts regularly sent to all customers?	
45.	Are the statements checked with the Debtors' Ledger before they are issued?	
46.	Does a person independent of the ledger keeper mail the statements?	
47.	Are confirmations of balances obtained periodically?	
48.	Do a person independent of the ledger-keeper and the person preparing the statement verify the confirmations?	
49.	Is special approval required for: a) Payments of customers' credit balances? b) Writing of bad debts?	
50.	Is any accounting control kept for bad debts written off?	

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51.	Is any follow-up action taken for recovering amounts written off?	
52.	In the case of export sales: a) Is a record maintained of import entitlements due? b) Does the record cover the utilization/disposal of such entitlements? c) Is there a procedure to ensure that claims for incentives etc., receivable are made in time?	
53.	Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?	
54.	Is age wise classification of debtors done? Has care been taken to exclude long outstanding debtors from drawing power calculation?	
55.	Whether the debt represents sales and service transactions only?	
56.	Whether all realizations from debtors are routed through the borrower's account?	
57.	Whether care is taken to ensure that receivables already advanced by way of bills purchased/ Bills discounted have been excluded?	
58.	Whether reasons for non-realisation of overdue debts have been examined?	
59.	Whether Power of Attorney in favour of the bank, wherever prescribed has been duly registered?	
60.	Whether the statement of book debts submitted to the bank is as per Bank's format?	
61.	Whether the drawing power is revised from time to time on the basis of the statements and the required margin is maintained in the account?	

III) Pledged Inventories

Sr. No.	Particulars	Yes / No/ Not applicable
1	Have you verified that a board is prominently displayed at the entrance and within the godown, clearly stating that the goods are hypothecated or pledged with the respective bank or financial institution?	

2	Have you examined the lock to ensure that Bank's / financial institution's name is engraved there on?	
3	Have you examined the layout of the godown where inventories are stored?	
4	If the godown is rented, have you inspected the rent receipt and ensured that it is in the name of the borrower? Have you ensured that the rent is not in arrears?	
5	If the godown is in ownership, have you verified the ownership agreement and ensured that it is in the name of the borrower?	
6	Have you ensured that there is no other gate or entrance to the godown and if it is there, it is properly locked from inside?	
7	Have you ensured that the godown is located at the address given to the bank and as mentioned in the insurance policy and other documents?	
8	Have you ensured that the ventilators are covered by grills?	
9	Have you ensured that no hazardous material is stored nearby the godown. (If so, it should be specifically mentioned in the insurance policy)	
10	Have you verified that no other inventories other than those pledged to the bank are stored in the godown without the specific prior authority and if they are stored, then adequate insurance cover is taken?	
11	Have you verified that the go down is in a good condition without and leakage or Seepage of water and dampness?	
12	Have you verified that the bin cards are signed by the godown keeper and by all inspecting officers?	
13	Have you verified that there is proper stacking of goods?	
14	Have you ensured that the deteriorated goods are not stored in the godown?	
15	Have you verified that the goods are not re-pledged?	

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16	Have you verified that manufactured goods are stored in their original packing?	
17	Have you ensured that goods are delivered only in the presence of the Bank's representative?	
18	Have you ensured that the turnover of the stocks is satisfactory and that there is no old stock?	

Annexure III

Specimen Engagement letter

The following letter is for use as a guide in conjunction with the considerations outlined in SA 210 [Earlier AAS 26] and will vary according to individual requirements and circumstances relevant to the engagement.

To the Board of Directors (or the appropriate representative of senior management)

You have requested that we audit the Inventories and receivables of (Name of the Company) as -----, 2012. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective verification of the assets so as to indicate their physical existence, valuation and safety aspects.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956 . An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

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The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.
Chartered Accountants
.....
(Signature)

Annexure IV

Specimen Management Representation Letter

[Client's Letterhead]

[Date]

To,

[Name]

Chartered Accountants

We are providing this letter in connection with the Inventories Audit for the period _____ for the purpose of expressing an opinion as to whether the stock records have been properly maintained or not and whether they are in conformity with the generally accepted accounting principles.

We confirm to the best of our knowledge and belief as under:

- 1) The financial statements referred to are in conformity with generally accepted accounting principles. (We have complied with all accounting standards issued by Institute of Chartered Accountants of India).
- 2) There have been no communications from regulatory agencies regarding non-compliance or differences, if any, in financial reporting practices.
- 3) There are no material transactions which have not been properly recorded in the accounting records underlying the financial statements.
- 4) There has been no:
 - a) Fraud involving management or employees who have significant say in internal control.
 - b) Fraud involving other than that would have a material effect on the financial statements.
- 5) The company has no plans or intentions that may materially affect the carrying value of assets and liabilities.
- 6) The following have been properly recorded or disclosed in the financial statements:

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- a) Related party transactions including sales, purchases, loans, transfers, and guarantees and amounts receivable from or payable to related parties.
 - b) Guarantees whether written or oral under which the company is contingently liable.
- 7) The company has satisfactory title to all owned assets and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
- 8) We further state as under:
- Accounting Policies:
- Method of Accounting:
- The Financial statements are prepared on accrual method of accounting.
- Inventories:
- Raw material is valued at cost on FIFO.
- Finished Goods is valued at lower of cost or net realizable value. Excise duties on goods manufactured by the company and remaining in Inventories are included as a part of values on of finished goods.
- 9) The Insurance for building and furniture is ₹ -----, Plant & Machinery ₹ ----- Stock in process ₹ ----- & for other items Rs -----, which will be expiring on -----.
- 10) a) The Installed capacity of the company is ---- millions pieces.
- b) Actual production for the year ended 31.03.2011 on ----- was -----pieces.
- 11) a) The total quantity produced during the month ----to ----- was ----- pieces.
- b) Total quantity cleared during the month ----- to ----- was ----- pieces and the value for the same was ₹ -----
- c) Actual production for the year e nded 31.03.2008 was ----- pieces.

The performance of the company for last 3 years was as follows:

Particulars	For the year ended 31.03.2010	For the year ended 31.03.2011	For the year ended 31.03.2012
a) Sales (including excise duty but exclude Sales tax)			
b) Purchases			
c) Net Profit			
d) Opening Stock			
e) Closing Stock			

13. Insurance Policy:

- a) Period of Insurance policy.
- b) Risks Covered.
- c) Place of Insurance
- d) Conditions of claim
- e) Name of insured
- f) Period of Validity of Policy & Time

14. Godown:

- a) Address along with Tele/Fax/E-mail.
- b) Ownership/Rented
(If leased/ rented obtain lease/ rent agreement)
- c) Period of Rent/ Lease agreement
- d) Monthly Rent/ Lease
- e) Name & Address of Owner (when it is rented / leased)

15. Office:

- a) Address along with Tele/Fax/E-mail
- b) Ownership/Rented
(Obtain copy of Rent/ Leased agreement if taken on Lease/ Rent)

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- c) Period of Rent/ Lease agreement
 - d) Monthly Rent/ Lease
 - e) Name & Address of Owner (when it is rented / leased)
Tele/Fax/E-mail
16. Factory:
- a) Address along with Tele/Fax/E-mail
 - b) Ownership/Rented
(Obtain copy of Rent/ Leased agreement if taken on Lease/ Rent)
 - c) Period of Rent/ Lease agreement
 - d) Monthly Rent/ Lease
 - e) Name & Address of Owner (when it is rented / leased)
Tele/Fax/E-mail
17. The total value of book debts less than 90 days as on ----- was --
----- and receipted challans was -----
18. The total value of the following items is as under:
- I Raw Material
 - i. Average Stock as per project report for the year ended 31.03.2012
 - ii. Average stock of last 12 months.
 - iii. Value of stock on date of physical Verification.
 - iv. Comparison of last 12 months stock as per records and as per statement
(reason for discrepancies)
 - II Work in Progress
 - i.
 - ii.
 - ii i.
 - III Finished Goods
 - i.
 - ii.
 - ii i.

19. Ratios:

	For the year ended 31.03.2012	For the year ended 31.03.2011	For the year ended 31.03.2010
a) Current Ratio.			
b) Liquid Ratio.			
c) Gross Profit Ratio.			
d) Stock Turnover Ratio.			
e) Debtors Turnover Ratio.			

For [Borrower's Name]

(_____)

Director/ Partner/ Proprietor

Annexure V

Specimen Letter of Confirmation from Third Party

[Client's Letterhead]

To

[Date]

[Name & Address of Customer]

Dear Sir,

Our auditors [name and address] are conducting an audit of our financial statements. Please examine the accompanying statement and either confirm its correctness or report any differences to our auditors.

Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

For XYZ Ltd.

(_____)

Director

Confirmation: The balance receivable from us of [amount] as on [date] is correct except as noted below:

Annexure VI

Specimen Letter of Confirmation of Inventories Held by Others

(Letterhead of entity)

Date: _____

(Name and address of holder of inventories)

Dear Sir /Madam,

For audit purposes, kindly furnish directly to our auditors (Name & Address of the auditors) details concerning our inventories held by you for (state the reasons/ purpose of holding of inventories by the third party) as on ___(date).

According to our records, you held the following inventories as on ___ (date).

Description	Quantity
-----	-----
-----	-----
-----	-----
-----	-----

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully

(Signature of responsible official of entity)

Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks.

Annexure VII

Specimen Letter of Confirmation of Inventories Held by the Entity on Behalf of Others

(Letterhead of entity)

Date: _____

(Name and Address of owner of inventories)

Dear Sir / Madam,

For audit purposes, kindly furnish directly to our auditors (name and address of auditors) details concerning your inventories held by us for (state here the purpose of holding of inventories by the entity) as on ___(date).

According to our records, we held the following inventories as of that date.

Description	Quantity
-----	-----
-----	-----
-----	-----
-----	-----

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully

(Signature of responsible official of entity)

Annexure VIII

Specimen Inventories /Receivables Audit Report

- 1) Bank: _____ Branch: _____ Zone: _____
- 2) Name of the account: _____
Address: _____
- 3) Office: _____
Ownership / Rented: _____
- 4) Factory & Go down: _____
Ownership / Rented: _____
Date of establishment: _____
- 5) Constitution: _____
- 6) Name of the Partners /directors: _____
- 7) Nature of business: _____
- 8) Inspected by: _____
- 9) Date of inspection: _____
- 10) Name and designation of Attendant: _____
- 11) Position of account: _____

Nature of Facility	Sanctioned Limit (₹)	Drawing Power (₹)	Outstanding as on (₹)	Overdue Excess, If any. (₹)
Term Loan Specify the assets a) Land & Building b) Plant & Machinery c) Others Cash Credit (Inventories & Book-Debts.)				

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Remarks on the payment of interest and installments:

12) Latest Sanction: Authority: Date:

13) Particulars of the godown and factory premises:

- (a) Address:
- (b) Whether owned or rented:
- (c) Total Area:
- (d) Constructed Area:
- (e) Condition of the godown:
- (f) Whether rented in borrower's name:
- (g) Whether rent is paid regularly.

14) Inventories (as on):
(Preferably on the last day of the previous month)

a)

Value of Inventories/ hypothecated Value of book – debts/ hypothecated (Less Than 90 days.)	
Total	
Less : Creditors	
Working Capital Gap	
Less :Margin 25%	
Drawing Power	
Outstanding (As on)	
Excess over drawing power, if any	

- b) Age and quantity of Inventories for more than six months old / amounts of old Inventories:
- c) Condition of inventories: (Whether properly stored / arranged.)

- d) Whether the mode of valuation is satisfactory:
Whether trade discount, if any, allowed is deducted while arriving at the price of inventories as mentioned in the Inventories statement checked with purchase bills:
Comments on verification and reconciliation of Inventories (quantity and value) as per Inventories statement and as per actual record such as purchase register, etc.:
- e) Value of entire book – debts:
- Less Than 90 Days :
 - More Than 90 Days :
 - Bad Debts (If Any) :
- f) Whether book – debts of associate / sister concerns are included in statement:
- g) Whether sales bills are accompanied by copy of lorry receipt/ receipt challans:
- h) Whether bills discounted are included in book-debts statement:
- i) Whether book debts are arising out of genuine trade transactions:
- j) Whether accommodation bills are observed:
- k) Whether party wise book – debt accounts / registers are maintained properly and kept up – to – date? :

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- l) Whether the outstanding book – debts are arisen out of normal business transaction, which Bank has financed:
- m) Normal time limit taken for realisation of book – debts vis – a – vis past trend or the industry trend. Give comments in case of abnormal delay :
 - * Book – Debts outstanding for 60 days is _____
 - * Outstation Customers are _____
- n) Are there any cases of diversion of funds for other than business needs? :
- o) Whether production / sales achievements found in line with production. If not, offer comments

Year ended	Projected sales (₹)	Actual sales achieved (₹)
2010		
2011		
2012		

- 15) Insurance Cover:
- 16) Other conditions whether satisfied:
 - (a) Bank’s name board whether displayed/ painted/ affixed/ engraved:
 - (b) Whether godown-keeper/ godown chowkidar is appointed?
 - (c) Whether the branch receives Inventories statements certified by borrower?

17) Books and records:

- (a) Whether the following records have been verified and found in order:
- Sales register:
 - Purchase register:
 - Sales bill:
 - Purchase bills:
 - Inventories register:
 - Debtors register:
 - Cash book:
- (b) Whether proper records are evidenced for goods in transit or sent to outsiders for processing or lying with sales depots branches is available:
- (c) On physical verification whether the individual items of Inventories appearing in Inventories statement submitted to the bank found in agreement with the Inventories register or excise records? :
- (d) Do Inventories registers tally with records provided to the bank?
- (e) Turnover in the account during last twelve months:
- (g) Sales during the last twelve months ending on _____ :
- (h) Sales tax paid up to:
- (i) Sales tax assessment completed up to:
- (j) Excise duty returns filed upto:
- (k) Excise duty assessment completed upto:
- (l) Advance income tax paid:
- (m) Income tax assessment completed unto
- (n) ESIS paid up to:
- (o) Provident fund paid up to :
- (p) Municipal taxes paid up to:
- (q) Rent paid up to:
- (r) Shop & establishment/factory license renewed up to:

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- No of fire extinguishers:
- Date of expiry :
- No of sand buckets :

(xix) Watch and ward arrangement :

(xx) Service Tax returns filed up to:

(xxi) Service Tax assessment completed up to:

18) Movement of inventories:

a) Is turnover in Inventories satisfactory? :

b) Is turnover in account satisfactory? :

19) Particulars of machinery:

Name of machines (with full description on like, make other details, etc.)	Whether purchased new or second hand?	Date of Invoice	Purchased Value	Latest Value Basis of Valuation	Written down Value as per B/S as on (₹)

20) No of employees:

Skilled :

Unskilled :

Office staff :

21) Information about shifts:

No of shifts :

Working hours:

22) Comments on working and capacity utilization:

23) Are the machines working in full capacity?

Annexure VIII

- Whether the plant and machine is maintained properly and found in working condition?
- 24) Value of fixed assets:
(As per latest balance sheet as on)
 - 25) Value of current assets:
(As per latest balance sheet as on)
 - 26) Was there any instance of breakdown of plant and machinery causing hindrance in progress of the unit during last six months?
 - 27) Other remarks/ observations
 - 28) Computation of Ratios