

Essentials of Stock Audit

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Brief Background

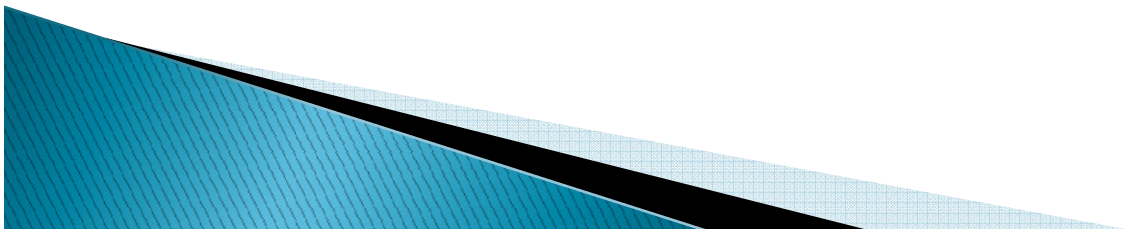
- ▶ Introduced way back in 1992 after Harshad Mehta Scam
- ▶ Exposure above 5 cr or in some cases above 1 cr are covered.
- ▶ Specialized type of audit
- ▶ The main objective is to certify the correctness of stock, debtors and creditors position of the borrower as submitted by him to the bank with the terms and conditions of the sanction letter.
- ▶ Benefits : warning signal for accounts likely to become NPA and helps in early detection and prevention of fraud.

Need for Stock audit:

- ▶ A stock audit is necessary to give an assurance regarding the following:-
- ▶ All sanction terms has been adhered to
- ▶ Stock is owned by the borrower
- ▶ Degraded stock has been written off
- ▶ Physical stock tally with the stock statement submitted to bank
- ▶ Stock is not stagnating or becoming obsolete.
- ▶ The pledged / hypothecated stock is realizable
- ▶ Adequate safeguards exists against fire and natural calamities.
- ▶ A suitable environment exists for preservation of stock.
- ▶ A responsible person is safeguarding the stock.

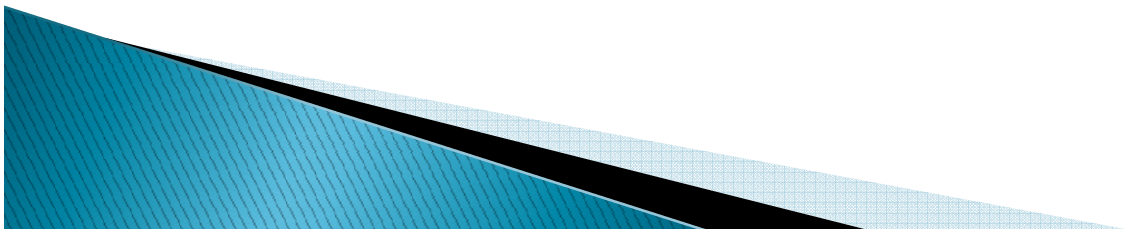
Scope of Stock audit:

- ▶ Physical verification of stock
- ▶ Verification of condition of storage
- ▶ Valuation of stock and pointing out variances
- ▶ Valuation of obsolete / nonmoving stock
- ▶ Age-wise categorization of stock
- ▶ Evaluation of stock management by the company
- ▶ Reconciliation of stock statement with stock records maintained by the company
- ▶ Verification and evaluation of sundry creditors indicating those relating to stock and their relationship with bank finance.



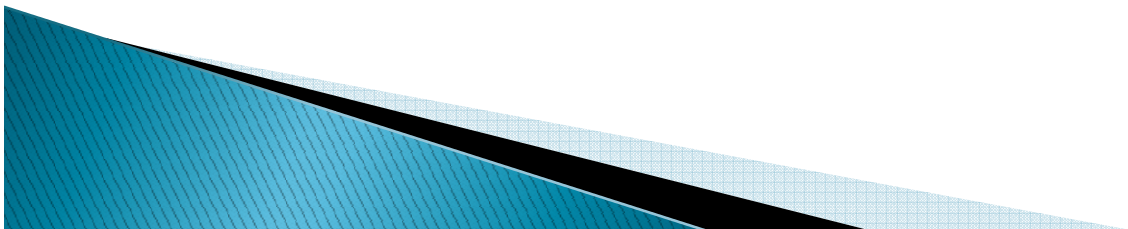
Scope Cont'd...

- ▶ Age-wise and value wise qualification of debtors
- ▶ Determination of drawing power.
- ▶ Checking on adequacy of insurance cover.
- ▶ Verification of documents and licenses
- ▶ Ensuring that the terms and conditions of limit sanctioned have been complied with
- ▶ Verification of transactions with sister concerns, unsecured loans to directors and others.
- ▶ Any other matter of interest to bank.



ICAI Pronouncements:

- ▶ As there is no guidance note or standard prescribed for stock audit, the auditors should conduct the audit based on the generally accepted auditing practices and to the best of his own judgment and ability.
- ▶ A reference to the following ICAI pronouncements can be made:
- ▶ Guidance note on audit of inventories.
- ▶ Guidance note on audit of Debtors
- ▶ AS 2 valuation of Inventory
- ▶ AS 9 Revenue recognition



Pre-Commencement:

- ▶ After getting the engagement letter obtain the name and phone number of the key person and their office and works address.
- ▶ Carefully go through the appointment letter given by the banker.
- ▶ Note the date of issue, expected date by which the report to be completed.
- ▶ Decide on whether you want to accept the assignment or not.
- ▶ As regards our remuneration, some banks have a fixed fee structure based on credit limit enjoyed by the borrower. In other cases, you can negotiate and fix up the remuneration.
- ▶ Always prefer to communicate your fee with him in writing and obtaining his consent to safeguard your fees.

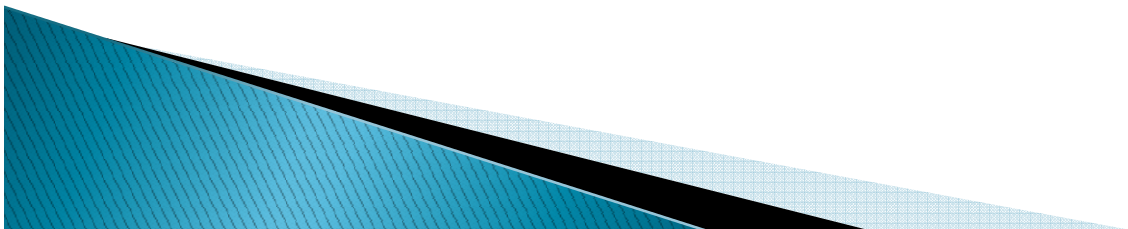
Knowledge of client's business:

- ▶ The knowledge of the client's business is one of the critical elements in formulating an audit program
- ▶ Among other things, the auditor can obtain such knowledge from:
 - ▶ The client's annual reports to shareholders.
 - ▶ Minutes of meetings of shareholders, Board of Directors and important committees.
 - ▶ Internal financial management reports for current and previous periods, including budgets, if any.
 - ▶ Discussions with the client.
 - ▶ The client's policy and procedures manual.
 - ▶ Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
 - ▶ Visits to the client's premises and plant facilities.

After having understood his credit exposure, line of activity, stock levels, data maintenance etc you can send him a letter requiring him to keep certain things ready for verification and inspection.

This letter generally should include:-

- ▶ Stock statements as submitted to bank as at the opening of the financial year and stock statement for the reporting date. In addition the latest stock statement for the date on which our visit is proposed.



Contents of letter continued...

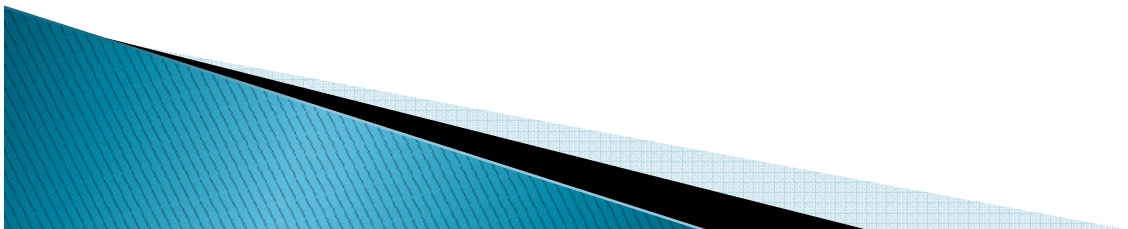
- ▶ Stock registers of Raw material, WIP and Finished goods, consumables.
- ▶ Excise record to verify stock as per records.
- ▶ Copies of sales tax returns and excise return submitted.
- ▶ Quantity wise details of slow moving, non moving stocks as per Industry norms.
- ▶ Basis of valuation in case of slow moving and non moving in case of Raw material, semi finished and finished goods.

Contents of letter continued...

- ▶ Certified copy of sundry Debtors and Creditors as at the opening date of the financial year as also the reporting date.
- ▶ List of L/C's discounted if any.
- ▶ List of EPC availed if any.
- ▶ Latest audited Balance Sheet.
- ▶ ROC records such as creation of charge, modification of charge etc.

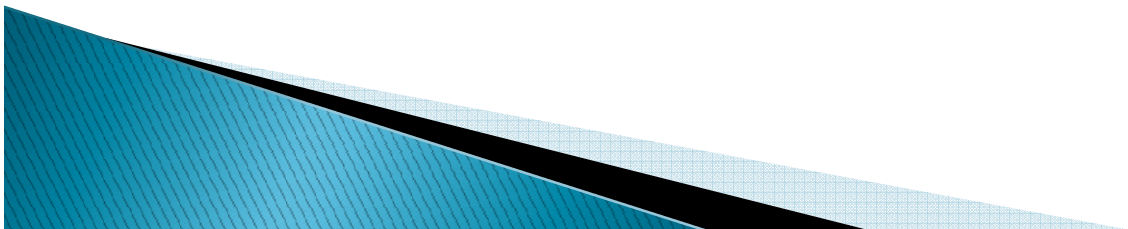
Contents of letter continued...

- ▶ Insurance copies of primary security and collateral security.
- ▶ Certified copy of aging of Sundry debtors for period 0-90 days, 91-180 days, 181 days and above
- ▶ Bank reconciliation statements of all bank accounts.



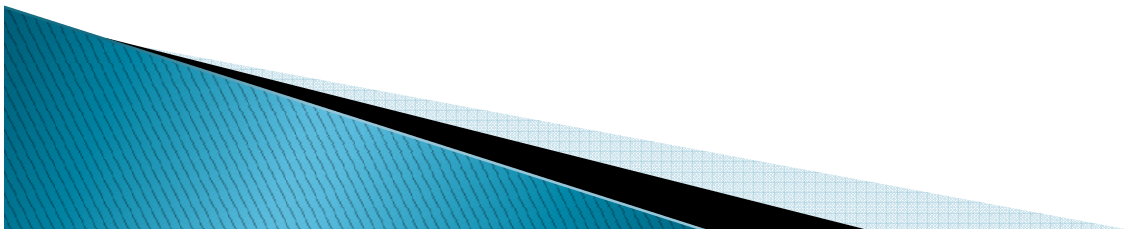
Substantive Procedures:

- ▶ In House audit
- ▶ Physical verification of stock
- ▶ Valuation of stock
- ▶ Verification of Debtors
- ▶ Calculation of Drawing power
- ▶ Checking adequacy of insurance cover



In house Audit:

- ▶ Ensuring compliance to sanction terms
- ▶ Analyzing stock statement for last six months
- ▶ Checking operations in accounts for last six months
- ▶ See whether there are any other bank accounts for diversion of funds
- ▶ Check all statutory dues are paid regularly
- ▶ See the previous stock audit report if available

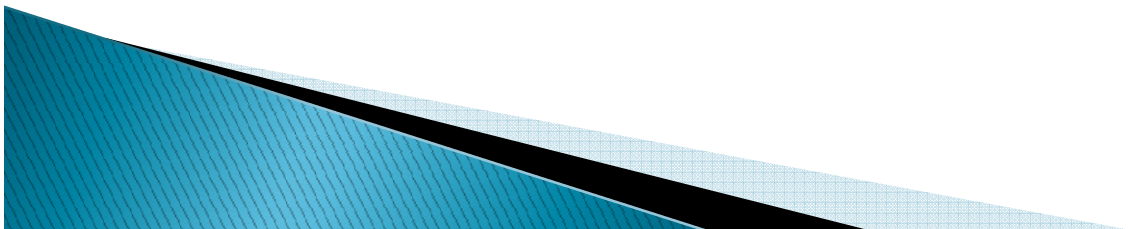


Records to verify

- ▶ Basic records like sales purchase invoices weighbridge slips etc.
- ▶ Stores / Stock Ledger/ register.
- ▶ goods received notes, inspection reports, material issue notes, bin cards, gate pass etc
- ▶ Excise records
 - RG-23-Part I – for raw material and exisable items to ascertain value
 - RG-23-Part II – for raw material and exisable items to ascertain quantity
 - RG 1- for sale price, duty component and quantity of finished goods
 - Annex IV – Stock send received from outside processors
 - Further we can get information from Excise and Vat Returns of the borrower

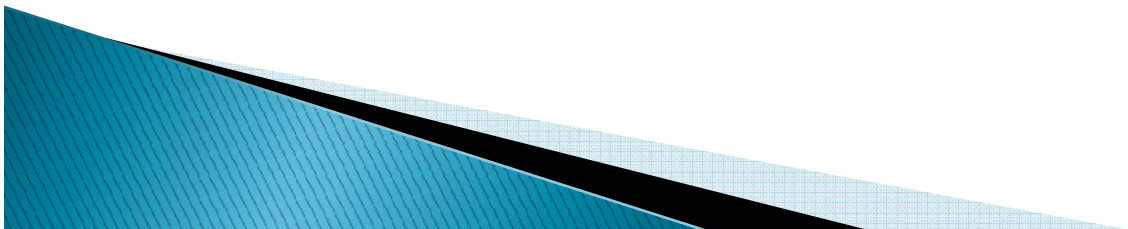
What is stock?

- ▶ Stock or inventory means the assets :
- ▶ Which are held for sale in ordinary course of business
- ▶ In the process of production for such sale; or
- ▶ In the form of material or supplies to be consumed in the production of goods or services for sale (as per AS 2)



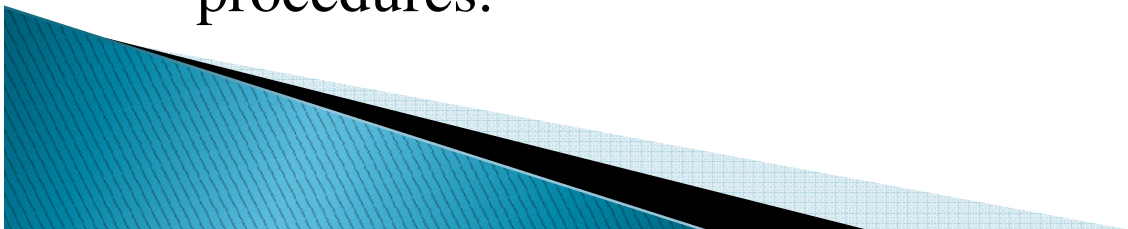
Inventory audit procedures

- ▶ *Cutoff analysis.*
- ▶ *Observe the physical inventory count*
- ▶ *Reconcile the inventory count with stock register*
- ▶ *Test high-value items*
- ▶ *Test error-prone items.*
- ▶ *Test inventory in transit*



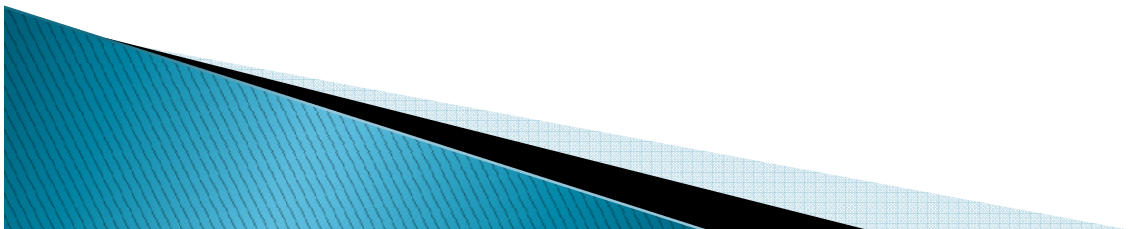
PHYSICAL VERIFICATION OF STOCK

- ▶ In most of the cases, physical verification and actual counting is not possible because of huge volume of stock and time limitation.
- ▶ In such cases, go for ABC analysis.
- ▶ In case of any difference in physical quantity of inventory, properly establish the difference and attest it by the concerned storekeeper or the official.
- ▶ Apart from this we can also comment on stacking and storing procedures.



VALUATION OF INVENTORY

- ▶ Go through the annual Financial statements to understand the accounting policy for the purpose of valuation of inventory.
- ▶ Ensure that the cost does not include:
 - Abnormal waste
 - Storage if not part of manufacturing process
 - Admin. overheads not contributing to bringing inventory to present location.
 - Selling and distribution expenses
 - Interest cost
- ▶ If significant deviation is observed in valuation, properly establish the point by obtaining proper evidence.
- ▶ Valuation should be thoroughly checked and commented upon in our report.
- ▶ Any material deficiency can be highlighted in our report.



VERIFICATION OF SUNDRY DEBTORS

While scrutinizing the debtors we should see that:-

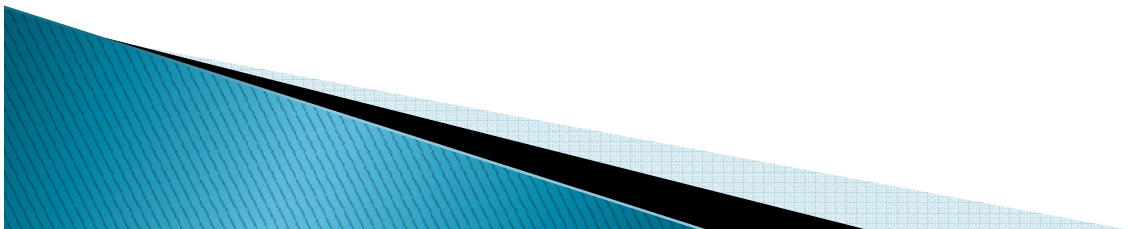
- ▶ The debtors' eligible balance is arriving out of genuine sale transaction and is not merely a book entry.
- ▶ While looking at the credits we can see that money is received and that the amount is routed through the bank account.
- ▶ Aging is correctly done and check that over age debtors are not included in the eligible debtors.

Verification of debtors continued....

- ▶ Check few sale invoices and gate pass to ensure actual movement of goods.
- ▶ Separate eligible debtors within the group or sister concern debts and see whether they can be considered as eligible debtors.
- ▶ Check whether the sale bill is raised when the sale has been made to sister concern or group concern.

CALCULATION OF DRAWING POWER

- ▶ Arrive at the correct value of stock as well as correct amount of eligible debtors and calculate the drawing power based on that.
- ▶ Clearly indicate the deviations in value ,if any, as submitted by the borrower with the values that you have arrived at while auditing.
- ▶ State whether the account is overdrawn or within the limit.



OTHER MISCELLANEOUS POINTS

- ▶ Check whether the stock is properly insured as per the requirement of the bank.
- ▶ Check whether the address of the location is properly mentioned in the insurance policy.
- ▶ See that the bank's name is indicated under the bank clause in the insurance policy.
- ▶ Slow moving and non moving stock can be certified from the management and the same should be removed while calculating the DP.

Misc points continued...

- ▶ Check whether all the bank accounts are properly reconciled.
- ▶ ROC documents relating to creation of charge should be seen and commented upon.
- ▶ Add a page to your report summarizing all the important observations.
- ▶ Report exceptional outstanding statutory dues, if any , as it will help to understand the finance position of the concern.
- ▶ Check whether the bank name plate indicating that the stock is hypothecated to the bank is placed at the entrance to the premises.

Irregularities Generally Found

- ▶ Stock Statements / QIS not submitted in time or not submitted in prescribed format or submitted with inadequate details.
- ▶ Stock/Book-Debt statement Submitted isn't certified by C.A. (as required by Bank such as quarterly, monthly)
- ▶ Stock Statement received from Party filed in a routine way without scrutiny.
- ▶ Debtors more than 90 days (or as per sanction terms) considered for calculating D.P.
- ▶ D.P. not calculated as per margin prescribed in Sanction Letter.
- ▶ Insurance Policy without Bank hypothecation clause, policy expired and not renewed, Under insurance of stock or insurance policy not on record.

Irregularities Cont'd.....

- ▶ Collateral Security not adequately insured.
- ▶ Stock on Job-work and Obsolete / Non-moving stock included in Stock figures submitted.
- ▶ Long pending Debtors shown as below 90 days (or as per sanction terms).
- ▶ Stock/Book Debt figures submitted at the year end and as per financial statement not matching.
- ▶ Bank name plate not displayed.
- ▶ Amount receivables from Sister Concern/ Associate concern considered for calculating D.P.
- ▶ Stock register not maintained / not updated.
- ▶ Balance over D.P. although within sanction Limit.
- ▶ Borrower having operations with other Banks and Realisation from Debtors routed through such other account.
- ▶ Operation in account not scrutinized with reference to projections, QIS, audited accounts, etc.
- ▶ Defects pointed out by internal / concurrent/ statutory / earlier stock auditor is neglected.

THANK YOU

