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INTRODUCTION:

Banking is an important sector of the economy of any country and for the development of the economy a healthy banking system is a must. After the liberalization of the economy, the banking system has undergone a total change in India. There is hard competition in the banking industry to survive in the current circumstances. With the purpose to have better financial discipline & to ensure uniformity in accounting norms RBI introduced the concept of asset classification & income recognition as per the recommendations of Narasimhan Committee. It was also suggested to classify the advances given by banks into Performing & Non Performing Advances (N.P.A.).

Banks and Financial Institutions lend money against hypothecation and pledge of stocks, book debts and securities. Banks have to closely monitor the activity of borrower to ensure that the money lended by bank is secure & there is adequate margin for recovery of loan.

To ensure the safeguard of the advances given and to identify the probable N.P.A. at an early stage, the Banks and Financial Institutions approach external Auditor to carry out an independent examination of these hypothecated and pledged stocks, book debts and securities. The role of the Auditor assumes a great importance, as he is an independent and neutral party whose report is looked upon with respect and credibility.

WHAT IS STOCK & RECEIVABLE AUDIT?

Stock or Inventory means the assets:

a) which are held for sale in the ordinary course of business;
b) in the process of production for such sale; or
c) in the form of material or supplies to be consumed in the production of goods or services for sale (As per Accounting Standard 2)

These goods are normally stored in the godowns, which are generally located near the factory.

Audit is an independent check on the functions of the management, which has some value in the eyes of law and the taxation authority. Audit refers to thorough check of the entire system so that it facilitates Prevention and early Detection of frauds.

Stock & Receivables Audit is one of the most important aspects of the overall exercise of audit of any organization. In stock and receivable audit, auditor ensures himself about the quantity, quality, composition and actual value of the stock & the debtors.

The stock audit covers examination of aspects such as reasonableness of the valuation of the security, routing of sale proceeds of hypothecated stocks largely through the borrowers account, maintenance of the prescribed margins, accuracy of the stock statements, reasonableness of the composition and age of hypothecated stock and their insurance, quality and age of the receivables etc.

The main object of such audit is
(a) To verify existence & ownership of stocks & book debts.
(b) To ascertain the quality & value of stocks & book debts.
(c) To exclude items not qualifying for credit
(d) To check insurance coverage & other aspects.

NEED FOR STOCK AUDIT:

The simple reason for audit and physical verification of the stock and securities is that it acts as a safeguard against occurrence of both, the Internal and External Frauds. The other reasons are listed below: -

1. To find out whether there is a sufficient and suitable environment for preservation of the stock & securities.

2. To find out whether the stocks & securities are safeguarded against theft or misuse by any person at any time.

3. To find out whether the stocks and securities can get degraded.

4. To find out whether the stocks and securities are safeguarded against fire, floods, natural calamities etc.

5. To find out whether the stocks and securities reconcile with the stock statements submitted to the Bank/ Financial institution.

6. To find out whether the stocks are in realisable conditions.

7. To find out whether stock is owned by the party.

8. To find out whether borrower has adhered to other terms and conditions as per the sanction letter

SCOPE OF STOCK AUDIT:

The scope of stock audit almost covers all the aspects, which has any bearing on the working capital profile of the borrowers as well as security & liquidity in view of banker. It encompasses the following aspects:

1. Physical verification of stocks.

2. Valuation of stocks.

3. Valuation of obsolete / non-moving stock.

4. Age-wise categorisation of stocks.

5. Review of the stock valuation system.

6. Determination of the drawing power.

7. Adequacy of the insurance cover.

8. Any other matters of interest to the bank.

RESPONSIBILITY OF THE STOCK AUDITOR

The responsibility of an auditor is always towards the authority that has employed them and the authority, which regulates the profession. In case of stock audit the auditor is employed by the bank or the financial institution. They place reliance on the audit report and acts accordingly, due to which the auditors are responsible to them.

(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)

VERIFICATION OF STOCK AND DEBTORS

Stocks and Debtors are two very important areas requiring attention of not only auditors, but also the management because they are the essence of every business activity and they provide the true indication of strength and vitality of a business. The primary objective of verification, from any point of view, is to ascertain whether they are realizable in cash for the value stated. The best symptom for this is a good, healthy, regular movement of both.

A. VERIFICATION OF STOCK:

There are several guiding as well as mandatory principles prescribed through the various pronouncements such as Standard Auditing Practices viz., SAP's, issued by the ICAI Various International Bodies also prescribe such standards. However, within the framework of all such guiding principles, the verification of stocks boils down to the following: Quantities and Rates. The thrust of any stock verification process is to verify the system followed or the procedure adopted to compile the quantities of stocks as on a given date and the rate applied for evaluation. The audit objectives remain the same though the accounting procedures vary from business to business, country to country, and product to product. A standard checklist can be effectively used provided it is customized to suit each individual case so as to cover its peculiarities and specific considerations. Due attention to exceptions such as damaged, unrealizable, scrap, unserviceable, and obsolete stocks is also expected to be given. Stock in transit must be reconciled to ensure that there are no duplications or omissions.

B. VERIFICATION OF DEBTORS:

As in the case of stocks, there are several guiding as well as mandatory principles laid down by the various pronouncements through standard auditing practices laid down by the ICAI as well as the various International Bodies. Here again the thrust of the verification procedures is on the accounting procedures relating to credit sales and collections. Verification procedures also include independent confirmation of balances and reconciliation of accounts.

C. PROCEDURE FOR VERIFICATION OF PLEDGED STOCKS

1. Co-ordinate with the manager or the concerned officer in the Bank who looks after the Advances before going for the Stock inspection or the Unit inspection.

2. At the godown ensure that a permanently fixed board is prominently situated, clearly stating that the goods are hypothecated or pledged with the respective bank or financial institution.

3. Examine the layout of the godown where stocks are stored.

4. If the godown is rented, inspect the rent receipt and ensure that it is in the name of the borrower. Also ensure 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.

5. If the godown has more than one doors, ascertain whether all the doors except one which is normally accessible are locked from inside.

6. Examine the lock to ensure that Bank's / financial institution's name is engraved there on.

D. PROCEDURE FOR VERIFICATION OF HYPOTHECATED STOCK

1. Verify the actual stocks in the godown physically with that declared in the stock statement.

2. Verify that whether the borrower maintains proper stock register or not.

3. Go through the Purchase register ", Sales register ", Goods received note ", and "Goods returned note and verify with the invoices.

4. Verify whether the stocks are valued properly.

5. If there is any difference between the physical verification of the stocks and the records, the same should be jotted down.

6. In case the stocks are lying with processors, verify whether the branch has obtained a letter of no-lien from the processors.

7. Scrutinize at least 20 % of the total Raw material and 85 % of the total finished

goods and Semi-finished goods lying in the godown.

8. Prepare the age-wise list of the stocks in the following manner: -
   # More than 12 Months Old
   # More than 6 Months Old and Less than 12 Months Old
   # More than 3 Months Old and Less than 6 Months Old
   # More than 1 Month Old and Less than 3 Months Old
   # Less than 1 Month Old

9. Bifurcate the stocks into paid and unpaid and ensure that only paid stocks are taken for the purpose of calculation of drawing power. In case of unpaid stock, the Bank / Financial Institution should not provide any assistance or credit facility to that extent.

10.Check whether the Insurance policies covers the below mentioned risks:

   a. Fire
   b. Marine
   c. Other Natural Calamities

If the policy taken by the borrower does not cover any or all the risk mentioned above the stock has to be insured against all the risks. Noncompliance of coverage of all the risks by the insurance policy can cause a big probable loss to the Bank/Financial Institution. This may happen because the borrower does not want to pay the premium for covering all the risk. In the event of say, occurrence of fire, destroying all the hypothecated stock, than it will be the Bank/Financial institution, who will be the sufferer.

11. In case of excisable items, the excise records should be thoroughly checked.

12. Also verification of the Production register should be done.

13. Details of the stock as regards to quantity, quality, life, date of purchase and price must be verified.

14. Check whether goods require any specialized preservation, and if so, then proper arrangement should be made for facilitating such storage.

15. Check the method, which has been employed for ascertaining the final value of closing stock.

16. Check whether borrower follows the method consistently or not.

17. Verify the movement of stock.

18. Check the work in progress and its basis of valuation and percentage of completion.

19. It should be ensured that the Insurance Policy value is sufficient to cover the amount of the stocks at any point of time.

20. Check whether all the insurance policies are in force.

E. PROCEDURE FOR VERIFICATION OF HYPOTHECATED BOOK DEBTS

1. Sundry Debtors may be classified as sound i.e. fully realizable or doubtful.

2. Prepare the age-wise list of the Book debts in the following manner.

More than 12 Months Old
More than 6 Months Old and Less than 12 Months Old
More than 3 Months Old and Less than 6 Months Old
More than 1 Month Old and Less than 3 Months Old
Less than 1 Month Old

3. Verify whether the stipulated margin is maintained against book debts.

4. If there is any payment towards the Book Debts than it must be paid directly in the bank branch.

5. 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.

6. Compare the statement of Book Debts with the Debtors ledger to ascertain the genuineness of the debt, aging of debt, & cases of non realization of long outstanding debts.

7. Confirmation of Accounts Receivables including loan from financial institutions or bank is a generally practiced auditing procedure to obtain External Audit evidence “The auditor should obtain direct confirmations from third party”. The entire process is as follows:

   1. Selecting the parties for obtaining confirmation.
   2. Designing the confirmation request.
   3. Communicating the confirmation request to the third party.
   4. Obtaining response from the third party.
   5. Evaluating the information provided by the third party and scrutinizing the same for reliability.
   6. The date of request of confirmation is also very important. The date may be as follows:
      1. Year end date
      2. Date prior to yearend.

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.

8. The auditor should also determine that the totals are correct, investigate credit balances and compare all or a selected sample of account balances with the account balances in the ledgers. Selection of Accounts for confirmation should be on following basis:

1. All accounts with a balance over a predetermined amount should be selected. The predetermined amount is based on the auditor's assessment of materiality.

2. All accounts having zero balances should be selected.

3. Accounts with old unpaid balances especially when subsequent sales have been paid off should be selected.

4. Accounts written off during the year under review should be selected.

5. Certain accounts that had appeared on the prior years accounts receivable schedule but not on the current year's schedule should be selected.

6. All accounts with credit balances should be selected.

PROCEDURE OF STOCK AUDIT

(A) Before making visit to party:

(1) Get the Name, Address, Telephone No., and Fax No. of the party.

(2) Get the bank account nos. and full banking details of the party.

(3) List down the various kinds of facilities enjoyed by party and the limits thereof.

(4) 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.

(5) See whether the party is regularly submitting the statement of stock & book debts.

(6) See whether the insurance policy has been issued in the favour of bank or not.

(7) See the amount of insurance policy & date of expiry.

(8) Go through previous visit record made by branch manager, advance officer or any other officer of the branch.

(9) Check whether the interest on overdraft or cash credit facility has been regularly paid. Same is in the case of instalment payments of term loan.

(10) See whether the operation of account is satisfactory or not.

(11) Get an appointment before visiting the party's office.

(B) At the party office

(1) Check whether the party has maintained the stock register.

(2) Check whether other books of account have been maintained by the party i.e. cashbook, bank passbook, purchase book, sales book, debtors ledger & creditor ledger etc.

(3) Bank nameplate stating “Hypothecated to Name of Bank/ Financial Institution” should be affixed on the wall in stock premise e.g. “Hypothecated to Corporation Bank”.

(4) If there is damaged stock, then it should not be taken into account for calculation of drawing power.

(5) Stock must be in sufficient quantity to cover the advance given by the bank.

(6) Stock should be kept in proper condition.

(7) Stock must be kept in the premises, which should be free from water leakages, fire, & other hazards etc. so that damage to stock does not occur.

(8)Fire-fighting equipment must be available in stock premises and it should be regularly checked to preserve its utility.

(9) Specify the name of the person who has attended the auditor.

(C) Photocopies of following should be obtained from party:

(1) Insurance premium receipt with respect to the insurance policy.

(2) Bank/ Financial Institutions original sanction letter and the latest review note.

(3) Balance Sheet & Profit & Loss Account of the borrower for last 3 years.

(4) Stock Statement & Book Debts Statement as on the last day of the quarter and year & preceding 3 months before date of inspection.

(5) Copy of Memorandum of association, Articles of association along with form No. 32 & 18, partnerships deed, Trust deed & its byelaws as may be applicable.

(6) In case the working capital facility granted is more than Rs 10 Lakhs, then the Balance Sheet and Profit & Loss Account must be audited by a Chartered Accountant.

Stock Audit is conducted in two Parts

I) In house audit and
II) Physical verification of the stock

I) IN HOUSE AUDIT:

a) Ensures compliance of sanctioned letters terms & conditions.

b) Check Documentation.

c) Check creation of charge wherever required.

d) Thoroughly check the operation of the Account during last 5/6 months.

e) Whether interest is being served in time and stipulated instalments are paid on the due dates in case of Term loans.

f) Stock Statements are being submitted regularly and drawing power is calculated accordingly.

g) Scan through the previous Audit report, if available, as also last annual report of the bank with specific reference to the Auditor's Report.

h) Verification of operations in the account with respect to the projections / QIS statement.

i) Check the adequacies of Insurance cover and whether it is endorsed in favour of the Bank .In case of Pledge of goods kept in the godown, ascertain whether the keys of the godown are with the branch.

II) Physical Verification of Stock:

The auditor should physically verify the inventories in order to satisfy himself about their quantities. The timing and extent of inventory checking is decided on the basis of clients inventory system and the effectiveness of internal control system Thus there are two major steps in checking of inventory:

a) Planning the physical verification
b) Undertaking the physical verification

a) Planning the physical verification:

Planning is very important. Basically the primary responsibility of conducting the physical verification is that of the client Planning is to be based on following aspects:

1) Plan the day and the time of the physical inventory verification.
2) Method of counting and maintaining of records.
3) Instructions to employees
4) Provisions for the following:
    a) Receipts and Shipment of inventory during the counts
    b) Segregation of inventory not owned by client
    c) Physical arrangement of inventory

Locations of inventory:

The client's plan should indicate the location of inventory. Inventory is usually located at the following:

1. Borrower's premises
2. At the borrower's plant.
3. In transit.

4. On Consignment.
5. In a public warehouse.
6. For processing.

b) Conducting the Physical Verification:

The Auditor should be personally present when the stock inspection is taking place and supervise the entire process.

Audit Programme for Physical Verification: The auditor should prepare in advance his audit program for verification. This includes the following steps:

1) Name of the person contacted & his designation.

2) Banks/ Financial Institutions name board is prominently displayed.

3) Checking of layout of the godown to ascertain quantity of stock, which can be stored.

4) Whether adequate Security arrangements are made at the godown.

5) In case of manufacturing Unit ascertain licensed capacity, installed capacity & actual capacity. Possibly try to understand the reasons for under-utilised capacity & verify that stock holdings are commensurate with the installed capacity.

6) Determine the methods of valuation for Raw material, Work in progress & Finished goods.

7) Advance payments to suppliers if any & volume of unpaid Stock should be ascertained.

8) Reasons of sudden increase in stock, if any during particular period, as also abnormal increase in stock of finished goods should be looked into.

9) Dead and obsolete stock should be kept separately and should not be included for the purpose of arriving at the drawing limits.

10) Whether the borrower maintains account with any other Bank.

11) Shortage in inventory if observed frequently should be questioned.

12) Any shortage observed in case of delivery and dispatch of stock to any specific customer, or conversely shortage in material received from a specific supplier should be questioned.

13) Check for Purchase bills/Inward Documents, Average level of stock maintained during last 1/2 year, Dispatch and Sales invoices, unexplained trends in Sales & Purchases, Inventory valuation norms/method.

14) Examine movement of high value items.

15) Verify frequent alterations in the Sales and purchases invoices and also all

cancelled documents.

16)Review of last years working papers to ascertain the following:
- a) Nature of inventory
- b) Materiality of items
- c) Various components of inventory
- d) Nature of problems faced, if any

16) Review and discuss with the client, the client's Physical inventory plan

17) Visit all locations where significant amounts of stock are held

18) Consider the need for using the services of an outside specialist to assist in identification and valuation problems for certain inventory items

19) Trained personnel for stocktaking

20) During the actual physical verification the auditor should obtain cut-off numbers (i.e. last receiving number and last shipping numbers prior to physical count)

21) Compare inventory serial numbers, sheets or cards

22) Make note of all tags, sheets or cards that represent obsolete, defective, excess or low moving inventory

23) Ensure that stock not owned by the client is not included in the count

24) Keep a list of all personnel who had conducted the stocktaking.

25) Ensure that the accounting of work in process is proper & based on adequate documentation.

Restrictions on Auditor: Sometimes, the stock of the client is stored at a public warehouse or sometimes it is in transit or sent on consignment. In such cases it is not possible for the auditor to physically verify the stock. In that case, the auditor may obtain a confirmation of the stock from the consignee or from the public warehouse.

VERIFICATION OF SECURITIES

What the term 'Securities' denotes?
According to Section 2 (h) of Securities Contracts (Regulation) Act, 1956, the term 'securities' include

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

(ii) derivative;

(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.

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

1. Scrips or Certificates.
2. Safe Custody Receipts (SCR).
3. Letter of Allotment.
4. Neither Scrips nor Allotment Letter.
5. Certificate of holding.

Registers maintained by Bank:

1. Vault Register:
In order to maintain the record of purchase and sale they maintain a vault register and give each certificate a specific security code number based on which category they belong to.
Category wise details of code number is as follows:

Code Number	Category
1. 10	Bank Investment Government Securities.
2. 2070	Bank Investment Other Trust Securities.
3. 8086,88 & 89	Bank Investment Other Authorised Securities(BIOAS).

2. Deposit & Withdrawal Register:

Whenever securities, scrips are required to be deposited or withdrawn permanently, the same are recorded in this register. It mentions date of receipt or withdrawal, particulars of securities, certificate numbers, number of scrips, face value, withdrawal memo number. Entries are initiated by joint custodian and Chief Manager.

3. Excustody Register (Redemption / Jumbo Certificate):

Securities, scrips which are required to be sent for redemption are entered in this register. Moreover, whenever bank opts for acquiring a jumbo certificate in common in exchange of holding large number of certificates of scrips, securities withdrawn are entered in this register, say if bank is holding 10,000 shares of certain company and it has 10,000 scrips in number, then it can opt for 1jumbo certificate in common for all these 10,000 shares of that company. Withdrawals when made, date, security code, company with whom it is being lodged, face value, purpose of withdrawal is mentioned in the register. Entries are initiated by joint custodian and Chief Manager. Entries of both receipt and withdrawal are made in the same register on deposit or withdrawal sides respectively.

4. Excustody Register (Interest Collection):

A scrip when handed over to respective holder branch for collection of interests are entered in this register. Register gives details of security code, description of securities, bank to be lodged with, due date for interest, face value, purpose of withdrawal, date of scrips returned to custodian, number of scrips. Entries are initiated by joint custodian and Chief Manager.

5. Withdrawal Memo:

Whenever any security is withdrawn from custody for whatsoever purpose redemption, interest collection etc., a withdrawal memo is being issued specifying the security code number, description of security, face value, date of withdrawal from safe custody. It is issued under the authority of Chief Manager.

Following are the computerized statements available:

1. Holding Statement as on date:

This statement contains specification of all the securities held by the Bank whether in physical form or demated form. This list is inclusive of securities sent for demat, redemption, excustody etc.. The list specifies security code, description of security, face value, and book value. In short it gives details total investment made by the Bank.

2. Depository Statement:

This statement is a kind of passbook issued by depository. It gives the details of shares demated, shares pending for demat, demat scrips that are redeemed. It gives details of ISIN code, description of securities, quantity of securities etc..

3. Safe Custody Receipts (SCR) :

At times branches do not physically handover scrips to custodian, but instead they submit a statement called SCR giving specification of scrips in which money is vested, date of purchase etc..

SCOPE OF AUDIT:

1. To verify physically the certificates of the securities held by the Branch.

2. To see that the registers for the securities held physically are maintained properly.

3. To verify that securities held by the branch are tallying with Security Holding Register.

4. To obtain the statement showing the securities sent for demat and cross tally with the records maintained in the register.

5. To check Vault and other registers with the Stock Holding Register to see the reconciliation 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.

6. To give the report on the below lines. 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 the redemption or for the purpose of demat.

    5. Statement showing the investments, where neither allotment letters are received nor the certificates.

    6. Statement showing certificates of the investments held by other branches of the SBI and for which there is Safe Custody Receipts.

7. The statement showing investments held by the other branches of the SBI where the Safe Custody Receipts are not received by the Bank's Investment Section.

8. Statement showing certificates withdrawn from the Vaults for the interest collection.

9. Statement showing the certificates of the investments by the R.B.I.

10. Statement showing dematerialized 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 (eg. Custody).

16. Statement showing scrips pending for demat.

17. The auditor has to physically verify securities and check the following points.

(A) WHEN THE ORIGINAL SECURITIES ARE IN CUSTODY OF CLIENT

(1) Whether the securities are in the name of the client. i.e. Ownership;
(2) Whether the securities are kept properly and in safe custody. i.e. Custodian;
(3) Whether the face value of the securities is properly mentioned. i.e. valuation;
(4) 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.

ANALYTICAL REVIEW PROCEDURE(RATIO ANALYSIS)

Apart from the audit procedures discussed above an auditor has to apply certain analytical procedures to review the financial soundness of the business of the borrower. 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 reinforce / 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:

Ratios Formula Purpose

Liquidity ratios: Measures the entities ability to meet its short term obligations, and provide an indication of the Company's solvency.

Current ratio = Current assets / Current liabilities

Indicates whether short term creditors can be met with current assets

Quick ratio or Acid ratio = Current assets – Inventory / 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 = Total debt / Total assets

Indicates percentage of total funds provided by creditors; high ratios when economy is in downturn indicates more risk for creditors.

Activity ratios: Measure how effectively an entity employs its resources.
Inventory turnover= Cost of goods sold /Average Inventory

Illustration 1(Debtors Turnover Ratio)

Facts

A company had sales (all credit) for the year of Rs.1, 20,000. Its accounts receivable at Yearend amounted to Rs.20, 000. Its days sales in account receivable is computed as follows:

1. SalesRs.120,000
2. Accounts receivableRs.20,000
3. Average daily sales (Sales Rs.120,000/360 daysRs. 333
4. Days sales in accounts receivable:
   [Accounts receivable / Average daily sales]= (Rs.20,000 / Rs.333)] 60

In the previous year, the days sale in account receivable was 45.

Analysis: Company is not collecting its receivables as rapidly as it did in the previous year. This increase in the days sales in accounts receivable indicates a possible problem in the collectability of the receivables.

Auditing Procedures

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 yearend sales to determine any unusually large sales. Determine the nature of these and sales and ascertain that they were recorded in the proper accounting period.

ILLUSTRATION 2(Inventory Turnover Ratio)

Facts

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

1. Average inventory

    Beginning balance Rs.20,000

    Ending balanceRs.16,000

Average Inventory = (20000+16000)/2 = Rs 18000

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

2. Cost of salesRs.108,000

3. I**nventory turnover = Cost of sales/ Average inventory**

= Rs 108,000/ Rs 18,000 = 6

In the previous year, the inventory turnover was 4.

Analysis

An increase in the inventory 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 inventory it requires. This will cause inventory levels to decline, and if sales do not decline as rapidly, the inventory turnover ratio will increase.

2. Unrecorded purchases.

3. Unusual inventory shrinkage.

4. Overly conservative inventory valuation.

5. Error in computing the inventory.

Auditing Procedures

There are no specific auditing procedures when the high turnover is caused by insufficient inventory 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 scepticisms than usual.

If the auditor believes the high turnover is caused by other than a poor credit rating, he or she may do the following:

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 inventory controls to determine the possibility of theft. Also, if the company is a manufacturer, review production records to determine spoilage and waste.

3. Compare inventory costs with inventory values.

4. Review inventory computations.

ILLUSTRATION 3 (Trend Analysis)

Facts

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

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

Analysis

Sales have increased at a steady rate over the 5year 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 years 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

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 yearend, did the Company make advance payments for the subsequent years selling program and classify these payments as an expense rather than as a prepayment?

Are expenses of executives, personal in nature, being charged to the company?

Internal Control Questionnaire(General)

Sr. No.	Particulars	Yes/ No	Remarks
1.	Have you obtained Standard letter from Management? e.g. Representation Letter, Letter Regarding Books maintained.		
2.	Have you obtained name of C.A. who have visited the party and Branch & his name is present in report? Also he should be present for discussion of report with Branch		
3.	Have you taken primary registration documents from the party?		
4.	Have you done documentary checking of ownership or lease and taken a copy of the same?		
5.	Have you studied and taken Position of Accounts as on date of Audit?		
6.	Avoid using abbreviation, if you use it in First place write full Form and then use abbreviations.		
7.	Have you checked up collateral securities?		
8.	Have you taken phone numbers of CA's – statutory Auditor, Tax Auditor etc?		
9.	Have you scrutinized Debtors' ledger?		
10.	Have you made a comparison of previous 2 to 3 years financial position of the borrower?		
11.	Have you checked the Bank Account operations of the borrower?		
12.	Have you received all the books/Register? If not, highlight in Red.		
13.	Have you conducted the audit as per the Standard Auditing Practices?		
14.	Have you checked up the Sales Tax Provision?		
15.	Have you checked Income Assessment Orders?		
16.	Have you checked the provisions relating to ESIS Challans?		
17.	Have you checked provisions relating to PF – Challans, assessment order?		
18.	Has the factory license been renewed?		
19.	What is the basis of checking of turnover of		

	stocks?		
20.	What is the value of machinery, furniture & fixture? Have you checked it?		
21.	Prepared a Valuation Report - Is it mortgaged? Have you seen the latest Valuation Report?		
22.	Have you received the details of no of skilled and unskilled employees, office staff? Have you checked up the Salary register?		
23.	Have you checked fixed assets? – Are there any breakdowns of Plant & Machinery? – Are Fixed assets Register being maintained?		
24.	Are Breakdown register, Repairs & maintenance register being maintained?		
25.	Have you checked up the latest Insurance Policy?		
26.	Have you checked up whether party is submitting stock statement as per format of Bank/ Financial Institutions?		
27.	Have you obtained Memorandum of Association & Articles of Association?		
28.	Have you obtained Balance Sheets of last 3 years?		
29.	Have you inquired about the Associations of which borrower party is member?		
30.	Have you obtained details of Sister Concerns?		
31.	Have you obtained details of Bank Account being operated along with details of cheques refunded, if any?		

Internal Control Questionnaire (Sales & Debtors)

Sr. No.	Particulars	Yes/ No	Remarks
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 Passers and customer's Orders?		
17.	Are acknowledgements obtained from the customer's, 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?		
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 dishonoured 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.	Do customers recorded accept bills of exchange (or other negotiable instruments)?		
29.	Are the bills of exchange, etc., as per such record periodically verified with the bills on hand?		
30.	Is a record of customers claims maintained? a) Are such claims properly dealt with in the accounts?		
31.	Does the Receiving Department record them on sales Return Note?		
32.	Does the Receiving Department count, weigh or measure the goods returned?		
33.	Are copies of Sales Returns Notes sent to: a) Customer? b) Sales Department? c) Debtors' Ledger Section?		
34.	Are the returned goods taken into stock		

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

	amounts written off?		
53.	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?		
54.	Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?		

List of documents to taken as working papers

1. Stock auditor's report. of three previous years

2. Last 3 month's bank statements.

3. Last one-year statement showing Opening stock, Purchases, Sales, Work in progress and Finished Goods.

4. Details of Installed capacity, Licensed capacity and Actual production with documentary evidence.

5. Copy of sales invoices of at least 3 per month, for last 12 months and checking the process of collection.

6. Copy of purchases invoices at least 3 per month, for last 12 months and checking the process of payment.

7. Certified copy of constitution of entity e.g Partnership Deed/ Memorandum and Articles of Association / Trust deed of Trust / Rules & Regulations of Society.

8. Copy of form No.18 along with filing fees receipt for registered office address.

9. Copy of form no 32 along with filing fees receipt for directors.

10. Copy of form No. 8 & 13 along with filing fees receipt & charge registration certificate.

11. Copy of Form No.8 & 17 along with filing fees receipt & certificate for registration of charge and balance sheet.

12. Last 3 years Profit and Loss account.

13. Stock statement of last one year (month wise).

14. Book debt statement of last one year (month wise).

15. Write up on manufacturing process.

16. Plant layout and details of plant and machinery.

17. List of Books and records maintained.

18. Organization chart along with responsibility.

19. Flowchart of movement of raw materials, work in progress, finished goods.

20. A write up on credit policy.

21. Statement of Debtors along with Bill date and age of debtors.

22. Stock statement on date of physical verification along with date of purchase: - bifurcation in **Paid, Unpaid Stock, Obsolete and Non-Moving.**

23. Agreement of ownership / Lease agreement / Rent agreement for office / Factory / Godown

24. List of sundry creditors with date of bill for goods purchased on date of physical verification.

25. Certified copy of Insurance policy.

26. Certified copy of loan sanction letter.

27. Comprehensive management representation letter.

28. Certified copy of Excise return (RT-12) Sales tax return, income tax return of one year.

29. Copy of registration certificate under Shops and Establishment Act, Register of Firms, Pollution control Board, Food and Drugs Approval Authority – other laws as applicable.

30. A note on accounting policies

31. A detailed note on accounting system for purchases, sales and inventories.

32. Industry Journal (for additional information).

Annexure1 (Specimen Confirmation Statement)

Specimen Confirmation Statement
[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 confirms 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 of [date] is correct except as noted below:

____
[Debtor's name]

Date ____________

Note: This confirmation is to be posted directly to the auditors as per the stamped envelope enclosed.

Annexure 2(Specimen Confirmation of Stock on Consignment / from public warehouse)

Specimen Confirmation of Stock on Consignment / from public warehouse

[Client Letterhead]

[Name and Address of consignee / Public warehouse]

[Date]

Dear Sir,

Our auditors [name and address] are conducting an audit of our inventories.

Please confirm to them our merchandise [consigned to you / Stored in on your premises] as of [date] as described below:

Description	Quantity

Your prompt attention will be appreciated. A stamped envelope is enclosed for your reply.

Very truly yours,

For XYZ Ltd

(______________)

Director

Confirmation: -

The merchandise listed above is all that is held by me as of [date] except as noted below

Description	Quantity

[Consignee /Keeper of Public Warehouse]

[Date]

Annexure 3(SPECIMEN INSPECTION REPORT OF STOCK AND BOOK DEBTS)

(Client's Name & Address)

SPECIMEN INSPECTION REPORT

STOCK AND BOOK DEBTS

1) Bank: **Branch:** **Zone:**

2) Name of the account:

3) Address:

I) Office:

Ownership / Rented:

II) Factory & Go down:

Ownership / Rented:

4) 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 (Rs.)	Drawing Power (Rs.)	Outstanding As On (Rs.)	Overdue Excess, If Any. (Rs.)
Term Loan Specify the assets a) Land & Building b) Plant & Machinery c) Others Cash Credit (Stock & Book-Debts.)				

12) Remarks on the payment of interest & instalments:

Latest Sanction: **Authority:**
Date:

13) Particulars of the godown & 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)Stocks: (As on):
(Preferably on the last day of the previous month)
(a)

Value of stock / 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 stock for more than six months old / amounts of old stock. :

(c) Condition of stocks: (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 stocks as mentioned in the stock statement checked with purchase bills

Comments on verification and reconciliation of stock (quantity and value) as per stock 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? :

(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 – is 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 (Rs.)	Actual sales achieved (Rs.)
2001		
2000		
1999		

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 stock statements certified by borrower?

17) Books and records:

(a)Whether the following records have been verified and found in order:

a) Sales register:
b) Purchase register:
c) Sales bill:
d) Purchase bills:
e) Stock register:
f) Debtors register:
g) 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 stock appearing in stock statement submitted to the bank found in agreement with the stock register or excise records? :

(d) Do stock registers tally with records provided to the bank?

(e) Turnover in the account during last twelve months:

(f) Sales during the last twelve months ending on:

(g) Sales tax paid up to:

(h)Sales tax assessment completed up to:

(i) Excise duty returns filed upto:

(j) Excise duty assessment completed upto:

(k)Advance income tax paid:

(l) Income tax assessment completed unto

(m)ESIS paid up to:

(n) Provident fund paid up to:

(o) Municipal taxes paid up to:

(p)Rent paid up to:

(q) Shop & establishment/factory license renewed up to :

1. No of fire extinguishers:
2. Date of expiry:
3. No of sand buckets:

(r) Watch and ward arrangement:

(s) Service Tax returns filed up to:

(t) Service Tax assessment completed up to:

18) Movement of stocks:

a) Is turnover in stock 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	WDV as per B/S as on (Rs.)

20) No of employees:
Skilled:
Unskilled:
Office staff:

21) Information about shifts:
No of shifts:
Working hours:

22) Comments on working and capacity utilisation:

23) Are the machines working in full capacity?

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
Current Ratio:
Debt – Equity Ratio:
Debtor’s Turnover Ratio:

Annexure 4(Management Representation Letter)

Specimen of

Management Representation Letter

[Client's Letterhead]

[Date]

To,
[Name]
Chartered Accountants,

We are providing this letter in connection with the Stock 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:

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:

(a) Method of Accounting:

The Financial statements are prepared on accrual method of accounting.

(b)Inventory:

1. Raw material is valued at cost on FIFO.

2. Finished Goods is valued at lower of cost or net realisable value. Excise duties on goods manufactured by the company and remaining in inventory is included as a part of values on of finished goods

9. The Insurance for building and furniture is Rs. -------, Plant & Machinery Rs. -------- Stock in process Rs. ------ & 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 31.03.2001 on -------- was --------- pieces

1. 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 Rs. ---------

c) Actual production for the year ended 31.03.2000 was ------ pieces.

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

Particulars	For the year Ended 31.03.1999	For the year ended 31.03.2000	For the year ended 31.03.2001
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)
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 31.03.2001

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 & as per Statement
(Reason for discrepancies)

II Work In Progress

i.
ii.
iii.
iv.

III Finished Goods

i.
ii.
iii.
iv.

19.

Ratios	For the year ended 31.03.2001	For the year ended 31.03.2000	For the year ended 31.03.1999
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