Stock Audit

CA. Rajkumar S Adukia

B.Com (Hons), FCA, ACS, ACWA, LLB, DIPR, DLL &LP, IFRS(UK), MBA

email id: rajkumarradukia@caaa.in

Mob: 09820061049/09323061049

To receive regular updates kindly send test email to : rajkumarfca-subscribe@yahoogroups.com & rajkumarfca+subscribe@googlegroups.com

Meaning of Stock

According to AS -2 Valuation of Inventories, stock or inventory is defined as follows

"Inventories are assets:

- ***(a) held for sale in the ordinary course of business;***
- ***(b) in the process of production for such sale; or***
- ***(c) in the form of materials or supplies to be consumed in***

the production process or in the rendering of services."

Meaning of Stock

Inventories thus normally comprises of

- stores,
- spares parts,
- loose tools,
- maintenance supplies,
- raw materials including components,
- work in process,
- finished goods including by-products,
- waste or by-products, etc.

Meaning of Debtors

A debtor 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

Inventory & Receivables

- Maintenance of inventory is a **major part of working capital requirement** of any unit.
- **Essential components**, of the total assets of an entity in general and current assets in particular are Inventories and Debtors.
- Stock and Debtors indicate the **health of a company**

Valuation of Inventories

- Different methods of valuation are adopted, depending upon the type of Inventories, in particular and the type of the business in general.
- 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

Method of Valuation

- 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.

Valuation of Different Types of Inventories

- 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.

Valuation of Different Types of Inventories

- For computing accumulation of huge inventories the number of days holding of Inventories etc, the following method may be followed:
  - For Raw Material:

$$= \frac{\text{Actual Holding} \times 365}{\text{Annual Raw Material Consumed}}$$

  - For Inventories in Process:

$$= \frac{\text{Actual holding} \times 365}{\text{Annual cost of production}}$$

  - For Finished Goods:

$$= \frac{\text{Actual holding} \times 365}{\text{Annual cost sales}}$$

  - For sundry debtors:

$$= \frac{\text{Actual outstanding debtor's} \times 365}{\text{Annual sales}}$$

  - for sundry creditors

$$= \frac{\text{Actual sundry creditors'} \times 365}{\text{Annual purchases}}$$

Bank Borrowing

- Entities obtain loans from banks in the form of **cash credit** against hypothecation of **Inventories and Debtors**

Consortium Lending

This approach to lending also called the **Single Window 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.

Cash Credit Facility

- Drawing is permitted against the Inventory of Goods in a Cash Credit Facility
- Both Deposits and Withdrawals are permitted in this facility
- Cash credit facility is offered on a permanent basis, as long as the business goes on.

Types of Cash Credit Facility

Cash credit facility is of two types based on the nature of charge on goods taken as security by bank.

(i) **Cash credit - Pledge**: When the possession of the goods is with 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 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.

Inventory Audit

Inventories audit is about the authentication of

- quantity,
- quality,
- composition and
- valuation

of the inventories and debtors.

Stock Audit Cycle

The five stages in any audit are:

- Pre-engagement
- Understanding the entity
- Audit planning
- Substantive procedures
- Reporting

Inventories Audit in Banks

The term Inventories Audit in the context of banks refers to

- verification and valuation of the entire gamut 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.

Inventories Audit in Banks

- The main purpose of audit in banks is to get an assurance on the quality and quantity of loan security.
- Inventories Audit in Bank verifies the following
  - Physical Verification of the Security
  - Valuation of Security
  - Security of the Security

Meaning of Mortgage

Sec 58(a) of the Transfer of Property Act 1882 deals with mortgage. Accordingly, the necessary ingredients of a mortgage are: -

1. Transfer of interest in specific immovable property
2. Transfer is for the purpose of securing the payment of money advanced or to be advanced by way of loan.
3. It may be existing and future debt.
4. It may be also for performance of an engagement, which may lead to financial liability.

Need for Inventory Audit

An Inventories audit is essential for the following purposes:

- To give the bankers an assurance regarding the following:
  - That a suitable environment for preservation of Inventories exists
  - That a responsible person for safeguarding the Inventories is always present
  - That degraded Inventories have been written off
  - That adequate safeguards exist against fire and natural calamities

Need for Inventory Audit

- That physical inventories tally with the Inventories statements submitted to bank
- That the pledged/hypothecated Inventories is realizable
- That Inventories is owned by the borrower
- That all sanction terms have been adhered to
- That inventories are not stagnating and becoming obsolete

- To investigate, wherever the party is not submitting periodic Inventories statements regularly.

Need for Inventory Audit

- To investigate, where the accounts have been marked as substandard.
- To find out reasons when there are too many qualifying remarks about inventories and receivables in the Auditor’s report on the Balance Sheet of the borrower
- To find out suspect dealing in lending procedure

Need for Inventory Audit

- 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.
- To fulfill Head Office requirement

Scope of Inventory Audit

- 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.
- It encompasses the following aspects:
  - Physical verification of inventories
  - Verification of condition of storage
  - Valuation of inventories and pointing out variances

Scope of Inventory Audit

- Valuation of obsolete / non-moving Inventories
- Age-wise categorization of inventories
- Evaluation of the Inventories management by the company
- Reconciliation of Inventories statements submitted with the accounting records maintained by borrowers particularly, relating to quantity, rate, value of inventories, age, marketability, etc
- Verification and evaluation of sundry creditors indicating separately those relating to Inventories and their relationship with bank finance

Scope of Inventory Audit

- 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
- Review of the Inventories valuation system
- Age-wise and value-wise qualification of debtors
- Determination of the drawing power
- Determining adequacy of the insurance cover
- Verification of documents/ securities

Scope of Inventory Audit

- Commenting upon the comparative Profitability and Inventories ratio
- Ensuring that the compliance of the terms and conditions of limit sanctioned
- Verification of transactions with sister concerns, unsecured Loans to Directors and others
- Any other matters of interest to the bank

When to perform Stock Audit

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

When to perform Stock Audit

- Where there are too many qualifying remarks about inventories and receivables in the auditors report on the balance sheet of a borrower
- Where the accounts is marked as sub-standard
- Suspect dealings in lending procedure, jeopardizing advances given
- An errant borrower, where Inventories audit is needed to supplement actions of the branches for recovery.
- Any other valid reason such as mismanagement, heavy losses, lockout, strikes etc
- Fulfilling the criteria fixed by the head office to get done Inventories audit.

Non Performing Assets

- An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.
- With effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance where;
  - Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
  - the account remains 'out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC),

Non Performing Assets

- the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Special Points on Stock Audit

- 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
- It should be seen that the stocks have been properly valued, after considering the relevant accounting principles, Accounting standards (AS) and Engagement Standards [earlier Known as Auditing and Assurance standards (AAS)]

Special Points on Stock Audit

- It should be seen that Current Assets are not over-stated.
- It should be seen that the Turnover is not over-stated.
- It should be seen that the stocks that are genuinely owned by the borrower are shown in the accounts

ICAI Pronouncements

- There are no guidance notes or standards prescribed for Inventories audit, the auditors should conduct the audit based on the generally accepted auditing practices and to the best of his judgment and ability.

Relevant Standards

- AS 2 – Valuation of Inventories
- IAS 2 – Accounting for Inventories

Relevant RBI Notifications

- RBI/2010-11/74 DBOD.No.BP.BC.21 /21.04.048/2010-11 – 1st July 2010 – Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances
- According to 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, nonsubmission of stock statements and nonrenewal of the limits on the due date, etc. In the matter of classification of accounts with such deficiencies banks may follow the following guidelines:

Relevant RBI Notifications

- 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.

Relevant RBI Notifications

- 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.

Relevant RBI Notification

- 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 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.

Relevant RBI Notification

- Para 5.3 on Doubtful Assets –

With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors

Relevant RBI Notification

- **Lending under Consortium Arrangement / Multiple Banking Arrangements** - RBI/2008-2009/379 - DBOD.No. BP.BC.110/08.12.001/2008-09 - February 10, 2009 – Annexure 1 – Part II - **Certifications of borrowal companies by chartered accountants / company secretaries/cost accountants** - 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.

Relevant RBI Notification

- **Lending under Consortium Arrangement / Multiple Banking Arrangements** - RBI/2008-2009/379 - DBOD.No. BP.BC.110/08.12.001/2008-09 - February 10, 2009 – Annexure II – Revised Format under Multiple Banking Arrangement Credit Information Exchange – Part IV – Credit Information Report – III. Compliance with Financial Covenants – Stock Statement/ Financial Data

Stock Audit Report

- Format for stock audit report may vary from bank to bank.
- A stock audit report should cover the following aspects
  - Compliance with terms and conditions of sanction.
  - Timely & adequate submission of stock statements & other important financial information.
  - Account operations – overdrawing, credit summation and cash withdrawals.
  - Drawing power calculations by banks and by the auditors & discrepancies, if any along with the reasons.

Stock Audit Report

- Physical maintenance and storage of stock and adequacy of facilities at the borrowers place.
- Systems / procedures implemented by borrower to identify the slow and non-moving stock items.
- Borrower's Management information system, its adequacy & Internal controls to safeguard stock.
- Method of valuation of stock, time interval for valuation and adequacy & sufficiency of procedures thereof.
- Insurance of stock.
- Verification of Debtors.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*
- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labour Laws and IPR.*
- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*
- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

- *The author can be reached at* ***rajkumarradukia@caaa.in***
  Mob – 09820061049 / 09323061049.

- *For more details log on to www.caaa.in*


Thank You