

Stock Audit of Bank Borrowers

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Introduction –

Working capital finance in the form of cash credit against the security of hypothecation of stock and debtors is one of the most common modes of finance frequently adopted by various bankers. The borrowers in such cases are expected 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 for ascertaining the genuineness & correctness of such statements appoint chartered accountant firms at frequent time intervals to conduct stock audit specifically where the exposure exceeds the predetermined threshold limit (generally over Rs. 100 Lacs).

This article therefore makes an attempt to throw light on the procedure of stock audit, its objectives and utility in a brief manner.

Appointment of Stock Auditors and period of audit –

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 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.

Objectives of Stock Audit –

The banker appointing the CA firm for conducting stock audit has main objective of ascertaining whether the security (borrower's stock and debtors) against which finance has been made is safe and is valued correctly.

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

- To ensure proper preservation / storage and handling of stock.
- To identify whether there exist any obsolete stock & if yes, whether it has been segregated & written off.

- 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)
- To ascertain whether physical stock tally with the stock statement submitted to the banker
- To ascertain whether hypothecated stock is realizable.
- To confirm that stock is owned by the borrower and finance is made against value of paid stock only.
- 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.

Steps involved in stock audit –

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.

- 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' affairs and conduct of the account.
- 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.
- 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 –

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 –

- 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.
- 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.

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 –

The common irregularities that may be observed by the CA firm during stock audit can be summarized as follows –

<p>Observations about statement submission & Scrutiny –</p> <ul style="list-style-type: none"> • Stock Book Debts statements not submitted / not 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 not given / done. Debtors over 90 days (or as per sanction) considered for drawing power. • Drawing power not correctly calculated. • Latest visit report by branch official not on record. 	<p>Observations about account operations –</p> <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 routed through account. • 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>Observations about Insurance coverage –</p> <ul style="list-style-type: none"> • Under insurance of stock. • Insurance expired and not renewed. • Premium for renewal policy paid but policy not 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 wrongly stated. • All locations of stock not covered.
<p>Observations about verification of stock and creditors –</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 	<p>Observations about verification of Sundry Debtors –</p> <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. 	<p>General Observations –</p> <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

- the year end and as per financial statement not matching.
 - Stock debtors as per statements submitted and as per books not matching.
 - 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.
 - Dispute with debtors and pending court cases.
 - Amount receivable from Sister concern considered for calculation of drawing power.
 - Advances received from debtors not reported resulting into lower DP than calculated by bank.
- displayed.

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 and its uses –

Stock audit by external CA firm 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, in my opinion unlike 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.