



hpsc
(Scheduled Bank)

हिमाचल प्रदेश राज्य सहकारी बैंक सीमित
H.P. State Co-operative Bank Ltd.

Policy for Stock Audit of Bank Borrowers

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A. Introduction –

Working capital finance in the form of cash credit (CC Limit) against the security of hypothecation of stock and debtors is one of the most common modes of finance by the Bank. 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.

With a view to bringing down divergence arising out of difference in assessment of the value of security, RBI vide Master Circular No. DOR.CRE.REC.No.17/13.05.000/2022-23 dated April 8, 2022 regarding Management of Advances has recommend to have a System of periodical stock audit, in case of working capital finance as a measure by the lenders for monitoring and ensuring end-use of funds.

Therefore, in order to enhance the reliability on stock valuations, Stock Audit should be conducted by appointing Chartered Accountants, who are in our panel as Stock Auditors or Concurrent Auditors or Statutory Auditors, for **Working Capital Limits of ₹ 1.00 Crore & above** (both Fund based and Non Fund based Limits) where the primary security is hypothecation of Stock and/or Book Debts at annual intervals.

B. Appointment of Stock Auditors and period of audit –

The appointment of stock auditors shall be made by BRCTL Section at Head Office. The concurrent auditors shall be assigned the stock audit of the borrowers. Terms of appointment shall be prescribed which involves conducting of stock audit as a one time exercise in a financial year. 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.

C. 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 are 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 paidstock 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.

D. Documents required from the borrower-

- Constitutional documents (Deed, RoC documents & certificate)
- Stock position as on date of Verification.
- Trial balance or Provisional Balance Sheet as on date of Verification.
- Last year's Audited Financial Statement & Audit Report
- Last 2 Years Stock Audit Report
- Copies of concurrent/Internal/Statutory audit reports related to period covered under audit

E. The Stock Auditor shall consider the following while conducting the Audit-

- Appraisal Note & Sanction letter
- Physical verification of the site Invoices (sale & purchase)
- Whether stock register is maintained properly like quantity, rate and values are mentioned properly.
- Details of obsolete or non-moving stock
- Insurance of stock and bank clause on policy cover note. Also, policy cover not is available on record and all risks are covered in the policy.
- Latest Review or renewal of the account.
- Frequent overdrawn over Drawing power or sanctioned limit
- Latest visit report by the bank branch officials
- Display of bank board on the godown or site
- Whether Drawing power calculation is correct (As per sanction letter) and DP register is updated regularly
- Defects pointed out by the concurrent or internal auditors.
- CIBIL or commercial report or external credit rating
- Whether stock and book debt statement has been submitted on time (as per sanction letter)
- Method of valuation followed for inventory with detailed working

- Whether sales have been routed through bank accounts
- Compliance of Income Recognition & Assets Classification Prudential norms (IRACP)
- Scrutiny of Collateral property (Verification of original documents, Valuation Report not more than 3 years old, legal search report (LSR/TSR), Insurance & CERSAI report)
- List of debtor & creditor (direct confirmation as per SA:505)
- Debtor aging as per sanction letter.
- Margin requirement as per sanction letter (25%, 30% as the case may be)
- Challans paid of various statutory dues (ESIC, PF, Property Tax, GST, Any other Cess)
- Total exposure i.e. Other facilities availed by the client from bank
- Charge on the stock and collateral property
- Whether Gate register is maintained or not.
- Procedure and Physical verification of inventory by management as per para 3 of Companies Auditor's Report Order, 2020 (CARO 2020)
- GST return for the period covered under audit.

F. Steps involved in stock audit –

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

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 Auditors, Concurrent Auditors etc) to have a brief understanding about the borrower and its financial affairs.

1. Visit to Borrower's Branch

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

2. 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.

3. 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.

G. Format for stock Audit-

Format for stock audit report should cover the following important parameters –

- 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.

H. Common irregularities / observations in stock audit –

Observations about statements submission & Scrutiny –

- 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 upto 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.

Observations about verification of stock and creditors –

- Stock book not maintained/ not updated.
- Obsolete stock not excluded from stock figures submitted to bank.
- Deteriorating stock turnover ratio.
- Stock figures submitted at the year end and as per financial statement not matching.
- Stock debtors as per statements submitted and as per books not 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.

Observations about Insurance coverage –

- 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.

General Observations –

- Diversion of funds and inter account transfers are not properly monitored.
- Borrower having operations with other bank for which permission of lender not obtained.
- Bank name plate not displayed.
- 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.

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.

I. 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.

The Bank shall include the following points under the **Long Form Audit Report (LFAR)** by the Statutory Central Auditors (SCA) to the Management of the bank as advised by RBI vide their circular no.RBI/2020-21/33,Ref.No. DOS.CO.PPG./SEC.01/11.01.005/2020-21 dated September 05, 2020.

- 1) Whether there exists a system of obtaining reports on stock audits periodically?
- 2) If so, whether the branch has complied with such system?
- 3) Details of cases:
 - a. where stock audit was required but was not conducted.
 - b. where stock audit was conducted but no action was taken on adverse features.

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.

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