UNIT 3: AUDIT OF ACCOUNTS OF NON-CORPORATE ENTITIES (BANK BORROWERS)

1. OVERVIEW

The Reserve Bank of India (RBI), keeping in view the need for bringing discipline in the matter of maintenance of accounts by non-corporate entities, has issued a circular dated 12th April, 1985 to all Banks recommending audit of accounts of all non-corporate borrowers enjoying working capital limits of ₹ 10 lacs and above from the banking system.

For the purpose of computing the above limit, the term borrowing will include borrowing of the following types:

<table>
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<tr>
<th>(i) Packing credit facilities</th>
<th>(ii) Cash credit facilities</th>
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<tr>
<td>(iii) Loans-secured and unsecured</td>
<td>(iv) Overdraft</td>
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<td>(v) Deferred payment facilities</td>
<td>(vi) Bill Discounting Facilities</td>
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<td>(vii) Guarantees:</td>
<td>(viii) Any other credit facilities (other than loans, guarantees, letter of credit etc.).</td>
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<td>(a) Performance guarantees</td>
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<td>(b) Financial guarantees</td>
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This requirement applied in respect of the accounting year of the non-corporate entity commencing on or after 1-4-1984. It is necessary for the non-corporate entity enjoying such credit facility to submit the audited statements and audit report to the concerned bank as early as possible but in any case not later than 6 months from the close of the accounting year. The primary responsibility for maintenance of books of accounts and records is that of the non-corporate entity.

2. AUDIT PROCEDURE

(i) The auditor is required to express his opinion as to whether the financial statements give a true and fair view of the state of affairs of the entity. For this purpose the auditor has to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require. Considering the contents of the audit report the auditor has to conduct the audit by applying the same principles which are applicable for an audit in the corporate sector. The audit report is to be given to the lending bank and therefore such report will be in the nature of a special purpose report.
(ii) If he finds that there is no internal control, it would not be advisable for him to conduct the audit by applying test checks. The auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case.

(iii) Section 143 of the Companies Act gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. In the case of audit of a non-corporate entity, it would be in the interest of the entity to furnish all the information and explanations and produce books of accounts and records required by the auditor. If, however, the entity refuses to produce any particular record or to give any specific information or explanation the auditor would be required to report the same and qualify his report.

(iv) The non-corporate entity is free to choose any practising Chartered Accountant to conduct this audit. In the event of any such change it is necessary for the incoming auditor to communicate with the outgoing auditor as explained in the Institute’s publication “Code of Ethics”. He should also ensure that he does not resort to undercutting while accepting any such assignment.

(v) As already noted, the primary responsibility for maintenance of books of account and records and that for preparation of financial statements is of the non-corporate entity. The auditor should obtain the letter of engagement and list of books of account and other records maintained by the entity before undertaking the audit assignment.

(vi) Non-corporate entities are, in certain cases; evidenced by documents/agreements, such as, partnership deed, deed of association, trust deed etc. It would be necessary for the auditor to check the compliance with the terms of documents, agreements, so far as they relate to accounts and audits and to report all material violations of such terms.

(vii) The figures of the immediately preceding year should be given in a manner so as to enable meaningful comparison. If the accounts of such preceding year are not audited, the fact should be indicated by way of a note and also reported by the auditor.

(viii) The audited accounts should clearly disclose the results of the working of the entity for the year, every material feature, transactions of an exceptional and non-recurring nature and also transactions pertaining to earlier years, if material. The said accounts should be prepared in conformity with the generally accepted accounting principles followed consistently. Any deviation, if material, either from the accepted principles or from the policy/treatment followed in the preceding year should be clearly brought out in the notes and/or the Auditors’ Report.

(ix) The overall consideration should be that the financial statements so prepared should give a true and fair view of the working of the entity. Moreover, these statements should also assist the lending bankers in their evaluation of the loan proposals and in ensuring strict financial discipline, coupled with uniformity, in the existing as well as prospective customers.
3. SPECIAL AUDIT REPORT

A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis.

The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

In the quarterly special audit report, the auditor will have to give information relating to:

### Operating data:
For each quarter, this information will have to be classified as:

<table>
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<tr>
<th>(i) Actual production;</th>
<th>(ii) Actual production as a percentage of rated capacity;</th>
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<tr>
<td>(iii) Sales;</td>
<td>(iv) Cost of goods sold/cost of production;</td>
</tr>
<tr>
<td>(v) Gross margin;</td>
<td>(vi) Interest on bank borrowing;</td>
</tr>
<tr>
<td>(vii) Interest on others</td>
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</tr>
</tbody>
</table>

It is not necessary to work out the actual filed cost for this purpose.

### The age-wise classification of raw materials and finished goods is to be given.

For this purpose age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately:

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<th>(i) Inventory for more than one year;</th>
<th>(ii) Between 6 months and one year;</th>
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<tr>
<td>(iii) Between three months and 6 months;</td>
<td>(iv) Below 3 months.</td>
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Similar information about the work-in-progress i.e. the number of days of production which remains in progress should also be given.

The basis of valuation of raw material and finished goods should be given. For this purpose the following information is to be given:

| (i) The manner of determination of cost (i.e. components of cost) |
| (ii) The method of valuing stock i.e. FIFO, weighted average cost, etc. |

It is also necessary to state if there is any discrepancy between the quantity and value of the stock as furnished to the bank and as appearing in the books. The reasons for such discrepancy should be given in the audit report.

Age-wise classification of bills receivable and other receivables with reference to the, bills due from domestic parties and bills in respect of exports should be given. The age-wise classification is to be done on the same basis as the classification for raw materials and finished goods as stated above.
Information in respect of the following items is also to be given:

(i) Balances at the end of each month of the quarter for major categories of stock, receivables and bills receivables;

(ii) Tax assessments and payments made during the quarter;

(iii) Actual disbursement of capital expenditure during the quarter;

(iv) Outstanding contracts on capital account at the end of the quarter giving the details about the names of parties and amounts outstanding;

(v) The contingent liability which may or may not materialize during the financial year succeeding the relevant quarter;

(vi) Investment made during the quarter and the income from such investments including profit on sale of investments;

(vii) Loans given during the quarter;

(viii) Loans raised during the quarter from banks and from others. Separate figures to be given;

(ix) Overdue statutory liability at the end of the quarter;

(x) Amounts due but not paid at the end of the quarter in respect of (a) loans from banks, (b) public deposits, and (c) other loans; and

(xi) Figures of cash losses during the last 2 years to be stated on the basis of the annual accounts. If such accounts were not audited this fact should be stated.

The funds obtained from the lending banks have to be utilised for the purpose for which they are given by the bank. If the auditor finds that these funds have been diverted for the purposes other than those for which they were given by the bank the auditor will have to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give information about the following ratios:

(a) Current ratio 
(b) Acid test ratio

(c) Raw materials-turnover ratio 
(d) Finished goods-turnover ratio

(e) Receivables-turnover ratio 
(f) Return on investment

(g) Interest cover ratio 
(h) Net margin ratio

(i) Capital turnover ratio 
(j) Debt equity ratio

(k) Operating cash flow.