Guideline on
Verification of Working Capital Statement

The Institute of Chartered Accountants of Nepal (ICAN)

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First Edition	:	July 2022
Published By	:	The Institute of Chartered Accountants of Nepal (ICAN)
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Foreword

Working capital and its financing has been an important topic in today's business world. With the growth in the economy, the need for working capital has also increased immensely. Accordingly, financing of working capital has been an issue of great importance in Nepal as well. Regulatory Body has imposed various regulations for working capital financing. The Institute of Chartered Accountants of Nepal (ICAN) as a regulator of accounting profession has been providing guidance to its members in the areas of their professional expertise.

ICAN is consistently working towards enhancing professional skills and knowledge of its members by organizing mandatory CPEs trainings, seminars, workshops, issuing standards and guidelines etc. in order to support them in delivery of high-quality professional services that meets stakeholder expectations in the most efficient and effective manner. In this connection, this Guidelines on Verification of Working Capital Statement has been prepared on the basis of related regulatory and legislative developments specifically the relevant NFRS for valuation of current assets and liabilities pronounced by the Institute on the recommendation of Accounting Standard Board (ASB) of Nepal, Auditing Standards for the purpose of determining the scope of work, working procedure and report to be issued by the Professional Accountant in line with the pronouncements made by the Institute including the directives and circulars issued by the Nepal Rastra Bank (NRB) which are expected to be followed by the Professional Accountants while carrying out the verification of working capital statement.

This Guidelines on Verification of Working Capital Statement have been developed and issued by the Institute to provide a uniform standard to the Professional Accountants and Bank and Financial Institutions regarding working capital statement that should be used on various component of current assets and current liabilities. Along with the procedures, the guidelines also specify Professional Accountants' requirements during the verification process, their scope and limitation, use of verification statement and the reporting requirement. This guideline aims to provide minimum guidance to the Professional Accountants in determining the extent of procedures in order to maintain uniformity and consistencies of approach in the verification of working capital statement and constitute as the basis for maintaining quality of services rendered by the Professional Accountants. However, the guideline is not concerned with the working paper management of the entity. This guideline has been issued only for the purpose of verification of the working capital of the entity by the Professional Accountants which may be primarily required for the purpose of working capital financing.

I wish to place my appreciation to the entire team of management and committees of the Institute in taking this initiative of preparing and reviewing this Guideline. Further, I extend my sincere thanks to Council Members for approval to this guideline.

I believe that this technical guideline would be immensely helpful to the members as well as other stakeholders.

Date: 22 July 2022
Place: Lalitpur, Nepal

CA. Yuddha Raj Oli
President, ICAN

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Chapter 1: Background

1.1. Introduction

Working Capital

Working capital is the capital available for conducting the day-to-day operations of an entity, normally the excess of current assets over current liabilities. The amount of the working capital has direct effect on the liquidity position of an entity.

Working Capital = Current Assets – Current Liabilities

Current assets and current liabilities are those assets or liabilities which are expected to be realized or settled down within a period of one year from the measurement date or operating cycle specific to nature of business. Whereby, key current assets generally include cash, cash equivalents, bank balance and deposits, inventory of raw material, work in progress, finished goods, trade receivables, and prepaid expenses. Likewise, key current liabilities include trade payable, short term loan, long term loan maturing within a year and other payables due within a year.

The working capital characteristics varies according to the nature of entity. Such as the working capital requirement of the service sector industries varies significantly with that of the manufacturing or trading industries.

Working capital can be categorized on two basis:

a) **On the basis of value**: This can be further classified as Gross Working Capital and Net Working Capital

   - Gross Working Capital is the total of current assets
   - Net Working Capital is the difference between total current assets and total current liabilities.

b) **On the basis of time**: This can be further classified as Permanent Working Capital and Temporary Working Capital.

   - Permanent Working Capital refers to the base working capital, which is the minimum level of investment in the current assets that is always carried by the entity to carry on its day-to-day activities.
   - Temporary Working Capital refers to the part of total working capital that is needed to meet the fluctuations in demand consequent upon changes in production and sales as a result of seasonal changes.

Working capital is a measure of entity's liquidity, operational efficiency, and its short-term financial health. If an entity has substantial positive working capital, then it should have the potential to invest and grow. If an entity's current assets do not exceed its current liabilities, then it may have trouble growing or paying back creditors, or even go bankrupt. An entity has negative working capital if the ratio of current assets to liabilities is less than one. However, high working capital isn't always a good thing. It might indicate that the entity has too much inventory or is not investing its surplus cash.

Inventories and Receivables are two significant areas in working capital valuation as they are essence of every business activity and they provide the true indication of the strength and vitality of an entity. The primary objective of valuation from any point of view, is to ascertain whether they are realizable in cash for the value stated. The best indication for this is a good, healthy, regular movement of both. The thrust of any stock verification process is to verify the system followed or the procedure adopted to compile the qualities of stocks as on a given date and the rate applied for evaluation. The valuation objectives remain the same though the accounting procedures vary according to the nature of entity, type of product and regulatory requirement of different countries.

1.2. Objectives of Verification of Working Capital Statement

Verification of working capital statement is an agreed upon procedure engagement and objective of such engagement is for the Professional Accountant to carry our procedures of an audit nature to which the Professional Accountant and the entity and any appropriate third parties have agreed and to report on factual finding.

The general objective of the agreed upon procedure engagement for verification of working capital statement as per NSRS 4400 shall be as under.

i. The objective of the engagement is for Professional Accountant to carry out procedures of an audit nature to verify subject matter which shall be the statement of working capital prepared by the client/entity and to report on factual findings.
ii. As the Professional Accountant simply provides a report of factual finding of the agreed upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the Professional Accountants and draw their own conclusions from the Professional Accountant's work.
iii. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the result.

The specific purposes expected to be achieved through verification of working capital statement may be summarized as follows:

a. To ensure proper preservation/ storage and handling of stock.
b. To identify whether there exist any degraded/ obsolete stock and if yes, whether it has been segregated and written off.
c. 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.).
d. To ascertain whether physical stock tally with the stock statement.
e. To ascertain whether hypothecated stock is realizable.
f. To ascertain that inventories, receivables and payables are owned by the entity
g. To confirm that stock is owned by the borrower and finance is made against value of paid stock only.
h. To examine the age wise debtors and creditors outstanding as per books.
i. Exclusion or inclusion of debtors and creditors for working capital valuation.
j. To confirm whether the party is submitting periodic working capital statements regularly or not.
k. To analyze the reasons when there are many qualifying remarks about inventories and receivables in the report of the entity.
l. To make banks financial institutions and regulators aware of working capital management and working capital requirement of the borrower.

1.3. Scope of Verification of Working Capital Statement

The scope of verification of working capital statement may be different for different objective and uses. This also includes verification of working capital statement to comply with the directive issued by the Nepal Rastra Bank (NRB) for A, B, C class Bank and Financial Institutions.

1.4. Special Consideration while Conducting Verification of Working Capital Statement

There are many aspects to be considered while conducting verification of working capital statement as per the scope and objectives of assignment and as per need of users of the report and regulators. But following aspects are to be considered at minimum.

(i) If the inventories, receivables and payables statement as shown in the hypothecation statement does not tally with those as in the annual or periodical financial statement, then appropriate action should be taken to find reasons for the differences.
(ii) It should be seen that the inventories have been properly valued as per NAS 2 "Inventories".
(iii) It should be seen that net current assets are not over-stated or under stated.
(iv) It should be seen that the net current assets turnover is not over-stated or under stated.
(v) It should be seen that the inventories, receivables and payables that are genuinely owned by the borrower are shown and calculated in the accounts in accordance with relevant accounting standards.

1.5. Working Capital Financing

Management of sufficient liquid resources to continue in business and to increase its profitability has always been one of the major challenges to the business. Therefore, working capital financing has become the major concern. Working capital financing is the financing for the operations of the business unit to meet the net working capital requirement as well as to finance current assets and to manage the temporary liquidity. Working capital finance is normally secured by inventories and receivables. Generally, primary securities will be hypothecation charge over current assets including inventories and assignment of bills & accounts receivable. Secondary securities may include mortgage of land, building, machinery etc. and may be sanctioned through single or multiple banking transactions.

Working capital Financing should be made based on cash conversion cycle. The tenure of working capital financing must not exceed one year and the facility may be renewed for further period after satisfactory account performance review. Working capital financing is provided based on the **Net Working Capital** (Inventories + Trade receivables + Prepaids + Trade advance – Trade payables). Trading Stock is defined as normal and tradable inventory and not obsolete inventory. Obsolete inventory includes stock which are expired or model outdated or now not related to the borrower's current trading items. Likewise, trade receivables and trade advance are defined as those receivables which are solely related to non-capital goods (i.e. only trading items) and is in the books of the borrower for a period not exceeding the borrower's cash conversion period, or period stipulated in the sanction letter or the credit policy of the banks and financial institutions or as prescribed in NRB directives. Receivable exceeding the stipulated period or borrower's cash conversion period and bad debt shall be deducted while assessing the working capital requirement. Trade payables includes dues to be paid to the supplier for purchase of trade stock.

Working capital loan are released on the basis of statements relating to the security (which may be book debts, stock in trade, prepaid and advances etc.) submitted by the borrower as per periodicity laid down in the terms of sanction. The bank officials verify the statements (in some cases, tangible securities like stock-in –trade are also physically verified) and calculate the 'drawing power' based on Net Trading Assets held by the borrower and the margin prescribed in the sanction letter and the regulator. In case of consortium accounts, the drawing power calculation and allocation is made by the lead bank and is binding on the member banks.

Working capital loan is provided mainly to entities engaged in manufacturing and trading activities to enable them to meet the gap in their working capital requirements and management. The working capital loan is generally granted against the security of stocks of goods, standing crops, bill/book debts representing genuine sales etc. all belonging to the entity. However, depending upon the financial standing, nature of business etc. of the borrower, the bank/financial institutions may call for collateral securities.

Working Capital Loan is provided in the form of overdraft loan, cash credit etc. Generally, cheque book is raised to the entity for withdrawal of money against the limit sanctioned. The withdrawals are permitted within the drawing power balance available against facilities amount approved. This is a revolving facility and is generally, reviewed and renewed annually.

Working Capital Financing /Loan generally includes the following:

1.5.1. Overdraft Loan/ Cash Credit Loan

Overdraft loan is an open-ended loan with a borrowing limit that the entity can draw against or repay at any time during the loan period. This allows flexibility to the borrower to borrow exact fund amount as and when the need arises and repay the borrowed fund during any time under loan period. Interest is paid only on the amount borrowed, typically on a monthly/quarterly basis. The standard term of an overdraft loan is one year with renewal, subject to satisfactory performance of borrower and lender's confidence during annual review and renewal of service sector entities and trading & industrial entities may avail overdraft loan facilities.

Major disbursement criteria for overdraft loan is the net working capital of the borrower. The overdraft loans are generally provided on 'floating' interest rate basis. The rate may change in certain interval depending upon any changes in the bank/financial institution's cost/base rate, mutual understanding between bank and borrower, risk appetite of the bank, risk exposed by the borrower, and the guidelines prescribed by the regulator from time to time.

1.5.2. Demand Loan /Short Term Loan

A demand loan is an advance of a fixed amount repayable on demand. The repayment of demand loans may be either in lump sum or installments. Major disbursement criteria for demand loan is margin on stock. Demand loan is provided to finance short term fund requirement of the borrower generally to finance purchase under local LCs (Letter of Credit) /TT (Telegraph Transfer) /DD *Demand Draft) etc.

1.5.3. Trust Receipt Loan/Importer's Loan

Trust receipt loan is provided to facilitate the import/purchase of goods under LCs. It is for post import financing. The importer may not be able to make entire payment under LC to the beneficiary at the time of LC payment. Hence, the financing in the form of Trust Receipt is provided to the borrower as working capital financing and the loan has to be settled upon receipt of the fund or after completion of cash conversion cycle of the imported goods which should not exceed the timeline defined by the regulator.

1.5.4. Hypothecation Loan (in case of A Class Banks Only)

Hypothecation loan is provided to finance working capital requirement of the unit/entities whereby, the possession of the goods remains with the borrower and a floating charge over the inventories and advance and receivables is created in favor 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. Major disbursement criteria include margin on stock and the term is generally for one year. The borrower has to submit the details of inventories and debtors to the lending bank based on which the drawing power after reducing the prescribed margin is calculated.

Chapter 2: Legal and Regulatory Provisions

2.1. Relevant Regulatory Framework for Working Capital Valuation in Nepal

In the context of Nepal, businesses finance their working capital requirement (fund based and non-fund based) through various A Class Commercial Banks, B Class Development Banks, and C Class Finance companies except for hypothecation loan which can only be financed by A Class Commercial Banks. Several regulatory controls have been exercised for reducing misappropriation and increasing the effectiveness of working capital financing. Brief extract of the regulatory provision for working capital loan and its valuation has been pointed in this chapter.

2.1.1. Bank and Financial Institution Act, 2073

Section 49 (2) and (3) of Bank and Financial Institution Act, 2073 prohibits 'B' and 'C' class financial institutions to provide loan against hypothecation.

So, on only Class "A" commercial banks could lend loan to the borrower on the basis of hypothecation of working capital of the borrower.

2.1.2. Unified Directives and Circulars of NRB

- Directive 2 Unified Directive, 2078 for A, B and C Class Bank and Financial Institutions prohibits 'C' categories of financial institutions from providing overdraft facilities to their customers.
- Directive No. 2 of the Unified Directive, 2078 for A, B and C Class Bank and Financial Institutions issued by Nepal Rastra Bank contains the provision for independent auditor's certification of statement of current assets and current liabilities of the borrowers at the time of approval or renewal of working capital nature loan exceeding NRs. 250 million.

2.1.3. The Institute of Chartered Accountants of Nepal (ICAN)

In this regard, The Institute of Chartered Accountants of Nepal has issued notice to the practicing members of ICAN holding Certificate of Practice (CoP) and concern banks and financial institutions clarifying the eligibility of auditors who can certify the statement of working capital of the borrower. As per the decision of 231st council meeting dated 2075/09/08, an independent auditor, excluding the following CoP holders, are eligible to certify the working capital statement of the borrower:

1) Current Statutory Auditor, Internal Auditor, and Financial Advisor of the borrower.
2) Current Statutory Auditor and Internal Auditor of the concern Banks and Financial Institutions

Chapter 3: Verification Process

The process of verification of working capital statement may be different depending upon the scope and objectives of assignment and as per need of users of valuation report and/or regulators. But following general process are to be follow.

3.1. Pre-commencement

Before commencement of any verification of working capital statement, the Professional Accountant should obtain the following documents/ details from the client:

1. An appointment letter/engagement letter
2. All relevant details of the entity including:
   i. Name of the business unit and of the key persons.
   ii. Address of registered office, branches/business places and factory of the unit.
   iii. Nature of Entity.

In case of verification process carried out to comply with regulatory requirement

If the advance is a consortium lending, name of lead bank and other banks and their respective participation proportion.

   iv. Balance Certificate as on the date of statement and bank statement on date of verify the working capital statement
   v. Inventories statements, physical verification report of inventories showing the reconciliation of difference between physical/actual stock and stocks in books, if any.
   vi. Aging detail of receivable and payable.
   vii. Latest inspection report of the account, Internal valuation reports, relevant and recent Annual Report and any reports that are relevant to the assignment.
   viii. Insurance details.
   ix. Prepaid expenses, investments and other current asset details.
3. Communication with the previous Professional Accountant shall also be made if the Professional Accountant deems necessary.

3.2. Engagement Acceptance and Continuance

1. The Professional Accountant needs to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and agreed upon procedure engagements have been followed and should determine that conclusions reached in this regard are appropriate.
2. The Professional Accountant should accept or continue an agreed upon procedure engagement only when
   (a) The Professional Accountant has no reason to believe that relevant ethical requirements, including independence will not be satisfied.

(b) The Professional Accountant is satisfied that those persons who have performed the engagement collectively (the engagement team) have the appropriate competence and capabilities; and

(c) The basis upon which the engagement is to be performed has been agreed, through:

i. Establishing that the preconditions for an agreed upon procedure engagement are present; and
ii. Confirming that there is a common understanding between the Professional Accountant and the engaging party of the terms of the engagement, including the Professional Accountant's reporting responsibilities.
iii. Type of a report issued by the Professional Accountant

3. If the Professional Accountant obtains information that would have caused the Professional Accountant to decline the engagement had that information been available earlier, the Professional Accountant should take necessary action promptly. In case of a firm, the Professional Accountant (i.e., the engagement partner) should communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

3.3. Preconditions for the Agreed Upon Procedure Engagement

1. In order to establish whether the preconditions for an agreed upon procedure engagement are present, the Professional Accountant should on the basis of a preliminary knowledge of the engagement circumstances and discussion with the appropriate parties, determine whether:

(a) The roles and responsibilities of the appropriate parties are suitable in the circumstances; and

(b) The engagement exhibits all of the following characteristics:

i. The underlying subject matter is appropriate;
ii. The criteria that the Professional Accountant expects to be applied in the preparation of the subject matter information are suitable for the engagement circumstances, including that these exhibit the following characteristics:

a. Relevance.
b. Completeness.
c. Reliability.
d. Neutrality.
e. Understandability.

iii. The criteria that the Professional Accountant expects to be applied in the preparation of the subject matter information which will be available to the intended users.

iv. The Professional Accountant expects to be able to obtain the evidence needed to support the conclusion;

v. The Professional Accountant's conclusion, in the form appropriate to agreed upon procedure engagement, is to be contained in a written report; and

2. If the preconditions for an agreed upon procedure engagements are not present, the Professional Accountant should discuss the matter with engaging party. If changes cannot be made to meet

the preconditions, the Professional Accountant would be well advised not to accept the engagement, unless required by Law or Regulation to do so.

3.4. Limitation on Scope Prior to Acceptance of the Engagement

If the engaging party imposes a limitation on the scope of the Professional Accountant's work in the terms of a proposed engagement, such that the Professional Accountant believes the limitation will result in the Professional Accountant not being able to make conclusion, the Professional Accountant should not accept such an engagement, unless required by law or regulation to do so.

3.5. Agreeing on the Terms of the Engagement

The Professional Accountant should agree the terms of the engagement with the engaging party. The agreed terms of engagement should be specified in sufficient detail in an engagement letter or other suitable form of written agreement, written confirmation, or in Law or Regulation. It is in the interests of both, the engaging party and the Professional Accountant, that the Professional Accountant communicates in writing the agreed terms of the engagement before the commencement of the engagement to help avoid misunderstandings. The terms of engagement, at a minimum, should include the following

(a) The objective and scope of engagement;
(b) the responsibilities of the Professional Accountant;
(c) the responsibilities of engaging party/entity;
(d) the responsibilities of the responsible party (if different from the engaging party);
(e) identification of the suitable criteria to be used
(f) identification of the subject matter including reference to the law or regulation or the contracts;
(g) unrestricted access to whatever records, documentation and other information requested in connection with the engagement;
(h) fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist;
(i) reference to the expected form and content of report to be issued by the Professional Accountant; and
(j) statement that there may be circumstances in which a report may differ from its expected form and content.

The agreed terms of engagement can also include other general terms of engagement so long as those terms are not inconsistent with the applicable laws and regulations.

The form and content of the written agreement or contract will vary with the engagement circumstances. For example, if law or regulation prescribes in sufficient detail the terms of the engagement, the Professional Accountant need not record them in a written agreement, except for the fact that such law or regulation applies and that the appropriate party acknowledges and understands its responsibilities under such law or regulation. Law or Regulation, particularly in the public sector, may mandate the appointment of a Professional Accountant and set out specific powers, such as the power to access appropriate party(ies)'s records and other information, and responsibilities, such as requiring the Professional Accountant to report directly to an authority, the legislature or the public, in case appropriate party(ies) attempt to limit the scope of the engagement.

On recurring engagements, the Professional Accountant should assess whether the circumstances require the terms of the engagement to be revised and whether there is a need to remind the engaging party of the existing terms of the engagement.

3.6. Acceptance of a Change in the Terms of the Engagement

The Professional Accountant should not agree to a change in the terms of the engagement where there is no reasonable justification for doing so.

If such a change is made, the Professional Accountant should not disregard evidence that was obtained prior to the change. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, may justify a request for a change in the engagement, for example, from a non-assurance engagement to an assurance engagement.

3.7. Understanding the Entity and Internal Control

The Professional Accountant should have the following information to understand the entity:

1. The nature of Entity and its business.
2. The nature of goods, especially, with regard to the storage:
   (a) Whether stored at multiple locations,
   (b) Whether they are of deteriorating nature,etc.
3. The processes involved in manufacturing, production and ascertaining whether any part of the work is to be sent out of the entity for further processing.
4. The key personnel involved in preparation and submission of working capital statements.
5. The business of the entity in order to identify the events and risks that may have an impact on the working capital statement.
6. The process of identifying the irrecoverable debtors and its impairment testing.
7. Identifying the turnover cycle of the debtors, creditors and inventories based on nature of products.
8. Method of valuation of goods work in progress.
9. Accounting and internal control systems used regarding working capital management
10. The Professional Accountant should have sufficient knowledge of the Information Technology System to proceed with the verification work if the entity is recording the inventories using computer system.
11. Whether they have knowledge of any actual, suspected or alleged intentional misstatement or non-compliance with laws and regulations affecting the subject matter information.
12. Whether the responsible party has used any experts in the preparation of the subject matter information.
13. Identify areas where a material misstatement of the subject matter information is likely to arise

3.8. Professional Skepticism, Professional Judgment, and Assurance Skills and Techniques

The Professional Accountant would need to plan and perform an engagement with professional skepticism, recognizing that circumstances may exist that may cause the subject matter information to be materiality misstated.

The Professional Accountant needs to exercise professional judgment in planning and performing the engagement, including determining the nature, timing and extent of procedures.

The Professional Accountant should also apply appropriate skills and techniques as part of an iterative, systematic engagement process.

3.9. Planning

The Professional Accountant should plan the engagement so that it will be performed in an effective manner, including setting the scope, timing and direction of the engagement, and determining the nature, timing and extent of planned procedures that are required to be carried out in order to achieve the objective of the engagement.

In planning the verification of working capital statement, the Professional Accountant should consider the following:

(i) The nature of the accounting and internal control systems used regarding working capital management.
(ii) Inherent, control and detection risks, and materiality related to working capital management.
(iii) Whether adequate procedures are established and proper instructions issued for physical Inventories counting.
(iv) The timing of the count.
(v) The locations at which inventories is held and its nature.
(vi) Whether an expert's assistance is needed.
(vii) When inventories are situated at various locations, the Professional Accountant should decide, the location to be checked, considering the materiality of the inventories and the risk of material misstatement and the assessment of inherent and control risk at different locations.
(viii) Inventories are usually located at the following locations:
   a) Entity's premises
   b) At the entity's plant.
   c) In transit.
   d) On Consignment.
   e) Custom clearing agent.
   f) Dealer agents.

3.10. Materiality

The Professional Accountant would consider materiality when:

a) Planning and performing the engagement, including when determining the nature, timing and extent of procedures; and
b) Evaluating whether the subject matter information is free from material misstatement.

Professional judgments about materiality are made in light of surrounding circumstances, but are not affected by the level of assurance, that is, for the same intended users and purpose, materiality for a limited assurance engagement is the same as for a reasonable assurance engagement because materiality is based on the information needs of intended users.

Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence relevant decisions of intended users taken on the basis of the subject matter information. The Professional Accountant's consideration of materiality is a matter of professional judgment and is affected by the Professional Accountant's perception of the common information needs of intended users as a group. In this context, it is reasonable for the Professional Accountant to assume that intended users.

a) Have a reasonable knowledge of the underlying subject matter, and a willingness to study the subject matter information with reasonable diligence;
b) Understand that the subject matter information is prepared and assured to appropriate levels of materiality, and understand any materiality concepts included in the applicable criteria;
c) Understand any inherent uncertainties involved in the measuring or evaluating the underlying subject matter; and
d) Make reasonable decisions on the basis of the subject matter information taken as a whole.

3.11. Analytical Review Procedures

An analytical review is a kind of substantive test which can be used in the planning of or undertaking of a valuation and is used by Professional Accountants to assess the reasonableness of account balances. The Professional Accountant may use these procedures by comparing changes in account balances over time, as well as by comparing related accounts.

The detail about the analytical review procedure is discussed in Chapter 6 of this Guideline

3.12. Substantive Procedures

The substantive procedure can be derived based on the knowledge and judgments of the Professional Accountant related to business, market situation and information derived from above three steps in order to obtain sufficient evidence to reach the conclusion of valuation report.

In general, following steps are to be taken by the Professional Accountant for an effective verification of working capital statement:

1. Obtain the registration documents including Memorandum of Association, Articles of Association of the entity for the first time of engagement.
2. Bank/Financial Institutions sanction letter
3. Recent Audited financial statements and other interim financial statement and interim reports that are relevant to assignment of the entity.
4. Inventories Statement & Book Debts Statement as on the period covering the assignment and its preceding period.
5. The Professional Accountant should obtain a written representation from management regarding.

   (a) The completeness of information provided regarding the Inventories; and
   (b) Assurance with regard to adherence to laid down procedures for physical Inventories count

6. Obtain the bank account numbers and full banking details of the entity
7. List down the various kinds of facilities enjoyed by the business unit and the limits thereof.
8. List down the date of sanction, sanction limit, drawing power & current balance in the account.
9. Check whether the party is regularly submitting the statement of working capital.
10. Check whether the insurance policy has been issued in the favor of lender or not.
11. Check the amount of insurance policy and date of expiry.

12. Go through previous visit record made by official from the lender or internal or external auditor or regulators.
13. Check whether the operation of account is satisfactory or not.
14. Get an appointment and engagement letter before visiting the entity's office.
15. Check the legal deeds (Paripasu) and consortium agreement in the case of Lending under Consortium Arrangement/Multiple Banking Arrangements.
16. Check whether the party has maintained the inventory register.
17. Check whether other books of account have been maintained by the party, i.e., cashbook, bank pass book, purchase book, sales book, debtor's ledger and creditor ledger, etc.
18. Go through the "Purchase Register", "Sales Register", "Goods Received Note ", and "Goods Returned Note" and verify with the invoices on sample basis. If these registers are not prepared, then examine the books, which serve as a record of the things made as in these registers.
19. If there is damaged Inventories, then it should not be considered for calculation of working capital.
20. Ensure that Inventories are insufficient quantity to cover the advance given by the lender.
21. Check if the Inventories are kept in proper condition.
22. Examine the layout of the warehouse where inventories are stored.
23. Ensure that Inventories must be kept in the premises, which should be free from water leakages, fire, and other hazards, etc., so that damage to inventories does not occur and all safety measures are placed to ensure proper safety of inventories.
24. Ensure that Fire-fighting equipment must be available in inventories premises and it should be regularly checked to preserve its utility.
25. Note down the name of the person who has coordinated with the Professional Accountant.
26. Check Insurance premium receipt with respect to the insurance policy.
27. Ensure that the warehouse is located at the address given to the lender and as mentioned in the insurance policy and other documents.
28. Ensure that no other Inventories other than those that are related to nature of business of borrower without the specific prior authority is kept and if they are stored, then adequate insurance cover is taken.
29. Verify the actual inventories in the warehouse physically with that declared in the Inventories Statement.
30. Verify that the record keeping is proper and that there are no indications of dishonest or inefficient management.
31. Obtain and verify details of the inventories as regards to quantity, quality, life, date of purchase and price.
32. Check the work in progress and its basis of valuation and percentage of completion.
33. Verify that there are adequate internal control systems commensurate with the size of the concern regarding:
    (a) Accurate identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, Inventories owned by a third party, for example, on consignment and Inventories in transit; and
    (b) Appropriate arrangements made regarding the movement of Inventories between are as and the shipping and receipt of Inventories before and after the cut-off date.
34. Verify whether consistent and accepted accounting principles are adopted for valuation of Inventories

35. Verify whether entity uses the same cost formula for all inventories having a similar nature and use to the entity and it should be consistent from one period to another.
36. Obtain the external confirmation from the major receivable, payables and inventory with third party.
37. Prepare the age-wise list of the inventories, receivables and payables in the following manner:
    (a) more than12 Months.
    (b) More than 6 Months Old and Less than 12 Months Old.
    (c) Less than 6 Months Old.
38. The age of the book debts should not be more than stipulated in the sanction or the credit policy of the lender or as prescribed in NRB directives. The debts of over a period as stipulated as above should be excluded from the working capital statement.
39. The receivables impaired should be also excluded from working capital statement.
40. 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.

3.13. Statement of Net Working Capital

While calculating net capital statements, care must be taken to exclude old, obsolete and non- moving stock and long outstanding debtors.

The net working capital is calculated as follow. This is an illustrative for manufacturing companies only.

Particulars	Amount(Rs.)
Total Receivables (A)	XXXX
Total Physical Inventories (B)	XXXX
Total Prepaid and Advances (C)	XXXX
Total Current Asset (D=A+B+C)	XXXX
Total Payables (E)	XXXX
Net Trading Asset / Net Working Capital (F=D-E)	**XXXX**

The Professional Accountant should perform the following procedure regarding verification of working capital statement:

(i) Check for arithmetical accuracy.
(ii) Check that old and obsolete inventories are excluded.
(iii) Check that impaired receivables and receivables that are not related to regular business are excluded.
(iv) Check that the payables are deducted from the sum of inventory and receivables.

3.14. Written Representations

The Professional Accountant should request from the appropriate party(ies) a written representation:

(a) That it has provided the Professional Accountant with all information of which the appropriate party(ies) is aware that is relevant to the engagement.
(b) Confirming the measurement or evaluation of the underlying subject matter against the applicable criteria, including that all relevant matters are reflected in the subject matter information.

(c) If, in addition to required representations, the Professional Accountant determines that it is necessary to obtain one or more written representations to support other evidence relevant to the subject matter information, the Professional Accountant should request such other written representations.

When written representations relate to matters that are material to the subject matter information, the Professional Accountant should:

(a) Evaluate their reasonableness and consistency with other evidence obtained, including other representations (oral or written); and
(b) Consider whether those making the representations can be expected to be well-informed on the particular matters.

The date of the written representations should be as near as practicable to, but not after, the date of the report of factual finding.

3.15. Requested Written Representations Not Provided or Not Reliable

If one or more of the requested written representations are not provided or the Professional Accountant concludes that there is sufficient doubt about the competence, integrity, ethical values, or diligence of those providing the written representations, or that the written representations are otherwise not reliable, the Professional Accountant should:

(a) Discuss the matter with the appropriate party(ies);
(b) Re-evaluate the integrity of those from whom the representations were requested or received and evaluate the effect that this may have on the reliability of representations (oral or written) and evidence in general; and
(c) Take appropriate actions, including determining the possible effect on the conclusion in the report of factual finding.

3.16. Subsequent Events

When relevant to the engagement, the Professional Accountant should consider the effect on the subject matter information of events up to the date of the report of factual finding and should respond appropriately to the facts that become known to the Professional Accountant after the date of the report, that, had they been known to the Professional Accountant at that date, may have caused the Professional Accountant to amend the report. The extent of consideration of subsequent events depends on the potential for such events to affect the subject matter information and to affect the appropriateness of the Professional Accountant's conclusion. However, the Professional Accountant has no responsibility to perform any procedures regarding the subject matter information after the date of the report.

3.17. Other Communication Responsibilities

The Professional Accountant should consider whether, pursuant to the terms of the engagement and other engagement circumstances, any matter has come to the attention of the Professional Accountant that is to be communicated with the responsible party, the measurer or evaluator, the engaging party, those charged with governance or others.

3.18. Documentation

The Professional Accountant should prepare on a timely basis engagement documentation that provides a record of the basis for the report of factual finding that is sufficient and appropriate to enable an experienced Professional Accountant, having no previous connection with the engagement, to understand:

(a) The nature, timing and extent of the procedures performed to comply with the guidelines and applicable legal and regulatory requirements;
(b) The results of the procedures performed, and the evidence obtained; and
(c) Significant matters arising during the engagement, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

If the Professional Accountant identifies information that is inconsistent with the Professional Accountant's conclusion regarding a significant matter, the Professional Accountant should document how the Professional Accountant has addressed the inconsistency.

The Professional Accountant should assemble the engagement documentation in an engagement file and complete the administrative process of assembling the final engagement file on a timely basis after the date of the report.

The completion of the assembly of the final engagement file after the date of the report is an administrative process that does not involve the performance of new procedures or the drawing of new conclusions. Changes may, however, be made to the documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

(a) Deleting or discarding superseded documentation.
(b) Sorting, collating and cross-referencing working papers.
(c) Signing off on completion checklists relating to the file assembly process.
(d) Documenting evidence that the Professional Accountant has obtained, discussed and agreed with the relevant Professional Accountants of the engagement team before the date of the report.

After the assembly of the final engagement file has been completed, the Professional Accountant should not delete or discard engagement documentation of any nature before the end of its retention period. The retention period for valuation engagements ordinarily is no shorter than seven years from the date of the report.

If the Professional Accountant finds it necessary to amend existing engagement documentation or add new engagement documentation after the assembly of the final engagement file has been completed the Professional Accountant should, regardless of the nature of the amendments or additions, document:

(a) The specific reasons for making the amendments or additions; and
(b) When, and by whom, they were made and reviewed

Chapter 4: Verification of Working Capital Statement Method

4.1. Inventories/Trade Stock

Inventories are the assets which are held for sale in the ordinary course of business, in the process of production for such sale or in the form of materials or supplies to be consumed in the production process or in the rendering of services. Inventories, normally comprises of following:

- Raw materials including components,
- Work in progress.
- Finished goods including by-products etc.
- Agricultural Inventories

The recognition and measurement of inventory should be done according to relevant NAS/NFRS.

4.2. Measurements

Accordingly Inventories shall be measured at the lower of

- Cost or
- Net Realizable Value.

4.3. Cost of Inventories

Cost of Inventories shall comprise all cost of purchase, cost of conversion, and other cost incurred in bringing the inventories to their present location and condition.

a. Cost of Purchase

It includes the purchase price, import duties, other taxes (other than those subsequently recoverable by the entity form the taxing authorities), transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the cost of purchase.

b. Cost of Conversion

It includes costs directly related to the units of production, such as direct labor. I t also includes a systematical location of fixed and variable production overheads that are incurred in converting materials into finished goods.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment and right-of-use assets used in the production process, and the cost of factory management and administration. The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities.

Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labor.

A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realizable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

c. Other Costs

It includes the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

Examples of costs excluded from the cost of inventories and recognized as expenses in the period in which they are incurred are:

- Abnormal amounts of wasted materials, labor or other production costs;
- storage costs, unless those costs are necessary in the production process before a further production stage;
- administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- selling costs

b. Agriculture Inventories

It comprises agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair valueless costs to sell at the point of harvest.

4.3.1. Techniques for the Measurement of Cost

a. Standard Cost Method:

Cost is based on normal levels of materials and supplies, labor efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions

b. Retail Method:

The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used

4.3.2. Methods for the Measurement of Cost

a. Specific Identification Method:

It means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced.

b. First-in First-out Method (FIFO):

This method assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. This method is used when specific identification of costs is in appropriate when there are large numbers of items of inventory that are ordinarily interchangeable.

c. Weighted Average Method (WAM):

As per this method, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or a seach additional shipment is received, depending upon the circumstances of the entity. In other words, the total value of the inventories should be divided by the total quantity to arrive at the weighted average price.

4.3.3. Net Realizable Value

Net realizable value is the estimated selling price in the ordinary course of businessless the estimated costs of completion and the estimated costs necessary to make the sale. It is an entity-specific value.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of finished products exceeds net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

4.3.4. Valuation of Different Types of Inventories

Different type of inventories requires different methods of valuation depending on their unique characteristics. The following points should be kept in mind while arriving at their value:

i. Raw Materials:

It consists of the inventories that is consumed in the process of manufacture. Raw material is valued at the invoice price, i.e., the cost price plus a reasonable proportion of freight, duty etc. that has been paid with regard to the inventories. Either the actual cost or the average price can be taken as a method of valuation of raw material, depending upon the availability of data. For any diminution in the value of the raw materials, sufficient provision of the fall in the value should be made.

The raw materials should be valued at a price, which is never higher than the market price. In case of the goods, whose value appreciates with the passage of time, they are value data price higher than the cost price. It is the Professional Accountant's duty to see to it that they are not value data price that is higher than the price of the similar goods.

ii. Materials in Process:

The goods which are not completed on the cut-off date, some process needs to be carried out thereon, are called materials in process or semi manufactured goods. They should be valued at cost plus a proportionate amount of production overhead which consists of amount of wages and other charges, on the basis of completion. The Professional Accountant should verify that the percentage of completion has been worked out properly and hence valuation is in order.

In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work-in-process may be complex. In such cases the Professional Accountant should emphases on obtaining the reliable information, and obtain expert opinion, where necessary.

iii. Finished Goods:

The finished goods are valued at cost price which is derived by adding all the expenses incurred in the process of manufacturing. The Professional Accountant shall check the appropriateness of cost allocation.

iv. Stores:

Stores have been defined as that component of Inventories that is not held for sale. They are in fact, consumed in the manufacturing process. Examples of stores would include, oil, tallow, grease, dyes, fuel, etc. Since they are not Inventories in the real sense of the term, they should be shown as a separate item in the balance sheet and the amount of stores consumed should be debited to the Manufacturing Account, so as to arrive at the true cost of manufacture. The stores should be shown at cost price only. However, any deterioration in the price should be incorporated to arrive at their true value.

v. Spare Parts:

It refers to the parts that form part of any Plant and Machinery. If any such spare part is consumed, they should be capitalized as part of the asset they have been used for. Spare parts should be valued at the cost price only. It is the duty of the Professional Accountant to get a list of these spare parts from the Works Managers otha the can verify their existence

vi. Goods on Consignment:

It may happen sometimes that the goods are sentona consignment basis and they do not arrive till the date of the balance sheet. In this case, the goods should be valued at the cost price plus proportionate expenses like, freight, dock dues, etc. the Professional Accountant should insist on the consignee to verify the quantity of Inventories lying with him. Any expenses incurred during the process of sale, it should be allocated only to the goods sold and not added to the unsold Inventories. Here again the principle of conservatism should be followed, a price higher than the market price should not be taken, while provision for losses should be done. If the inventories are valued at selling price, when sentasa consignment, it should be ascertained that the inventories should be valued after making the adjustments, or else the inventories will be over-valued.

vii. Obsolete Inventory/Dormant/Slow-Moving/ Excess Inventories:

a. Obsolete inventories should be valued at net realizable value.

b. The slow moving and non-moving Inventories should be valued at net realizable value or cost which ever is the lower. Professional Accountant should bear in mind the fact that either of the above kind of Inventories necessitates additional blockage of funds, mis-utilization of space, maintenance cost, storage cost and fear of pilferage and further deterioration. This has an adverse impact on the bottom line of the Entity. He should thereof retry to see that proper controls are in force so as to ensure that such inventories are kept under check and as far as feasible avoided.

The Professional Accountant shall not include the value of Obsolete Inventory /Dormant /Slow-Moving / Excess Inventories at the time of certifying the working capital but may separately disclose.

viii. Scrap, Waste and Spoilage

The Professional Accountant should bear the following points in mind while exercising control over the scrap, waste and spoilage:

(i) The management should establish normal rates of scrap at which scrap is generated after having considered the past records and experience.

(ii) Proper documentation of the scrap records should be done.

(iii) The actual scrap realized should be compared with the standard set and the variance should be reported.

(iv) The scrap should be considered as good units for the purpose of valuing the Inventories. Any sale proceeds derived from the sale of such scrap should be deducted from the cost of production.

(v) An important area for the Professional Accountant to keep a check is that of sale proceeds of the scrap. He should satisfy himself that the sale proceeds are properly accounted and they have not been misappropriated.

(vi) The scrap units should be properly stored in the stores department.

4.4. Receivables and Payables

4.4.1. Impairment of Receivables and Advances

The Professional Accountant should obtain the aging report of receivables and advances and test for the impairment of the receivables and advance as per the NFRS / NAS. If the receivables and advances fulfill the criteria of impairment, such items should not be considered for working capital valuation.

Further, the receivables and advances whose credit period has expired should not be considered for working capital valuation

4.4.2. Payables

The Professional Accountant should obtain the aging report of all current payables of the entity and identify the items which are not payable in future and such items should not be considered for working capital valuation.

Chapter 5: Physical Verification of Inventory

Physical verification of inventories would mean verification with regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the Professional Accountant to make use of his professional judgment.

Physical verification of the inventory is one of the major aspects of the working capital valuation which consumes majority of the time and resources. Inventories consist of the majority of the value of the working capital in manufacturing and trading industry. In order to conduct proper valuation of the working capital, conducting physical verification of the inventory is must to obtain assurance that the physical inventory exists as disclosed in books of account.

The Professional Accountant should check the following regarding the physical verification of the inventory.

(i) Ensuring whether the entity is maintaining proper records of inventories.
(ii) Conduct of physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification.
(iii) Whether any material discrepancies were noticed on physical verification.
(iv) Whether such discrepancies have material impact on working capital valuation.
(v) If so, whether the same have been properly dealt within the books of accounts

5.1. Maintenance of Record

In general, the Professional Accountant should document and record the following records relating to inventories:

(i) Locations of Stocks
(ii) Types of Inventories
(iii) Quantity of Inventory
(iv) Rate of Inventory
(v) Amount of Inventory
(vi) Aging of Inventory

5.2. Process of Verification

The process of physical verification of the inventory may be different according to the nature of the items, number of locations and its movements. The Professional Accountant should devise a process to physically count the material items of inventories to obtain sufficient and appropriate evidence of existence and conditions. In general, following steps could be followed:

(i) Before commencement of verification, the Professional Accountant should obtain appropriate instructions from management involved in stock keeping which will help to identify the items of inventory and take necessary safety precaution if needed by stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the Professional Accountant. The Professional Accountant should examine these instructions to assess their efficacy.

(ii) The Professional Accountant has to use his professional judgment regarding the nature, timing and extent of the procedures to be applied.

(iii) The Professional Accountant should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.

(iv) The Professional Accountant has to ensure that entity has maintained adequate stock records that are kept up-to-date;

(v) The Professional Accountant has to ensure that entity has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the designated person or team for physical verification will cover all material items of inventory at least once during the year; and

(vi) The Professional Accountant should investigate and corrects all material differences between the book records and the physical counts if it is identified during the assignment.

(vii) The Professional Accountant should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.

(viii) The Professional Accountant should review those written instructions given by the management to the concerned staff engaged in the verification process;

(ix) The Professional Accountant should obtain and review physical verification inventory sheets duly authenticated by the field staff and responsible officials of the Entity;

(x) The Professional Accountant should review summary sheets/consolidation sheets duly authenticated by the responsible officials;

(xi) The Professional Accountant should review internal memos etc., with respect to the issues arising out of physical verification of inventory.

5.3. Discrepancies on Verification of Inventory

The Professional Accountant needs to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases, circumstances may warrant those records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the Professional Accountant will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible and the Professional Accountant is unable to determine the discrepancies then he/ she should mention same in the verification report or withdraw from assignment as appropriate.

Chapter 6: Analytical Review Procedures

The Professional Accountant has to apply certain analytical procedures to review the financial soundness of the business of the entity and its working capital management. The Professional Accountant should carry on the following procedures:

(i) Checking records of opening stock, purchases, production, sales and closing stock
(ii) Comparison of closing stock with those of previous year quantity
(iii) Comparison of composition of closing stock with the previous year
(iv) Compare the current year Gross Profit with that of last year
(v) Compare actual stock with budgeted figures
(vi) Compare Inventories ratios with those of the industry and firms

The most common analytical procedure is **Ratio Analysis**. Ratios are useful tools for review of performance and state of affairs of the Entity. 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 Professional Accountant for areas to be covered for verification of working capital statement, during field work. They help the Professional Accountant to draw inferences and identify the main points to be dealt in report while after completion of the ratios help the Professional Accountant to re-enforce/establish his inferences and conclusions in the 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

6.1. The Working Capital Cycle (Cash Operating Cycle)

The working capital cycle for a business is the length of time it takes to convert the total net working capital (current assets less current liabilities) into cash. Entity typically tries to manage this cycle by selling inventory quickly, collecting revenue from customer quickly, and paying bills slowly to optimize cash flow.

It is the length of time between the Entity's outlay on raw materials, wages, and other expenditure and the inflow of cash from the sale of goods.

The length of cash operating cycle is often dictated by the industry. For example, a construction business may have a long cash operating cycle because of high level of work in progress, however a restaurant business may have short cash operating cycles because of short inventory periods and debtor's collection period. The lower the cycle of working capital, lower the investment in working capital.

6.2. Cash Operating Cycle for Manufacturing Entity:

Particulars	Months
Raw material holding period	XXXX
Less: Period of credit taken from suppliers	(XXXX)
WIP holding period	XXXX
Finished Goods holding period	XXXX
Receivables collection period	XXXX
Cash Cycle	XXXX

6.3. Cash Operating Cycle for Trading Entity:

Particulars	Months
Inventory holding period	XXXX
Less: Period of credit taken from suppliers	(XXXX)
Receivables collection period	XXXX
Cash Cycle	XXXX

6.4. Liquidity Ratios

These ratios measure the entity's ability to meet its short-term obligations and provide an indication of the entity's solvency.

6.4.1. Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The Current ratio is the standard test of liquidity. Superficially, a ratio in excess of 1 implies that the Entity has enough cash and near cash assets to satisfy its immediate liabilities. However, interpretation needs to be conducted with care. Too high a ration implies that too much cash may be tied up in receivables and inventories. However, what is standard varies according to different types of Entity.

6.4.2. Quick Ratio

$$\text{Quick ratio or acid test ratio} = \frac{\text{Current assets less inventories}}{\text{Current liabilities}}$$

The quick ratio is considered a more conservative measure than the current ratio, which includes all current assets excluding inventories, receivable and advances as coverage for current liabilities. This ratio should be at least one for companies with slow inventory turnover.

6.5. Activity Ratio

These ratios measure how effectively an entity employs its resources

6.5.1. Account Receivable Collection Period

The Account Receivable Collection Period = $\frac{\text{Average Trade Receivables}}{\text{Average Credit Sales}} * 365\ days$

This is a rough measure of the average length of time it takes for an Entity's accounts receivable to pay what they owe. The trade account receivable is not the total figure for accounts receivable in the statement of financial position, which includes prepayments and non-trade accounts receivables. The estimate of accounts receivable days is only approximate.

6.5.2. Inventory Turnover Period

The Inventory Turnover Period (Finished Goods) = $\frac{\text{Average Inverntory}}{\text{Average Cost of Sales}} * 365\ days$

Raw Material Holding Period (Finished Goods) = $\frac{\text{Average Raw Materials Inverntory}}{\text{Average Purchase}} * 365\ days$

Work in progress Holding Period = $\frac{\text{Average WIP}}{\text{Cost of Sales}} * 365\ days$

This indicate the average number of days those items of inventory are held for. A lengthy inventory turnover period indicates:

- A slowdown in trading or
- A build –up in Inventory levels, perhaps suggesting that the investment in inventories is becoming excessive.

6.5.3. Accounts Payable Period

The Accounts Payable Period = $\frac{\text{Average Trade Payables}}{\text{Purchases or Cost of Sales}} * 365\ days$

An increase in accounts payable days is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from the suppliers, increased bank overdraft, and so on.

6.5.4. Sales Revenue to Net Working Capital Ratio

The sales revenue to net working capital ratio= $\frac{\text{Sales Revenue}}{\text{Current Assets-Current Liabilities}} * 365\ days$

This ratio shows the level of working capital supporting sales. Working capital must increase in line with sales to avoid the liquidity problems. Moreover, this ratio can also be used to forecast the level of working capital needed for a projected level of sales.

6.5.5. Inventory Turnover

Inventory Turnover = $\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$

It estimates how many times a year inventory is sold.

6.5.6. Age of Inventory

Age of Inventory = $\frac{\text{365 days}}{\text{Inventory Turnover}}$

It indicates number of days of inventory on hand at year-end:

6.5.7. Accounts Receivables

Accounts Receivable Turnover = $\frac{\text{New Credit Sales}}{\text{Average Accounts Receivable}}$

It estimates how many times a year, account receivables are collected.

6.5.8. Age of Accounts Receivable

Age of Accounts = $\frac{\text{365 days}}{\text{Account Receivable Turnover}}$

It indicates the age of accounts receivables or number of days sales not collected.

6.5.9. Total Asset Turnover

Total Asset Turnover = $\frac{\text{Net Sales}}{\text{Total Assets}}$

It estimates volume of sales based on total assets.

6.6. 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.

6.6.1. Debt Ratio

Debt Ratio = $\frac{\text{Total Debt}}{\text{Total Assets}}$

It indicates percentage of total funds provided by creditors; high ratios when economy is in down turn indicate more risk for creditors.

6.6.2. Times Interest Earned or Interest Coverage Ratio

Times Interest Earned = $\frac{\text{Earning before Interest and Tax}}{\text{Interest Charges}}$

It measures extent to which earnings can decline and still provide entity with ability to meet annual interest costs, failure to meet this obligation may result in legal action by creditors, possibly resulting in bankruptcy.

6.6.3. Long Term Debt to Equity

Long Term Debt to Equity = $\frac{\text{Long Term Debt}}{\text{Shareholder's Equity}}$

It indicates the proportion of the entity financed through long- term debt Vs owners'equity.

6.7. Profitability Ratios

It measure show effectively the entity is being managed.

6.7.1. Sales to Total Assets

Sales to Total Assets = $\frac{\text{Net Sales}}{\text{Total Assets}}$

It indicates the ability of an Entity to use its assets to generate sales.

6.7.2. Gross Margin

Gross Margin = $\frac{\text{Gross Profit Margin}}{\text{Net Sales}}$

It provides a percentage relationship based on sales.

6.7.3. Profit Margin on Sales

Profit Margin on Sales = $\frac{\text{Net Profit Income}}{\text{Net Sales}}$

It indicates the return an Entity receives on sales.

6.7.4. Net Operating Margin

Net Operating Margin = $\frac{\text{Operating Income}}{\text{Net Sales}}$

It indicates management's effectiveness at using Entity's assets to generate Operating income.

6.7.5. Return on Total Assets

Return on Total Assets = $\frac{\text{Net Inocme Before Tax +Interest Income}}{\text{Total Assets}}$

It indicates the return an Entity receives for its assets.

6.7.6. Return on Common Shareholders Equity

Return on Common Shareholders Equity = $\frac{\text{Net Profit Income-Preferred Dividends}}{\text{Average Stockholder's Equity}}$

It indicates return on investment to common shareholders

The Professional Accountant may use other ratios as well apart from above if needed.

Chapter 7: Reporting

7.1. Forming the Conclusion

The Professional Accountant should evaluate the sufficiency and appropriateness of the evidence obtained in the context of the engagement and if necessary, in the circumstances, attempt to obtain further evidence. The Professional Accountant should consider all relevant evidence, regardless of whether it appears to corroborate or to contradict the measurement or evaluation of the underlying subject matter against the applicable criteria. If the Professional Accountant is unable to obtain necessary further evidence, the Professional Accountant should consider the implications for the Professional Accountant's conclusion.

The Professional Accountant should conclude whether the subject matter information is free of material misstatement. In forming that conclusion, the Professional Accountant should consider the Professional Accountant's conclusion in regarding the sufficiency and appropriateness of evidence obtained and an evaluation of whether uncorrected misstatements are material, individually or in the aggregate.

7.2. Preparing the Verification of Working Capital Statement

In the context in which the Guidelines on Verification of Working Capital Statement is issued, the Professional Accountant is engaged to issue a report of factual finding originating from verification of working capital statement which is mainly agreed upon procedure report as per Nepal Standard on Related Service (NSRS 4400). An illustrative example of report on factual finding is appended under **Appendix VI,** the professional accountant is expected to list down all his reportable findings in the report as appropriate.

If the Professional Accountant is unable to obtain sufficient appropriate evidence, a scope limitation exists and the Professional Accountant should mention the findings in the Report of Factual Finding as per NSRS 4400, or withdraw from the engagement, where withdrawal is possible under applicable law or regulation, as appropriate.

The report on factual finding as per NSRS 4400 should be in writing and should contain a clear expression of the Professional Accountant's conclusion about the subject matter information.

The Professional Accountant's conclusion should be clearly separated from information or explanations that are not intended to affect the Professional Accountant's conclusion, including any findings related to particular aspects of the engagements, Emphasis of Matter, Other Matters, recommendations or additional information included in the report. The wording used should make it clear that an Emphasis of Matter, Other Matter, findings, recommendations or additional information is not intended to detract from the Professional Accountant's conclusion.

7.3. Report Content

These Guidelines does not require a standardized format for reporting on verification of working capital statement engagements. Instead, it identifies the basic elements the report is to include. Reports may be tailored to the specific engagement circumstances.

In order to assert compliance with this Guideline, among other things, the report should include at a minimum the following basic elements.

a. Title
b. Addressee (ordinarily the client who engaged the Professional Accountant to perform the agreed upon procedures)
c. Identification of specific financial and non-financial information to which the agreed upon procedure have been applied.
d. A statement that the procedure performed were those agreed with the client.
e. A statement that the engaged was performed in accordance with Nepal Standards of Related Services applicable to agreed-upon procedure engagements, or practices
f. When relevant a statement that the Professional Accountant is not independent of the entity.
g. Identification of the purpose for which the agreed upon procedures were performed.
h. A listing for the specific procedures performed.
i. A description of the Professional Accountant's factual findings sufficient details of errors and exceptions found.
j. Statement that the procedure performed do not constitute either an audit or review and as such no assurance is expressed.
k. A statement that had the Professional Accountant performed additional procedures, an audit or a review, other matters might have come to light that would have been reported.
l. A statement that the report is restricted to those parties that have agreed to the procedures to be performed.
m. A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information and that it does not extend to the entity's financial statements taken as a whole.
n. Date of report
o. Address
p. Signature

Appendix VI to this Guideline contains an illustrative example for a report of verification of Working Capital Statement issued in connection with an engagement to perform agreed upon procedures regarding the financial information.

Chapter 8: Glossary

8.1. Consortium Lending

In the financial world, a consortium refers to several lending institutions that group together to jointly finance a single borrower. These multiple banking arrangements are very similar to a loan syndication, although there are structural and operational differences between the two. Each consortium has a lead bank, which has the largest share in the loan and also conduct majority activity of administration, regulation and control of the borrower.

8.2. Creditors

An entity (person or institution) that extends credit by giving another entity permission to borrow money with a stipulation for repayment later.

8.3. Debtors

A person or entity that owes an amount of money or favor to another.

8.4. Drawing Power

It is the limit up to which the borrower can utilize the cash credit. Drawing power is required to be arrived at based on the stock statement which is current. If the outstanding exceeds the drawing power, it will attract penal interest. While calculating drawing power based on stock and debtors' statements, care must be taken to exclude old, obsolete and non- moving stock and long outstanding debtors

8.5. Dormant Inventories

Dormant inventories mean the Inventories whose movement is temporarily hampered due to a variety of reasons, but they are expected to be consumed in the days to come. One such reason for their slow movement is that the Inventories is consumed in the manufacture of goods that are sold seasonally and hence their production is stopped during off-season

8.6. Engagement Team

All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

8.7. Evidence

Information used by the Professional Accountant in arriving at the Professional Accountant's conclusion. Evidence includes both, information contained in relevant information systems, if any, and other information

8.8. Intended Users

The individual(s) or entity(s), or group(s) there of that the Professional Accountant expects will use the verification report.

8.9. Misstatement

A difference between the subject matter information and the appropriate measurement or evaluation of the underlying subject matter in accordance with the criteria. Misstatements can be intentional or unintentional, qualitative or quantitative, and include omissions.

8.10. Obsolete Inventories

The term obsolete inventories refer to the inventories that has become unsalable due to following reasons:

(a) Discontinuation of the product in the market.
(b) Physical deterioration.
(c) Change in the design of the product.
(d) Substitution by a better material in lieu of the existing one.

8.11. Professional Accountant

Professional Accountant is a member of the Institute of Chartered Accountants of Nepal appointed by entity/client to conduct verification of Working Capital Statement prepared by the client. The Professional Accountant is eligible to conduct verification work if he /she fulfill the criteria mentioned on point no: 2.1.3 of chapter 2 of this Guideline.

8.12. Professional Judgment

The professional judgement is the application of relevant training, knowledge and experience, within the context provided by assurance and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the engagement.

8.13. Professional Skepticism

Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement, and a critical assessment of evidence.

8.14. Responsible Party

The party(ies) responsible for the underlying subject matter. All assurance engagements have at least three parties: the responsible party, the Professional Accountant, and the intended users. In many attestation engagements, the responsible party may also be the measurer or evaluator, and the engaging party.

8.15. Slow Moving Inventories

Slow moving Inventories means the Inventories with a low turnover rate. In other words, they move at a slow rate.

8.16. Scrap

The term scrap refers to that Inventories that arises due to the manufacturing process and has very small value.

8.17. Spoilage

It refers to those goods that do not meet the quality standards and hence have to dispose-off at less than their actual value.

8.18. Working Capital

There are two measures of working capital: gross working capital and net working capital. Gross working capital is the total of the current assets. Net working capital is the difference between the total of current assets and the total of current liabilities.

8.19. Waste

It means goods that have no recovery value.

Chapter 9: Annexures

9.1. Annexure I Specimen Engagement Letter

(Professional Accountant's Letter Head)

Date:
……………(Official of the entity),
……………(Name of the entity)
……………(Address of the entity)

Sub: Engagement Letter for Verification of Working Capital Statement as on …….. (Date)

Dear Sir,

We have been appointed to conduct verification of working capital statement of **………… (Entity)** as on………… which comprise valuation of inventories, receivables and payables for the above period and other relevant annexures and disclosures, as per your appointment letter dated ……….(Date). We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

Our assignment will be conducted with the objective of verification of the inventories, receivables and payables so as to indicate their physical existence, valuation and safety aspects.

We conduct our assignment as per the requirement of the Directive No. 2 of Unified Directive, 20.... to bank and financial institution of Class A, B and C.

We exercise professional judgment and maintain professional skepticism throughout our assignment. We also:

- Identify and assess the risks of material misstatement of the working capital statements and obtain evidence that is sufficient and appropriate to provide a basis for our report. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control
- Obtain an understanding of internal control relevant to the valuation in order to design valuation procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Evaluate the overall presentation, structure and content of the working capital statements, including the disclosures, and whether the working capital statements represent the underlying transactions and events in a manner that achieves fair presentation

Our assignment will be conducted on the basis that management acknowledge and understand that they have responsibility:

a. For the preparation and fair presentation of the working capital statements in accordance with the requirement of lending bank and financial institutions and regulators;
b. For such internal control as management determines is necessary to enable the preparation of working capital statements that are free from material misstatements, whether due to fraud and error; and
c. To provide us with:

  i. Access to all information of which management is aware that is relevant to the preparation of the net working capital statements such as records, documentation and other matters;
  ii. Additional information that we may request from management for the purpose of valuation; and
  iii. Unrestricted access to persons within the entity from whom we determine it necessary to obtain evidence.

As part of our assignment process, we will request from management, written confirmation concerning representations made to us in connection with the valuation of the working capital.

We look forward to full cooperation from your staff during our assignment.

Our fees, exclusive of Value Added Tax, will be as under:

S. No.	**Details of Fee**	**Amount (Rs.)**
1	Fee for Verification of Working Capital Statement	……………………………
	Total	**……………………………**

In words: ……

Other engagements if any will be charged on mutual consultation.

The form and content of our report will be based on requirement of lending bank and financial institutions and regulators. The form and content of our report may need to be amended in the light of our findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our assignment including our respective responsibilities.

Yours Faithfully,

(Name and designation of Professional Accountant)

Acknowledged on behalf of ……………. (Entity).

……………………………………....

(Signature of responsible official of entity)

Date:

9.2. Annexure II Specimen Management Representation Letter

(Borrower's Letter Head)

Date:

To

(Name of Professional Accountant)

Partner / Proprietor

(Firm's name and Address)

Dear Sir/ Madam,

This representation letter is provided in connection with valuation of the working capital of **……….. (Entity)** for the period……… for the purpose of verification of working capital statement.

We confirm that

Working Capital Valuation

- We have fulfilled our responsibilities, as set out in the terms of the engagement dated ………….., for the preparation of the working capital statements in accordance with Nepal Financial Reporting Standards and directives of Nepal Rastra Bank and lending bank and financial institutions.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed as required by lending bank and regulators.
- All events subsequent to the date of report on factual finding have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the working capital valuation as a whole.

Information Provided

- We have provided you with:
    - Access to all information of which we are aware that is relevant to the preparation of the working capital valuation, such as records, documentation and other matters;
    - Additional information that you have requested from us for the purpose of the working capital valuation; and
    - Unrestricted access to persons within the entity from whom you determined it necessary to obtain evidence.

- All transactions have been recorded in the accounting records and are reflected in the working capital valuation.
- We have disclosed to you the results of our assessment of the risk that the working capital valuation may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the working capital valuation.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's working capital valuation communicated by employees, former employees, analysts, regulators or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing working capital valuation statement.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.

Yours faithfully,

……………………………………………

(Signature of responsible official of entity)

9.3. Annexure III Specimen of Confirmation from Third Party

(Borrower's Letter Head]

[Date]

To

[Name & Address of Customer]

Subject:

Dear Sir/ Madam,

The Professional Accountant [name and address of the Professional Accountants] are conducting a verification of working capital statement. Please examine the accompanying statement and either confirm its correctness or report any differences to our Professional Accountant.

Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

Yours faithfully

(Signature of responsible official of entity)

9.4. Annexure IV Specimen Letter of Confirmation of Inventories Held by Others

(Borrower's Letter Head)

Date:

(Name and address of holder of inventories)

Subject:

Dear Sir/Madam,

For verification of working capital statement purposes, kindly furnish directly to our Professional Accountants (Name & Address of the Professional Accountants) details concerning our inventories held by you for (state the reasons/ purpose of holding of inventories by the third party) as on ……………. (date).

According to our records, you held the following inventories as on …………… (date)

S. N.	Stock Code	Description	Quantity	Remarks

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

Yours faithfully

(Signature of responsible official of entity)

9.5. Annexure V Specimen Letter of Confirmation of Inventories Held by the Entity on Behalf of Others

(Borrower's Letter Head)

Date:

(Name and address of owner of inventories)

Subject:

Dear Sir/Madam,

For verification of working capital statement purposes, kindly furnish directly to our Professional Accountants (Name & Address of the Professional Accountants) details concerning your inventories held by us for (state / the reasons/ purpose of holding of inventories by the entity) as on ………… (date).

According to our records, we hold the following inventories as on …………… (date)

S. N.	Stock Code	Description	Quantity	Remarks

Yours faithfully

(Signature of responsible official of entity)

9.6. Annexure VI Specimen of Report of Verification of Working Capital Statement

Note: The illustrative formats of report of factual finding for special purposes given in Annexure VI should be tailored by the practitioner to meet the specific circumstances and requirements of the engagement. The practitioner shall also include all his findings/comments on the subject matter information in the report as appropriate.

(Letter Head of Professional Accountant)

INDEPENDENT PROFESSIONAL ACCOUNTANT'S REPORT

TO THE ……….................... (Entity)

<u>To (Those who engaged the assignment)</u>

We have performed the procedure agreed with you and enumerated below with respect to verifying the Working Capital Statement of ……… (Entity) as at …….. (Date), set forth in the accompanying schedule (the subject matter " statement of working capital as on… that needs to be signed by the client/entity and the professional accountant). Our engagement was undertaken in accordance with the Nepal Standard on Related Services (or refer standards or practices) applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in verifying the Working Capital Statement of the ………….. (Entity) as at …….. (Date).

We have conducted our assignment in accordance with Guidelines on Verification of Working Capital Statement issued by The Institute of Chartered Accountants of Nepal (ICAN). Our responsibilities further described in the Professional Accountant's Responsibilities for the Guidelines on Verification of Working Capital Statement of our report. We are independent of the entity in accordance with the Handbook of The Code of Ethics for Professional Accountants issued by The Institute of Chartered Accountants of Nepal (ICAN), and we have fulfilled our other ethical responsibilities in accordance with the ICAN's Handbook of The Code of Ethics for Professional Accountants. We believe that the evidence we have obtained is sufficient and appropriate to issue the report.

We report our finding/conclusion below:

We have conducted the verification of working capital statement of ……(Entity) as on ……. (Date) as per the terms of engagement; we hereby certify the working capital of ….(Entity) as on …….: (Date) is NRs. …………..

(The subject matter "Statement of Working Capital as on… that needs to be signed by the client/entity and the professional accountant shall be attached as a schedule to the report)

The other disclosure and the annexures attached are the integral part of this report.

The practitioner shall also include all his findings/comments on the subject matter information in the report as appropriate.

The other disclosure and the annexures attached are integral part of this report.

Because of the above procedures do not constitute either an audit or review made in accordance with Nepal Standards of Auditing or Nepal Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the Working Capital Statement as on ……...(Date).

Had we performed additional procedures or had we performed an audit or review of the financial/working capital statements in accordance with Nepal Standards of Auditing or Nepal Standards on Review Engagements (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose of set forth in the first paragraph of this report and for your information and is not to be used for any purpose or to be distributed to any other parties. The report related on to the accounts and item specified above and does not extend to any financial statement of (Entity), taken as a whole.

Name of Professional Accountant

Date

Address

UDIN