CHAPTER IV

COMPLIANCE AUDIT OBSERVATIONS

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4. COMPLIANCE AUDIT OBSERVATIONS

Important audit findings emerging from test check of transactions made by the State Government companies/corporations have been included in this Chapter.

Government companies

The Kerala State Cashew Development Corporation Limited

4.1 Procurement of Raw Cashew Nuts

4.1.1 Introduction

The Kerala State Cashew Development Corporation Limited (Company) was functioning from July 1969 with 10 factories with the objective of processing Raw Cashew Nuts (RCN) and its trading. Subsequently, Government of Kerala (GoK) took over (July 1988) 36 factories in private sector which were locked out and entrusted with the Company for operating and providing employment to the workers. At present the Company is operating 30 cashew factories, two Value Addition Units and has 776 employees and 14994 factory workers in its rolls as on 31 March 2013. During the period from April 2008 to March 2013 the Company purchased 1,33,380 MT of RCN worth ₹771.44 crore through 22 tenders and 46 purchase agreements, besides procurement directly from farmers.

4.1.2 Background and Scope of audit

The Company is incurring losses continuously and the accumulated loss as on 31 March 2009 (latest finalised accounts) was ₹812.92 crore. One of the major reasons for the loss was deficiencies/irregularities in the purchase of RCN. Based on the Audit Reports for the years 1996 and 2008 the Committee on Public Undertakings (COPU) had recommended (July 2003 / June 2012) to do away with the post tender negotiations and streamline the procurement of RCN in a transparent and cost effective manner. The Expert Committee (EC) appointed (April 2007) by GoK had also made (August 2007) similar recommendations.

The Board of Directors (BoD), however, continued with the prevailing practice after obtaining (December 2007) approval from Industries Department, GoK. Based on quick verification (November 2012) by Vigilance and Anti-corruption Bureau (VACB), the Vigilance Department was requested (March 2013) by VACB for according sanction to conduct a detailed enquiry to unearth the irregularities in the procurement of RCN. The Vigilance Department, however, denied sanction stating that a vigilance enquiry was not necessary.

In view of the above state of affairs, Audit decided to conduct a detailed study covering a period of five years up to 2012-13 to assess the transparency and

fairness, equity and economy, efficiency and effectiveness of the prevailing system of procurement of RCN by the Company besides a review of the follow up action on the earlier audit findings and COPU recommendations.

4.1.3 Audit Findings

Audit analysed all the 22 tenders and 46 purchase agreements from 2008-09 to 2012-13. It was noticed that the purchases were made disregarding the COPU and EC recommendations and were plagued by various deficiencies in planning, tendering and award of contracts as discussed in succeeding paragraphs.

4.1.3.1 Excessive dependence on a local trader for procurement

The average annual production of RCN in Kerala was estimated at 72000 MT[1]. Instead of procuring maximum quantity of Kerala RCN, the Company also imported cashew nuts from African countries viz. Tanzania (CDJKL), Guinea Bissau (GB), Ivory Coast (IVC), and Mozambique (MOZ). During the period covered in audit the Company procured 17, 636 MT (13.22 *per cent*) of domestic nuts and 1,15,744 MT (86.78 *per cent*) of African nuts as detailed below:

Table 4.1: Details of supply of RCN from each origin

Country of Origin	African origin (MT)		Kerala origin (MT)		Total (MT)	Percentage of total supply from each origin to total supply
	International traders	Local traders	Directly from farmers	Local suppliers		
CDJKL	2164	29118			31282	23.45
GB	4454	14651			19105	14.32
IVC	9339	41312			50651	37.98
MOZ	9414	5292			14706	11.03
Kerala			1086		1086	0.81
Kerala				16550	16550	12.41
Total	**25371**	**90373**	**1086**	**16550**	**133380**	**100.00**
Percentage	**19.02**	**67.76**	**0.81**	**12.41**	**100**	

The most prevalent method was indirect purchase through traders – for both domestic as well as imported RCN and the direct purchase from domestic farmers was negligible at 1086 MT (0.81 *per cent*). Imported nuts were procured from:

- International traders (19.02 *per cent*) who procure RCN from international markets and sell directly to the Company. The major traders were Olam International, Sayeed Mohammed & Sons Traders, PTE Ltd, Valency International and Swiss Singapore Ocean Enterprise.
- Local traders (80.17 *per cent*), who procure RCN imported by international traders and resell to the Company. The major local traders were JMJ Traders (JMJ), Kailas Cashew, DM Traders, CEE BEE Commodities, CKD (Mr.Alavi) Traders, INDAF and Asia Commodities.

[1] **Source : Data of Directorate of Cashew nut & Cocoa Development**

The details of the 46 purchase orders issued for domestic (nine orders) and imported (37 orders) RCN during the period from 2008-09 to 2012-13 were as follows:-

Table 4.2: Purchase Orders issued

Year	No of POs issued			Ordered Quantity (in MT)			Supplied quantity (in MT)			Total payments			Percentage of quantity placed on JMJ
	JMJ	Others	Total	JMJ	Others	Total	JMJ	Others	Total	JMJ (₹ in crore)	others (₹ in crore)	Total (₹ in crore)	
2008-09	7	4	11	15000	8000	23000	15042	7761	22803	71.82	35.59	107.41	65.22
2009-10	5	9	14	16500	20750	37250	18014	20186	38200	78.77	84.57	163.34	44.30
2010-11	7	2	9	26500	7000	33500	24426	4277	28703	157.86	31.20	189.06	79.10
2011-12	6	0	6	24250	0	24250	25585	0	25585	194.38	0	194.38	100
2012-13	4	2	6	17500	2500	20000	15625	1378	17003	106.10	5.10	111.20	87.50
Total	**29**	**17**	**46**	**99750**	**38250**	**138000**	**98692**	**33602**	**132294**	**608.93**	**156.46**	**765.39**	**72.28**
Percentage	**63.04**	**36.96**		**72.28**	**27.72**		**74.60**	**25.40**		**79.56**	**20.44**		

Analysis of these purchases revealed that out of the 46 orders for 1.38 lakh MT RCN, 29 orders for 0.99 lakh MT (72.28 *per cent*) valuing ₹608.93 crore were placed on JMJ, which was a local trader and supplied either already imported RCN[2] or through High Sea Sale[3] (HSS). It was also noticed that during the year 2011-12, 100 *per cent* orders and in 2012-13, 87.50 *per cent* orders were placed on JMJ. Audit found that the Company's procurement process violated recommendations of COPU/EC and favoured indirect purchase over direct procurement to the advantage of a few traders.

The Company, while accepting the audit observation, stated (November 2013) that private processors procure maximum quantity of Kerala origin by making flexible payment to the farmers. It was further stated that the suppliers' credit was their main source of working capital. The reply was not acceptable as domestic nuts comprise only 13.22 *per cent* of the procurement and the Government releases grants to give fair price to farmers and avoid exploitation by intermediaries.

4.1.3.2 Unauthorised diversion of grants and furnishing incorrect utilisation certificates

The average annual production of RCN in Kerala was estimated at 72000 MT and quality-wise the Kerala origin was one of the best in the world[4]. In order to save the cashew farmers from the exploitation of middlemen and ensure good quality

[2] **The African origin RCN, which was already imported to Kerala, in the name of local supplier and held in stock.**
[3] **Orders are placed with a local firm which in turn procures RCN from another international supplier when the container carrying the RCN from exporting countries reaches the High Sea, a High Sea Sale agreement is executed between the local firm and the Company and the local firm clears the shipment in the name of the Company.**
[4] **As the outturn of exportable grade kernel from processing Kerala origin RCN was 25 *per cent.***

of RCN, GoK released grant of ₹137.62 crore during the period 2008-2013 to the company for the following purposes:-

Table 4.3: Details of GoK Grant

Sl no	Purpose	₹ in crore
1	Procurement of Kerala Origin RCN directly from farmers	80.00
2	Modernisation of Existing facilities in Cashew Factories	57.62
	Total	**137.62**

Audit noticed that only a meagre portion of the grants was actually utilised for the intended purposes as out of ₹80 crore provided for direct procurement it had utilised only ₹0.35 crore (0.44 *per cent*) for procurement of Kerala origin RCN directly from farmers and balance amount was diverted for the procurement of Kerala and African origin RCN through traders (African for ₹44.36 crore and Kerala for ₹35.29 crore) defeating the very purpose of provision of funds.

Similarly, out of ₹57.62 crore of grant released for modernisation and renovation, ₹39.30 crore (68 *per cent*) was diverted for the procurement of African RCN through local traders. It was further observed that this diversion was without the approval of the GoK. More serious issue was the Utilistion Certificate (UC) submitted to the GoK, stating that the grants were utilised for the purpose for which the same were sanctioned. Thus, UCs were factually incorrect, misleading and violated Articles 210 (1) and 211 of the Kerala Financial Code, Volume I (KFC).

The Company stated (November 2013), that the local season runs from March to June of each year and the grant of ₹80 crore was released on different dates only after the local procurement season. The reply was not acceptable as the funds released as grant should have been utilised only for the purpose for which it was released or the unspent balance should have been surrendered. Further, the funds received after the season could have been utilised for procurement during next season.

The Company also admitted that significant portion of the grant of ₹57.62 crore released for modernisation, renovation, etc., was utilised for procurement of RCN. Thus, the grant intended for helping farmers and for reducing imports were utilised for generating business to private traders and for procuring African RCN and false UCs were submitted for the same.

4.1.3.3 Purchase of inferior quality Kerala RCN through traders

The quality of the RCN procured is assessed through a cutting test[5] which measures the outturn[6]. An analysis of outturn of Kerala RCN procured directly

[5] **Commonly followed testing practice to assess the quality of RCN by collecting samples from each lot of supply. RCN samples are cut and the kernals are sorted into acceptable and unacceptable and weighed. The weight of acceptable kernels is averaged to find out weight of outturn per MT.**

[6] **Expressed in lbs. It is the output obtained after processing each bag of 80 KG RCN (1 kg =2.2046 lbs).**

from farmers and through traders made in audit revealed that the Company sustained huge loss due to poor quality of RCN procured through traders.

Outturn obtained from processing RCN procured directly from farmers was much higher than that from the RCN procured through traders during the same periods. The Exportable Grade Whole Nuts (EWN) obtained per 80 kg bag of Kerala RCN procured directly from farmers ranged from 14.59 to 16.36 kg as against 11.56 to 14.57 kg obtained from that procured from traders and the resultant loss to the Company on this account worked out to ₹17.89 crore (***Annexure 18***). Though these indicate poor quality of Kerala RCN supplied by traders, the Company continued procurement through traders ignoring the Government's specific direction to procure RCN directly from farmers.

The Company stated that it could not purchase directly from farmers completely avoiding intermediaries. The reply was not acceptable as it contradicts the proposal submitted by the Company to Government to promote direct purchase from farmers. Further, the reply was silent about the lower output of EWN from Kerala RCN procured from traders and the resultant loss.

4.1.3.4 Deficiencies in the purchase process of African RCN

A detailed analysis of 37 orders placed for procurement of African RCN revealed that 10 orders were placed on international traders and 27 on local traders including 23 on JMJ as detailed below:

Table 4.4: Details of Purchase Orders for African RCN

Year	International Traders		JMJ		Others		Total	
	orders	Qty (MT)	orders	Qty (MT)	Orders	Qty (MT)	Orders	Qty (MT)
2008-09	3	6770	5	11934	1	991	9	19695
2009-10	6	16437	3	15267	1	1190	10	32894
2010-11	1	2164	7	24426	1	2113	9	28703
2011 -12	0	0	5	21185	0	0	5	21185
2012 -13	0	0	3	12433	1	834	4	13267
Total	**10**	**25371**	**23**	**85245**	**4**	**5128**	**37**	**115744**

The deficiencies noticed in audit are summarised below:

Failure to use Memorandum of Understanding to import directly from Tanzania

The Secretary to Government, on behalf of GoK entered (November 2008) into a Memorandum of Understanding (MoU) with the United Republic of Tanzania for the direct import of 75000 MT of RCN every year for the Company and CAPEX[7] at mutually agreed quality and price. The MoU was valid initially for six months (November 2008-April 2009) which could be extended further by mutual consent.

Audit scrutiny revealed that Tanzanian (CDJKL) origin RCN was available at a negotiated price of $ 900 per MT and the Board in its meeting held on 14 January

[7] **Cashew Workers Apex Industrial Co-operative Society.**

2009 decided to procure the same. The Company, however, procured 2000 MT of MOZ origin RCN at $ 925 per MT through an international trader (Sayeed Mohammed & Sons) as decided by the Board on 28 February 2009 stating that CDJKL RCN was not likely to be available due to delay in completion of formalities under the MoU. The extra expenditure on this account was ₹24.60 lakh [8]. Moreover the output from the MOZ origin RCN was also less (cutting outturn 50.35lbs) compared to that (52-53 lbs cutting outturn) of CDJKL RCN. The details of the formalities to be completed were not made available to Audit. As the Company did not extend the validity of the MoU to subsequent years Audit could not compare the price and assess the loss.

The Company stated that the MoU was signed between GoK and Tanzania and there was no further instruction from the Government in this regard. The reply was not acceptable as the MoU was signed by GoK for procurement of RCN by the Company and CAPEX and hence further action was to be initiated by the Company for procurement of the same in order to avoid traders.

Failure to import through State Trading Corporation of India Limited

The Company entered (17 April 2009) into a five years' agreement with State Trading Corporation of India Limited (STC) for import of nuts, whereby STC would either directly import RCN for the Company or facilitate financing for the import of RCN through the traders selected by the Company. In consideration for this, the Company has to pay to STC a maximum of 2.5 *per cent* of the value of imports including payment towards interest on Usance Letter of Credit[9] (LC).

Audit found that out of 37 purchase orders issued for African RCN, the Company utilised the financing facility of STC in eight orders and did not avail the option for direct procurement through STC and instead placed orders with traders. Out of the 85,245 MT of African RCN procured from JMJ through HSS mode, Audit verified the available Bill of Entry and Foreign Bill Transaction Advice (FBTA) for 7836MT (nine *per cent*) and found that JMJ used upto two intermediaries to procure from the foreign supplier. Each level of intermediary hiked the price and the total price hike was about three to 54 *per cent* over and above the original cost. Audit worked out the extra charges paid *vis a vis* the STC charges of 1 to 2.5 *per cent* of the import price. The avoidable extra expenditure worked out to ₹8.77 crore (***Annexure 19***). The extra expenditure on the balance 77409 MT could not be assessed, as the related documents were not produced to Audit.

The Company stated that agreement with STC was for the utilisation of STC's LC facilities by the Company for consideration of trade margin and payment of related expenses like LC opening and retiring charges. It was further stated that it was not mandatory to purchase through STC. The reply did not address the issue

[8] ($ 925 - $ 900 X 1974.843 MT (being the actual supply) X ₹ 49.82 (being the exchange rate at which the payment was given).

[9] It is a kind of LC in which payment is not made immediately but only after an agreed period as accepted by the buyer and seller.

as to why the Company could not have purchased RCN through STC and thereby avoid extra expenditure

Lack of purchase planning

As the price of RCN in the international market is subject to high fluctuation, the Company should have devised a strategy to ensure procurement of quality RCN at most favorable prices considering the recommendations of EC. Audit analysed 15 major purchase orders (nine GB and six CDJKL) which constituted about 55 *per cent* of the total procurement of African RCN during the period. It was noticed that the Company failed to avail the seasonal price advantage as 13 out of the 15 orders were placed when the prices were higher. As per the data[10] of import of RCN to India, the price trend and the number of orders issued during 2008-2013 are detailed below:

Table 4.5: Price trend and the number of orders issued during 2008-2013

Country of Origin	Increasing trend in import price			Decreasing trend in import price		
	Period	No of Orders issued		Period	No of Orders issued	
		JMJ	Others		JMJ	Others
CDJKL	November-February	5	1	March- May	0	0
GB	July- November	7	0	May-June	0	2
Total		**12**	**1**		**0**	**2**

Audit observed that the Company placed five orders for CDJKL origin RCN during the high price period and the delivery was to be completed before the end of February[11] with a view to get new crop of the season. JMJ, however, supplied the RCN during the low price period. Thus in four out of the above five orders, JMJ supplied 13 to 100 *per cent* of ordered quantity during March to May when the price was very low. Audit compared the actual purchase price with the import rate prevailed during the month of supply and found that the trader obtained undue financial advantage to the extent of ₹8.30 crore ***(Annexure 20).*** Absence of sufficient provision in the purchase agreement for recovery of penalty for belated supply enabled the supplier to delay the delivery and take advantage of the price fluctuations and the Company could not initiate any penal action.

Similarly, the company placed (July to November) seven orders on JMJ for GB origin RCN and procured it when the prices were high. Audit observed that the prices were lower during May and June. Failure of the Company to place order when prices were advantageous resulted in avoidable extra expenditure of ₹19.91 crore ***(Annexure 21).***

The Company stated that an assertive policy could not be formulated at times due to non-availability of timely working capital. The reply was not acceptable as one of the terms of the agreement with STC was that they would facilitate financing for import of RCN and therefore the facility should have been utilised by the Company.

[10] **Compiled by Cashew Export Promotion Council for the five years from 2008-09 to 2012-13**
[11] **Except in one case where delivery period was given up to 31st March.**

4.1.3.5 Deficiencies in Tendering

During the period covered in audit the Company had issued 22 tenders[12]. The Company started e-tendering with effect from 15 September 2012 and three e-tenders were invited. The following deficiencies were noticed in tendering:

Inadequate publicity

As per the stipulation in Store Purchase Manual as well as the recommendations of EC, in the case of purchase through import, the requirement should be published nationally/globally and intimation had to be given directly to the international suppliers of the commodity with a view to generate maximum competition. In contravention to the above, the Company published the tender notices only in local dailies as well as in Kerala Edition of one to three English dailies. Thus, the tenders got only limited publicity and local bidders alone participated in the tender.

The Company replied that it was not in a position to follow the Store Purchase Manual of the Government in total but the same was being followed as far as practical. It was further stated that as the purchase had became a routine process and parties were well aware of the development/possibility of a new tender, which they would come to know before publishing. Company started e-tendering since September 2012. The reply was not acceptable as it being a Government owned Company, Store Purchase Manual should have been scrupulously followed. Awareness among local parties on routine tender invitation was not a valid reason for not inviting tenders nationally/globally with wide publicity.

Issue of tender documents without specifications and award of contract without cost benefit analysis

In order to ensure transparency in procurement and to get RCN with required specification it is essential to mention clearly in the tender document the required quantity, origin and quality of the raw nuts along with other terms and conditions of procurement. The Company, however, did not mention these details and the bidders quoted for different quantity of different origin with different rates. Thus, the bidders in the 22 cases mentioned above, quoted different origins of RCN that varied widely in the outturn, mode of delivery and quantity offered. Hence, there was no uniformity in the offers received rendering them incomparable cost, quality, outturn wise and BoD while finalising the tenders was left with no option other than to select one among the available offers. The BoD, however, should have considered the financial interest of the Company by analysing various factors like cost, outturn, etc.

Audit noticed that the Company did not conduct any cost benefit analysis before awarding the contract (22 August 2011) for high priced RCN of GB origin by rejecting the offer of low priced IVC origin obtained in same tender. Audit further noticed that prior to August 2011 the Company obtained a maximum additional outturn of 2.80 kg on processing each bag of GB origin RCN over that of IVC

[12] **Out of 24 tenders issued in total two tenders were cancelled due to participation by none/one bidder**

origin. In the present procurement (August 2011) also the average outturn from GB origin was 2.89 kg higher than IVC origin. Though the outturn was higher the price of GB origin ($ 1790 per MT) was also very high compared to IVC origin ($ 1290 to $ 1325 per MT) and the Company had not compared the procurement cost of IVC origin and additional cost to be incurred for justifying the procurement of GB origin as the selling price of processed cashew nuts was same. Thus, the purchase of 4000 MT of GB origin RCN by rejecting the offer of IVC origin RCN resulted in a loss of ₹4.57 crore due to extra expenditure for the GB origin over IVC origin after adjusting the additional gain obtained from additional outturn.

The Company stated that:

- while making purchase decision, the primary objective was giving maximum employment rather than profitability;
- the GB origin could fetch an additional output of 3.01 kg EWN per bag over the IVC origin and
- IVC origin was generally inferior quality so its processing cost was very high.

The reply of the Company that primary objective was to give maximum employment rather than making profit was not acceptable as COPU recommended not to procure RCN which result into negative contribution. Further, Audit noticed that the additional purchase cost incurred for the procurement of GB origin was over and above the earnings obtained from the sale of the additional output of three kilogram of EWN. The Company's plea as to inferior quality of IVC origin was also factually incorrect as the procurement of IVC origin was highest (37 *per cent*) during the period covered in audit.

4.1.3.6 Deficiencies in contract terms and conditions

On scrutiny of the terms and conditions of the agreements entered into with the suppliers, Audit noticed absence of the following standard terms and conditions to safeguard the financial interest of the Company which resulted in extra expenditure and losses:

Table 4.6: Deficiencies in contract terms and conditions

Deficiency		**i) Absence of Penalty clause for belated Supply**
Effect	i	In 25 out of 56 orders 12 to 90 *per cent* of the quantity was delivered after the delivery schedule. All suppliers were benefited due to this deficiency.
	ii	The operations of the Company were suspended for three months (November 2012 to January 2013) due to the non-supply of 4000 MT by JMJ within the delivery period (30 August 2012).
	iii	All Additional cost for belated supply by JMJ had to be borne by the Company.

Impact	i	Liquidated damages could not be recovered in spite of delay of one to five months.
	ii	The fixed cost for three months was not recovered.
	iii	Company incurred ₹1.05[13] crore on account of exchange rate hike.
Reply and further remarks	Company replied that terms of the contract had adequate provision to recover the loss, sustained by the company due to violation of any of the condition subject to force majeure clause. The reply was not tenable as Audit found that there was no specific provision for the action to be taken in event of belated supply. Further, during the review period the company had not recovered any damages from any party for the belated supply. Hence in majority of the cases the suppliers were getting the undue advantage of low international prices during the months of belated supply.	
Deficiency	**ii) Absence of Risk purchase clause**	
Effect	The suppliers did not supply the entire ordered quantity. So the Company had to procure the undelivered quantity at higher rate from subsequent tenders (30 June 2008 and 5 November 2011).	
Impact	Company could not recover the extra expenditure of ₹2.35[14] crore incurred for the procurement of 8000 MT in the subsequent tenders due to the failure of Unicorp International and Olam International.	
Reply and further remarks	It was replied that adequate penalty clauses were incorporated in the agreement to protect the interest of the Company. It was also stated that even though Unicorp International had executed preliminary contract with the Company after remittance of EMD, they had not executed the tripartite contract, so in legal sense Unicorp International could not be held responsible for keeping out from the contract. The reply indicates failure of the Company to execute a legally binding contract incorporating risk purchase clause with the suppliers on awarding the contract. Further, in the case of Olam International though formal agreement was executed the Company did not initiate action for risk purchase despite termination of contract due to supply of inferior quality RCN**.**	
Deficiency	**iii) Absence of bench marks for actual output**	
Effect	The actual outturn obtained after processing RCN varied widely irrespective of the cutting outturn. Out of 47 purchases through all traders, actual outturn above 88 *per cent* (deducting 12 *per cent* processing loss) of the cutting outturn was obtained only in four cases.	
Impact	Loss due to shortfall in actual output below 88 *per cent* worked out to ₹22.97[15] crore.	
Reply and further remarks	It was replied that the 88 *per cent* of cutting outturn was not at all acceptable and the normal range of the shortage would be 8 lbs to 10 lbs (20 *per cent* loss) from cutting outturn. The reply was not acceptable as in many instances the Company got the optimum outturn of 88 *per cent***.** Further, in the tender/agreement, the Company did not stipulate any benchmark for actual outturn**.**	
Deficiency	**iv) Non stipulation of the source of exchange rate for making payment**	
Effect	The suppliers claimed payment applying the exchange rate obtained from their Banker which was higher than RBI reference rate. Further, the exchange rate adopted by the Company for making payment to the supplier and the actual rate at which the suppliers made payment to the international seller varied widely.	

[13] The actual delivery of 3840 MT against ordered (24-11-11) quantity of 10000 MT CDJKL RCN was delivered after the agreed delivery date (28-02-12) and the company settled the bills of belated delivery at higher exchange rate (@ ₹51.69 for 1668 MT and ₹ 52.03 for 2172 MT) against the exchange rate of ₹ 49.14 prevailing on 28-02-12.

[14] Ordered (April 2008) rate of 3000 MT RCN to Unicorp International was only ₹44 /kg but the rate in the subsequent tender was ₹48.88/kg. Similarly the ordered (August 2011) rate of 5000 MT RCN to Olam International was $1290/MT but the rate in the subsequent tender was $1585/MT.

[15] The shortage in the final outturn in respect of 41 purchases were calculated and it was multiplied with the average selling price.

Impact	The undue favour to the suppliers on account of this worked out to ₹0.20 crore compared to the RBI reference rate in three contracts[16] with JMJ test checked by Audit.
Reply and further remarks	It was replied that the RBI reference rate was only an average rate of the buying and selling rates of selected banks, hence it was only a 'reflection of market activity' for general users. The reference rate of RBI widely vary with the exchange rate of banks so it was incorrect and unfair to use the RBI reference as benchmark. However, the Company had not stated the accepted exchange rate of any particular bank in the agreement for effecting the payment.
Deficiency	**v) Right for increasing or decreasing the ordered quantity**
Effect	The right to increase or decrease the ordered quantity should vest with the buyer. But in the contracts awarded by the Company the right (10 *per cent* of ordered quantity) was vested with the suppliers. The suppliers did not supply 10 *per cent* of the ordered quantity when there was increasing trend in prices and supplied additional 10 *per cent* quantity when the prices were decreasing.
Impact	In one order (29 September 2010) quantity of 456 MT of RCN short supplied by JMJ was procured from the same firm at higher rate by incurring additional expenditure of ₹0.52 crore [17].
Reply and further remarks	It was replied that since inception the right for increasing or decreasing the ordered quantity by 10 *per cent* was the exclusive right of the supplier and at times the clause was beneficial either to the supplier or to the Company, in case the parties supplied additional quantities on the request of the Company when the prices were on rising trend. However, Audit noticed that the suppliers were reluctant to supply the ordered quantity when the international prices were on the rising trend and supplied 10 *per cent* extra when the international prices were lower. Thus the suppliers were availing the undue advantage.
Deficiency	**vi) Provision for remedies for breach of contract**
Effect	There was no provision for blacklisting the supplier in case of non supply/partial supply of the ordered quantity within the stipulated time.
Impact	In one order (August 2012) for supply of 4000 MT of GB origin RCN at $ 1235 per MT with scheduled delivery up to 30 September 2012, JMJ did not commence supply within the delivery period. But the firm participated in the next tender (December 2012) and got order for the supply of CDJKL origin at higher rate ($1375). After getting new order the firm supplied 1849 MT leaving a balance of 2151MT which was procured incurring extra expenditure of ₹1.64 crore[18].
Reply and further remarks	It was stated that there was no breach of contract which happened deliberately from the sellers (JMJ) point of view. Due to the unavailability of Government funds, the company could not settle pending dues amounting to ₹13 crore to JMJ traders with respect to RCN delivered against previous orders, hence the supplier could not supply the ordered quantity. The reply was not acceptable because Government did not give any fund for the purchase of African origin RCN. Further, the procurement of RCN through traders was carried out through supplier credit and buyers advance hence financial crunch could have been avoided through existing fund management mechanism. Since JMJ was a regular supplier, average amount payable in every month to JMJ was ₹10 crore and such dues were existing while JMJ entered into a contract to supply 4000 MT of GB origin also, so the non-delivery of agreed quantity citing the reason of old dues were against the spirit of the contract. Giving another order while earlier order was pending for delivery was not a sound business practice.

[16] **13 HSS invoices from order issued on 16-4-12 for IVC , six invoices from orders issued on 23-8-11(GB &IVC).**
[17] **(456MT X ($ 1430- $ 1175) x ₹ 45.42 being the average exchange rate at which the payment was made).**
[18] **(4000 MT – 1848.99 MT) x ($1375 - $ 1235) x ₹ 54.62 being the exchange rate on 17-12-2012.**

The Legal section of the Company, which was responsible for finalising the standard terms and conditions of the agreement, failed to incorporate conditions protecting the financial interests of the Company resulting in loss/extra expenditure.

4.1.3.7 Irregularities in award of contract

Post tender negotiations and its impact

As a best practice, post tender negotiations are to be avoided. The COPU as well as EC directed to stop the practice of negotiation with all bidders and if required negotiation was to be held only with the lowest bidder. The BoD of the Company, however, negotiated with all the bidders after opening tenders. During negotiations, the bidders are given another chance to amend their quoted price, offered quantity, quality (outturn and count), mode of delivery, etc., defeating the very objective of tendering procedure. Based on the negotiations the BoD selected the bidder, decided the price and quantity for which orders were to be issued and authorised the MD to place orders.

On scrutiny of the negotiation proceedings of the Company, Audit noticed that the tendered rate of JMJ in seven tenders[19] were not the lowest but in subsequent negotiation JMJ got orders by agreeing to supply the RCN at rates lower than the rates quoted by the then lowest bidder. In one instance (27 December 2012), JMJ quoted rates to be on par with the rate quoted by the lowest bidder and the BoD awarded the contract to JMJ ignoring the other lowest bidder. It was seen in audit that in two tenders[20] during negotiations JMJ reduced the quoted rates together with the guaranteed outturn by one lbs. The Company failed to assess the impact of this reduction in the outturn which amounted to ₹1.58 crore[21] resulting in extension of undue benefit to the supplier and loss to the Company.

Company replied that the recommendations of COPU and EC were adopted and it had started e-procurement since September 2012. However, the fact remained that the recommendations of COPU (July 2003) were ignored by the Company due to which it suffered loss of ₹1.58 crore. There was also gross violation of integrity of the contract procedure.

Executing HSS agreement before finalising the tender

As per the prevailing practice the tender finalisation and award of contract is done by the BoD at its meeting. During the meeting, the BoD negotiates with bidders on the rate and selects a bidder. After obtaining the contract, the successful bidder executes a General Purchase Agreement (GPA) with the Company. In HSS type of purchases, when the ship reaches the High Seas, subsidiary agreements called HSS agreements for each consignment showing the details of Bill of Lading,

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[19] Tender negotiation held on 1/11/08, 12/5/10, 13/7/10, 6/11/10, 7/1/11 , 22/11/11 & 27/12/12.

[20] Tender negotiation held on 12-05-2010 and 07-01-2011.

[21] (1 LBS could generate the output of 0.88 LBS from each bag hence the total shortage from processing 171643 (104079 + 67564) bags was 151045 LBS which is equivalent to 68513 Kg(151045 / 2.2046) so the total monetary impact was 68513 KG X ₹ 230 (being the average selling price per Kg of EWN and EBN) = ₹ 1,57,57,990).

quantity, etc., in addition to GPA are entered into with the supplier to enable clearing of the consignment at port.

It was noticed in audit that in the tender invited on 20 July 2011, the Company executed three HSS agreements with JMJ on 20 August 2011 for the delivery of 716.98 MT RCN of the GB origin and 191 MT of IVC origin though tender finalisation and award of contract by the BoD was made on 22 August 2011 and the successful bidder (JMJ) had executed the GPA on 23 August 2011. Thus, the Company agreed to purchase the tendered quantity from JMJ at the quoted rate before finalisation of tender by the Board.

The Company stated that the date (20 August 2011) mentioned in the HSS agreement was a typographical error. The reply was not acceptable as the computerised invoice was also generated by JMJ on 20 August 2011.

Delayed and untimely procurement of IVC origin RCN

The harvest season for IVC origin RCN was March to July and as per data available with the Company, quality (outturn) of the RCN procured during this season was best. Though the BoD was aware of this, it decided to procure 10,000 MT of IVC origin RCN and placed orders (October 2009) on JMJ for local supply of the same. The firm supplied 10,994 MT up to January 2010. Audit noticed that as against the average outturn of 19.02 kg per 80 kg bag obtained from IVC origin RCN ordered during the harvest season, the outturn obtained from the RCN supplied by JMJ was only 17.87 kg and the consequent loss worked out to ₹3.63[22] crore.

The Company admitted that season of IVC origin RCN was March to July and the yield of the IVC origin RCN was less in comparison to other origins because of "*puzhukuthu*" (infestation). It was further stated that as it was off seasonal purchase, its guaranteed outturn was only 46 lbs and the actual outturn obtained in grading was 39.40 lbs which was within limit.

The reply was not acceptable. To assure better quality and better price, procurement should have been planned in-season.

4.1.3.8 Payment of ineligible clearing and forwarding charges

In the case of HSS purchase, clearing of imported RCN at port was done in the name of the Company and hence the agreement provided for reimbursement of the clearing and forwarding (C&F) charges incurred by the supplier. But in the case of local procurement of already imported nuts, reimbursement of C&F charges does not arise. Audit, however, noticed that the Company reimbursed ₹0.55 crore to JMJ towards clearing charges for 3,269 MT of GB Origin RCN purchased (August 2011) locally.

Company admitted that no C&F charges were payable for local purchase and further stated that the first agreement (1000 MT) was HSS at the rate of US$ 1790

[22] **Under recovery from each bag was 1.15kg (19.02-17.87) hence the total under recovery from processing 137429 bags was 158043 kg (137429 bags X 1.15 kg) and the loss was 158043 kg x ₹ 230 (being the average selling price per KG of EWN and EBN) = ₹ 36349971**

per MT and the second agreement (3000 MT) was for local supply at the same rate. As the cargo had already arrived on port, the JMJ could not supply on HSS basis and the Company directed JMJ to supply at the same rate of HSS agreement without additional burden to the Company which necessitated payment of C&F charges. The reply was not acceptable as there was additional burden due to reimbursement of ineligible C&F charges of ₹0.55 crore which was an undue favour to the supplier.

4.1.3.9 Impact of the deficiencies in the procurement of cashew nuts

Audit estimated the total avoidable loss due to above mentioned deficiencies, as per the information provided by the Company as ₹93.93 crore as detailed below:

Table 4.7: Total of loss and additional expenditure

No	Details of the lapses	Impact (₹ in crore)	Para reference
1	Loss due to purchase of inferior quality Kerala origin RCN	17.89	4.1.3.3
2	Failure to import through STC	8.77	4.1.3.4
3	Lack of purchase planning	28.21	4.1.3.4
4	Deficiencies in tendering	4.57	4.1.3.5
5	Deficiencies in contract terms and conditions	28.73	4.1.3.6
6	Irregularities in award of contract	5.21	4.1.3.7
7	Payment of ineligible clearing and forwarding charges	0.55	4.1.3.8
Total of loss and additional expenditure		**93.93**	

4.1.3.10 Inadequate follow up action on inquiry reports

Based on the complaints received, the Vigilance Department, Finance Department and Public Sector Restructuring and Internal Audit Board (RIAB) conducted inquiries and the recommended actions were not initiated by the Government as detailed below:

Table 4.8: Findings/Recommendations in inquiries and Action taken

Name of the authority	Date	Findings/Recommendations	Action taken
Finance Department	4 May11 to 7 May 11	A detailed inquiry by a competent authority was proposed for unearthing all irregularities of purchases.	No further action was taken
		The administrative department should conduct a detailed inquiry for accepting the incomplete bid of JMJ on tender opened on 6 January 2011 and giving orders to JMJ.	
RIAB	July 2012	Pointed out undue favours extended to JMJ traders.	No action was taken on the report. Board of Directors made
		JMJ had purchased poor quality item from international trader and supplied it to Company as superior grade.	

		Recommended to conduct a detailed enquiry after removing the present MD from his position to ensure availability of all records to investigating agency.	an advertisement in newspapers refuting the findings in the report.
Vigilance & Anti-corruption Bureau	November 2012	Made a quick verification and found wasting of public money and recommended the Industries Department to take action on the quick verification report.	No action was taken on the recommendation

The Company stated that GoK had not initiated any action because it was of the opinion that there was no need to do so. Reply of the Government was awaited (February 2014).

4.1.3.11 Violation of the COPU and EC recommendations

The COPU as well as the Expert Committee (EC) recommended the Company to streamline the procurement ensuring transparency and economy. The Company, however, instead of complying with the recommendations continued the prevailing system of procurement, after obtaining permission from GoK. A gist of recommendations and its violations noticed are given below:

Table 4.9: Recommendations of COPU/EC and violations

Sl No	Recommendations of COPU/EC	Violations	Para Reference
1	Preparation of purchase strategy and procurement policy	Not prepared. Options for direct procurement scuttled.	4.1.3.4
2	Procurement at best possible price	Procured when prices were high	4.1.3.4
3	Adequate Publicity of tenders	Inadequate publicity	4.1.3.5 and 4.1.3.1
4	Preparation of vendor list	Not prepared	
5	Negotiation with L1 bidder only	Negotiated with all bidders especially in the first tender opened (31 July 2012) after COPU specifically banned negotiation with all bidders on 30 June 2012.	4.1.3.7
6	Conduct cost benefit analysis before each purchase decision	Purchases were done without doing cost-benefit analysis.	4.1.3.5
7	To ensure that outturn in cutting test should be reflected in final output.	No attempt was made to fix benchmark for final output or to compare the actual output with the outturn in cutting test.	4.1.3.6

The Company stated that the recommendations of COPU and EC were being complied with by the implementation of e-procurement. As there were no regular participants in bid, preparation of the vendor list was not successful. Since September 2012, after the implementation of e-procurement, only L1 is being considered for negotiation, that too on case to case basis and as situation warrants. The reply is not sufficient as the Company is yet to implement major recommendations relating to the purchase procedure and working results. The

Company has not initiated any steps to have a policy to increase direct procurement and to check windfall gain to intermediaries or to plan seasonal procurement. No framework has been established to do proper cost benefit analysis, to give adequate publicity, to prepare vendor list, to have a proper internal control and internal audit framework to check undue favour and unethical practices. Penalty for delay, risk purchase clauses are not being inserted in contracts and agreements with foreign countries to enable direct purchase are gathering dust giving opportunities to private traders for breach of contract and for undue benefits. In utter disregard to all vigilance, finance and audit findings, no action or inquiry has been initiated or responsibility fixed on findings pointing out gross irregularities leading to pecuniary gain of crores of rupees to private traders in the procurement of raw cashew nut and loss to the exchequer.

Thus, the Company continued to procure nuts in an adhoc and arbitrary manner violating all the directions of the COPU as well as EC. It failed miserably in ensuring transparency, fairness and competitiveness in the procurement of RCN.

The matter was reported to the Government in October 2013; their reply was awaited (January 2014).

Kerala State Financial Enterprises Limited

4.2 Conduct of Chitty Business

4.2.1 Introduction

Chitty is a kind of monthly savings cum loan scheme conducted as a contract between the Foreman[23] and the subscribers. The Foreman collects a fixed amount every month as subscription from each subscriber. The share of subscriber in a chitty is called a *ticket* and the total amount payable by a subscriber during the tenure of a chitty, excluding auction discount, is termed as *sala*[24] or chitty amount. An individual may choose to subscribe for more than one ticket subject to a maximum of 10 *per cent* of the total tickets. Total number of tickets enrolled in a chitty will be equal to the duration of the chitty in months. The Foreman pays a discounted value of the chitty *sala* as "prize money" which is a lump sum advance after deducting the commission[25] of Foreman. The prize money received less own contribution is a loan to the subscriber and the amount foregone (auction discount[26]) is considered as the interest for the loan. The entitlement to prize money is determined by monthly auction or in such other manner as may be specified in the chitty agreement. The discount foregone by the successful bidder (maximum upto 25 *per cent*) in the monthly auction is equally shared among the

[23] **Foreman is one who promotes and conducts chitty as per the regulations of the Chitty Acts and Rules and can be an institution or Company.**
[24] **Sala – for example ₹1000 (monthly subscription) x 50 (months) = ₹50,000.**
[25] **The Foreman is entitled to a commission of not more than five *per cent* of the chitty sala.**
[26] **Auction discount/Discount foregone means the amount foregone by the bidder to get the chitty amount in the chitty.**

subscribers as "*veethapalisa*[27]" (auction discount/dividend). Foreman's commission is the major source of income from chitty business.

Chitty business is regulated by the Kerala Chitties Act and Rules 1975. After the enactment of Chit Funds Act, 1982 (Central Act)[28], the Kerala Chitties Act and Rules 1975 got repealed. The Central Act was later enforced in Kerala with effect from 30 April 2012. Under this Act, the State Government framed Kerala Chit Funds Rules, 2012[29] which was notified on 4 June 2012. Under these Rules each chitty is to be registered with the Registrar of Chitties.

The Kerala State Financial Enterprises Limited (Company) was incorporated in 1969 as a Miscellaneous Non-Banking Financial Company (MNBFC) fully owned by the Government of Kerala (GoK) with the objective to provide an alternative to the private chit operators, in order to bring in social control over the chit fund business and to protect public from the clutches of unscrupulous fly-by-night chit fund operators. Apart from chitty business, the Company also extends loan to public viz., Gold Loan, Consumer Vehicle Loan, Reliable Customer Loan, etc.

4.2.2 Organisational setup

The Management of the Company is vested with a Board of Directors consisting of 14 Directors including the Managing Director (MD). The MD is the Chief Executive of the Company. As on 31 March 2012, the Company has 387 branches with 28,224 chitties and 14,96,998 subscribers. Branch Managers are entirely responsible for the operations of the chitty conducted by their branches[30]. In addition to the Chitty Acts and Rules, the Company had formulated a Manual of Procedure (MoP) prescribing the procedures to be followed for conduct of chitty business.

4.2.3 Audit coverage

Audit analysed the operation of chitty business for four years from 2008-09 to 2011-12 to assess whether the chitty business was carried out in compliance with the provisions of Chitty Acts and Rules and MoP. Audit selected 20 out of 60 branches which were computerised prior to April 2009 and 10 more branches based on the volume of business. Thus, 441 chitties with 16,630 subscribers in 30 branches with monthly subscription of ₹20,000 and above were selected.

4.2.4 Performance of Chitty Business

The chitty business contributed around 80 *per cent* of the total turnover of the Company (***Annexure 22***) on an average and chitty income constituted 59 *per cent* of the total income (***Annexure 23***) during the three years ending 2010-11. The *table* below indicates growth of chitty business for the four years up to 2011-12:

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[27] Veethapalisa means the share of subscriber in the discount at each instalment of the chitty.

[28] Enacted by Government of India.

[29] Government of Kerala framed Rules in accordance with Section 89(1) of Chit Fund Act, 1982.

[30] The Branch Managers are responsible for enrolling subscribers, remitting the first instalments collected from the subscribers in treasury as security deposit, registering the chitty, collection of monthly subscriptions, conducting monthly auctions for each chitty, disbursing prize money to prized subscribers, termination of completed chitties and release of security deposit from treasury on completion of the chitty.

Table 4.10 : Growth of chitty business

(₹ in crore)

Particulars	2008-09	2009-10	2010-11	2011-12
Number of chitty	19138	23536	26218	28224
Number of subscribers	1099281	1324770	1405868	1496998
Total *sala*	361.58	515.22	625.79	754.13
Chitty turnover	3680.78	6278.42	6896.45	8195.86
Total default	**585.32**	**801.64**	**1116.45**	**1497.97**
Default to total turnover (percentage)	**15.90**	**12.77**	**16.19**	**18.28**

Though there was an increase of 122 *per cent* in chitty business during the four years upto 2011-12, it has to be viewed in the context of the increase in the default in payment of instalments which increased by 156 *per cent* i.e. from ₹585.32 crore in 2008-09 to ₹1497.97 crore in 2011-12. According to the audited accounts during the three years ended March 2011, the Company earned profits in overall business of ₹31.26 crore, ₹36.79 crore and ₹52.22 crore respectively. This again needs to be viewed in the context of continuous losses in the chitty business. As per the Audit assessment, the chitty business incurred loss during 2008-09 (₹9.68 crore) and 2009-10 (₹6.76 crore) and earned a meagre profit during 2010-11 (₹3.10 crore)[31] .

The major deficiencies in conduct of chitty business noticed in audit are discussed below:

4.2.5 Over dependence on borrowed funds due to negative cash flow from chitty business

A summarised statement of cash flow from business of the Company for the three years ending 2010-11 was as follows:

Table 4.11 : Cash Flow Statement

(₹ in crore)

Particulars	2008-09	2009-10	2010-11
Cash from operating activities including borrowings as per Accounts of the Company	144.30	458.37	-15.10
Less: Borrowings (Secured and Unsecured)	383.59	713.41	162.69
Net cash flow from operating activities	**-239.29**	**-255.04**	**-177.79**

A negative cash flow, as can be seen from the above table, reflects that the cash generated from operating activities of the Company during the above three years was insufficient to meet the activities of the Company resulting in dependence on borrowed funds. The high incidence of defaults in prized and non-prized chitties and low progress in the recovery from defaulters were the main reasons for the insufficient cash inflow from operating activities.

[31] **Accounts for the year 2011-12 were not yet finalised.**

Audit noticed that the borrowings of the Company was very much on the higher side (₹3135.60 crore) when compared to Shareholders' fund (₹191.13 crore) with a very high debt equity ratio of 16:1. Given the situation of high defaults in the remittance of monthly instalments in the running as well as completed (terminated) chitties, the high debt equity ratio would lead to working capital crunch and would force the Company to borrow more from outside sources. The Government replied (January 2014) that various stringent measures are being implemented at Branch/Regional Office/Head Office level to reduce the mounting default in non-prized and prized chitty.

4.2.6 Issues related to the enrolment of subscribers

The various steps to float a chitty as prescribed in Manual of Procedure (MoP) are as follows:-

- Obtain sanction from the Registrar/Government for registration of the chitty.
- Enrolment of subscribers (*Chittals*) by allotting one or more tickets by collecting the first instalment in cash/demand draft/money order along with duly filled in and signed *Variola*[32]. In exceptional cases, cheques can also be accepted subject to the condition that enrolment should take effect only after realisation of the cheques.
- Registration of the Chitty - The Registrar registers the chitty only when all the tickets specified in the Chit Agreement filed with Registrar are fully subscribed and first instalment collected. On registration the chitty is commenced.
- Security deposit – The first instalment collected from the subscribers is to be deposited as security deposit with the Registrar of Chitties. During the last three years upto 2012-13, the Company had floated 24,466 chitties and deposited ₹808.72 crore as security deposit.

Audit found that the Branch Managers in order to achieve targets failed to comply with the rules and regulations which led to huge defaults as discussed below:

4.2.6.1 Fixing of target without basis

The targets fixed by the Company for the four years up to 2011-12 were as follows:

[32] **Variola means the document containing the articles of agreement between the foreman and subscribers relating to the chitty.**

Table 4.12 :Target for chitties

(₹in crore)

Particulars	2008-09	2009-10	2010-11	2011-12
Target for chitty business in *sala*	330.56	500.00	592.50	715.19
Achievement	361.58	515.22	625.79	754.13
Percentage of increase in target as compared to previous year	--	51.00	18.50	21.00

Audit noticed that the Company had fixed branch wise targets for new chitties without any detailed analysis of status of ongoing chitties with regard to defaults, recovery of dues, substitution[33] by new subscribers/ by Company, profitability of terminated chitties, etc. The Branch Managers achieved the targets by enrolling subscribers without realising the first instalment, enrolling defaulters in earlier chitties in same branch, etc.

The Government contended that the annual target of chitty business was reckoned based on the previous year's target and increase in default was due to non-follow up action of the default cases and not due to unscientific targets. The reply was not acceptable as targets were fixed without considering status of defaults in ongoing chitties, progress in recovery of dues, etc., which should have been reckoned while fixing targets.

4.2.6.2 Non-maintenance of chitty subscribers register and non-implementation of KYC norms

As per the Chitty Acts and Rules[34] it is mandatory for the Foreman to keep a register[35] containing the names and full address of the subscribers together with the number of tickets held by each subscriber and to get it endorsed and signed/sealed by the Registrar of Chitties. It was observed that out of selected branches, the aforesaid register was not maintained at Kesavadasapuram and Manacaud branches at Thiruvananthapuram. In the absence of proper records showing the details of subscribers, regularity of enrolment and substitution of defaulters could not be ensured.

The Company had prescribed (November 2008) 'Know Your Customer' (KYC) norms[36] to be followed by the Branch while enrolling customers for new chitties for correct identification and assessment of financial soundness of subscribers. Being a MNBF, it was also desirable to follow KYC norms in view of the enactment of Prevention of Money Laundering Act, 2002. However, Branch Managers were not observing KYC norms while enrolling subscribers in new chitties in any of the 30 Branches test checked which led to the various

[33] **If a non-prized subscriber defaults in payment of subscription, the Foreman should remove him from the list of subscribers after issue of written notice and substitute any other person in his place.**
[34] **Section 23 (a) (i) of the Chit Funds Act,1982, Section 18 (1) (a) of the Kerala Chitties Act, 1975, Rule 27 (1) of Kerala Chit Funds Rules, 2012 and Rule 75 (b) of the Kerala Chitties Rules, 1975.**
[35] **In Form No-XIII or Form No-XVIII.**
[36] **KYC compliance on Chitty scheme was with instalment amount/ticket size of ₹25,000 and above.**

deficiencies including enrolment of defaulters in other chitties in same/other branches as mentioned in succeeding paragraphs.

The Government stated that some of the branches were not following the directions issued and hence all units were again directed to comply with the KYC norms especially in high denomination chitties.

The Company should strictly follow the KYC norms in view of heavy defaults and consequent substitutions, stop payment of commission on defaulted chitties, ensure prompt reporting of defaults to Revenue Recovery (RR) Section by the branches and monitor the functioning of RR section.

4.2.6.3 Commencement of chitties without realising first instalment

As per the MoP, the first instalment is to be remitted either in cash or by demand draft or by money order. In exceptional cases, cheques could also be accepted subject to the condition that the enrolment should take effect only after realisation of the cheques. Audit noticed that 260 chitties were registered without realising the first instalment in respect of 940 tickets due to dishonour of cheques. This led to failure on the part of the Company to ensure that all the tickets were subscribed.

The Government replied that in most of the cheque dishonoured cases, the defaulted amount was collected subsequently from the original subscriber and admitted that in balance cases the tickets were substituted. It was also stated that strict directions were issued to branches not to start chitties without full enrolment of the tickets. The reply was not acceptable as registering the chitties without realising the first instalment was violation of the Act.

4.2.6.4 Enrolling defaulted subscribers/financially unsound persons in Chitties

A test check at 30 branches revealed that in 12 branches, subscribers who were defaulters in earlier chitties were again allotted 428 tickets. These persons had further defaulted in payment of monthly instalments. This has resulted in the Company's funds amounting to ₹19.13 crore, which could have been profitably utilised for its other activities, remaining blocked up with consequential loss of interest of ₹1.96 crore.

The Government stated that steps are being taken for implementing Centralised Liability Verification (CLV) system to ascertain and prevent the multiple chitty enrolment and liability creation.

4.2.6.5 Loss due to substitution by the Company

As per Section 24 (1) of the Kerala Chitties Act, 1975, if a non-prized[37] subscriber defaults payment of monthly instalment in time, the Foreman can, after serving a written notice of 14 days, remove his name from the list of subscribers by enrolling a suitable substitute. Such defaulter can remit the dues with interest at the rate of nine *per cent* per annum within one week from the receipt of notice to retain his ticket. If the defaulter fails to pay the dues with interest, the Company

[37] **Subscriber who is yet to get the prize money.**

either has to find out a new subscriber or substitute by itself. However, in case the default exceeds 60 *per cent* of monthly instalments, only Company can substitute such defaulted tickets. As the Company failed to initiate prompt action, as envisaged under Section 24(1), in finding out new subscribers who were capable of servicing chitties, considerable number of chitties were substituted by itself. In such cases, the Company incurred loss by foregoing Foreman's commission receivable at the rate of five *per cent* of chitty amount which amounted to ₹45.62 crore during the period 2008–09 to 2010-11.

Due to self-substitution, the Company fell short of funds and had to incur loss due to deployment of borrowed funds to pay prize money to regular subscribers in time. During the three years ending 2010-11 the Company had invested ₹798.94 crore in respect of 81,945 tickets in 11,916 terminated chitties at various branches. A test check of 838 tickets substituted by the Company in 141 chitties having denomination of ₹20,000 and above in 30 branches revealed that as against the reported profit of ₹1.81 crore on a total investment of ₹84.26 crore, there had been loss of ₹ 5.06 crore when cost of funds was actually considered.

The Government replied that though there was loss of Foreman's commission of five *per cent* of *sala*, the dividend earned in remaining tickets contributed by regular subscribers made good the loss on account of diversion of cost bearing funds.

The reply was not acceptable as the gain from the substituted chitties would be negative considering the cost of funds (10.51 *per cent*[38]) incurred by the Company.

4.2.6.6 Undue benefit to defaulters due to substitution by relatives/friends

A test check of substitution cases of high denomination chitties[39] in 14 branches revealed that defaulted non-prized subscribers were allowed to substitute by their spouse/children/ relatives/ friends in 90 cases enabling them to evade payment of penal interest of nine *per cent* per annum. This was detrimental to the financial interest of the Company and the Company sustained loss of ₹ 32.92 lakh towards penal interest. The Branch Managers being fully aware of relationship, permitted substitution of tickets and extended undue favour to defaulted subscribers.

The Government accepted that there were losses sustained on account of the above and instructions had been issued to the branches to avoid such substitutions.

4.2.6.7 Failure to recover agency commission on defaulted instalments

The Branch Managers are allowed to engage agents for canvassing subscribers for new chitties on a commission ranging from 10 to 13 *per cent* on the first instalment of the chitty. The Company directed[40] the Branch Managers to recover the commission paid to the agent in case the second and third instalments were

[38] **As worked out by the Company.**
[39] **₹ 20000/- per month and above.**
[40] **Vide circular No. 19/2009 dated 31-1-2009.**

not remitted on due dates. On a test check of commission paid to canvassing agents in 14 branches, it was noticed that in 213 cases, the Branch Managers failed to comply with the above directions and did not recover commission amounting to ₹6.56 lakh paid to the agents though the subscribers did not remit the second and third instalments on due dates. This resulted in extension of undue favour to the agents and loss to the Company to the tune of ₹6.56 lakh.

The Government replied that in certain cases they had recovered the excess commission paid and strict directions would be given to avoid payment of canvassing commission on defaulted chitties in view of the audit observation.

4.2.7 Allowing defaulted subscribers to participate in auction without collection of dues

Auction is the process by which a non-defaulted subscriber bids for the prize money. As per the Chitty Acts and Rules, the Foreman has to conduct monthly auction of chitty and file minutes of auction of each chitty with the Registrar. Subscriber who has not defaulted the monthly instalments gets an opportunity to participate in the auction. Where more than one person offers the maximum discount[41] (upto *25 per cent*) the prized subscriber will be determined by draw of lots[42].

As per MoP[43] a defaulted subscriber was not entitled to participate in auction and a subscriber/substituted subscriber who remitted the dues by cheque should not be allowed to participate in the auction unless and until the cheque was realised. It was noticed that in 215 cases at 27 branches, the Branch Managers permitted defaulted subscribers to participate in auction by furnishing cheques on the date of auction to obtain the prize money amounting to ₹23.95 crore. Of these, in 15 cases the cheques were dishonoured on being presented for realisation. Besides violation of the Rules, this reduced the chances of the regular subscribers of getting prize money.

Audit recommends that Company should take measures to ensure that subscribers should be allowed to participate in auction only after realising the cheque amount. Disciplinary action should be initiated against the Branch Managers for violation of the Rules.

The Government replied that certain branches had allowed defaulted subscribers to participate in auction without collecting the dues. The Company noted the audit observation for future guidance and branches were being instructed for strict compliance of the norms in this regard and the failure cases would be viewed seriously.

4.2.8 Recovery of dues from prized subscribers

A prized subscriber is one who got the auction in his favour and was paid the prize money. Since there is an element of advance/loan, the Company releases the

[41] **Maximum discount – the maximum amount foregone by the subscriber to bid the chitty amount.**
[42] **Explanation No. (4) under Section 6 of the Chits Fund Act, 1982.**
[43] **As per Para 8.4.2 (d) and Para 8.3.2 (b) of MoP.**

prize money after obtaining sufficient security including personal surety. Audit noticed that default by prized subscribers increased substantially from ₹86.75 crore in 2009-10 to ₹195.99 crore in 2011-12.

4.2.8.1 Release of Prize money based on bogus salary certificate as personal surety

The prize money to successful bidders was released on the security of salary certificate of Government employees. Audit noticed that in 36 cases at 21 Branches the salary certificates accepted as personal surety by the Branch Managers during the period 2008-09 to 2011-12 were bogus. The fraud came to light while initiating action as all those subscribers defaulted in remittance of subsequent instalments after obtaining prize money. Out of the total prize money of ₹36.67 lakh paid, the Company could realise only ₹11.19 lakh (in eight cases) and the balance amount of ₹25.48 lakh was pending recovery in 28 cases (June 2013). The chances of recovery in balance cases are remote as no other security was available with the Company to realise dues. The Branch Managers failed to ensure the genuineness of the salary certificates besides obtaining confirmation from the concerned offices. However, no penal actions were taken against those Branch Managers.

The Government replied that strict warning had been given to all branches to be alert and extra vigilant to prevent the incidence of bogus surety cases.

The Company should initiate disciplinary action against those Branch Managers who were responsible for releasing prize money based on bogus surety thereby causing loss to the Company.

4.2.8.2 Failure to initiate revenue recovery proceedings against defaulting prized subscribers

As per the standing instruction issued (August 2011) by the Company, the Branch Managers had to initiate RR proceedings in defaulted prized chitties, both running and terminated, under Kerala Revenue Recovery Act (Act 1968). The criteria for initiating RR proceedings against defaulted prized subscribers are:

- in running Chitties with default exceeding 18 months;
- in high value Chitties having monthly instalments of ₹25000 and above with high default exceeding 12 months and
- in terminated Chitties with three or more instalments under default on termination date and having no collection in the past three months.

It was noticed in audit that the Branch Managers were not referring chronic default in prized chitties for RR action. Test check of terminated chitties having high default amount in 18 branches revealed that as of May 2013, the Branches had not initiated RR action in 208 cases with a default amount of ₹5.70 crore even though a period of two to thirty months had elapsed since the date of termination of the chitties.

The Government replied that strict directions were issued to RR Department to

ensure that all pending cases of 12 months or more were referred to RR compulsorily.

4.2.9 Other deficiencies

In addition to above, some other deficiencies noticed by Audit are discussed below:

4.2.9.1 Irregular retention of money due to subscribers removed from chitties - ₹51.31 crore

As per Section 38 of the Kerala Chitties Act, 1975 and Section 42 of the Chit Funds Act, 1982, every non-prized subscriber shall be entitled to get back his subscriptions on termination of chitty without any deduction for dividend, if any, earned by him. Audit noticed that the Company had retained (31 March 2011) an amount of ₹51.31 crore, which was payable to subscribers who were removed from Chitty due to default (₹19.26 crore in running chitties and ₹32.05 crore in terminated chitties). On test check of amount payable to these subscribers in terminated chitties at nine branches, it was observed that contrary to the above provisions, the Branch Managers did not refund the amount payable to non-prized subscribers even after expiry of periods ranging from one to twenty three years from the date of termination of chitty. This had resulted in irregular retention of ₹51.31 crore by the Company which included ₹13.01 crore outstanding for more than 10 years.

The Government replied that the Company would be instructed to take immediate steps for the intimation and release of such amount to the concerned subscribers in compliance with the recommendation of Audit.

4.2.9.2 Delay in completion of formalities for release of security deposits and resultant interest loss of ₹0.75 crore

The Company had to deposit chit amount[44] with the Government Treasury as security deposit at the time of registering a new chitty which earns interest at the rate applicable to fixed deposit till its maturity (which is normally upto twelve months after the date of termination of chitty). The security deposit would be refunded after audit of Balance Sheet by Chitty Auditor of each chitty on termination and publication of Gazette notification in this regard.

A test check of records in 19 branches revealed that there was undue delay on the part of the Company in completing the above formalities which resulted in delay in getting refunds by the Company. The delay ranged upto 146 months beyond maturity date in 736 terminated chitties and in two cases it was still (June 2013) pending though 370 months have elapsed since maturity date. The loss of interest on the blocked up amount of ₹15.61 crore worked out to ₹0.75 crore.

The Government assured that all possible steps would be taken for speedy release of chitty security deposits in future to avoid loss of interest.

[44] **Chit amount means the sum-total of the subscriptions payable by all the subscribers for any instalment of a chit without any deduction of discount or otherwise (Section 2(d) of the Chit Funds Act, 1982)**

4.2.9.3 Opening of new branches

GoK granted (May 2008) autonomy to the Company for opening new branches subject to conducting study on commercial feasibility/economic viability before finalising the location and number of new branches to be opened in the budget proposals sent to the Government for approval.

An analysis of financial performance of 95 new branches opened during three years up to 2011-12 is given below:

Table 4.13 : Financial performance of new branches

Sl.No	Period	No. of new branches opened	Cumulative Nos.	No. of loss making new Branches	Net loss incurred (₹ in crore)
1	2009-10	44	44	41	2.64
2	2010-11	40	84	73	3.88
3	2011-12	11	95	75	2.91
	Total				**9.43**

Out of 95 new branches opened between 2009-10 and 2011-12, 75 branches (79 *per cent*) were running in loss leading to a cumulative loss of ₹ 9.43 crore.

The Government assured that all prescribed procedures would be followed strictly while opening new branches.

The Company should conduct proper survey and feasibility study before opening new branches.

4.2.9.4 Legal hurdles in carrying out lending business

As per Section 12(2) of Chit Funds Act, 1982 applicable from May 2012, a Company carrying on any business in addition to chitty business, shall wind up such other business before the expiry of a period of three years from the date of effect of the Act and the State Government can extend the above period of three years by a further period not exceeding two years. The State Government permitted[45] the Company (September 2012) to carry on the existing activity of lending/loan business along with the chitty business. Audit sought clarification from Reserve Bank of India (RBI) on the status of the Company. RBI stated that it had clarified (May 2013) to the State Government that the Company could not conduct chit and lending business simultaneously and advised them to hive off the lending business of the Company into a separate entity and register it as a Non-Banking Financial Company.

The Company replied that since the permission from the Government was obtained, the issue of winding up of other business did not arise.

The reply was not acceptable as the new Chit Funds Act, 1982 stipulates that Company could not conduct chit and lending business simultaneously. Therefore, the GoK cannot permit the Company to carry on any business simultaneously

[45] **Vide GO (Rt) No.644/2012/TD dated 04.09.2012**

with chitty business for more than five years and the Company needs to initiate urgent action in this regard.

4.2.9.5 Internal control lapse in preventing misappropriation

The Company introduced (July 2005) Collection Agency system for door to door collection of chitty instalments. The internal audit wing of the Company during a special audit (August 2010) at Thiruvalla branch detected misappropriation of ₹1.82 lakh by a collection agent by not remitting amount collected to the branch. Though stringent action against the staff and termination of the collection agent was proposed by the Managing Director, no penal action was implemented. This helped the agent to continue with the misappropriation and in a detailed enquiry it was found (July 2012) that a total amount of ₹98.39 lakh was embezzled. The Company constituted a public grievance cell (July 2012) and accepted a claim of ₹73.62 lakh of 147 subscribers.

In reply to a questionnaire on internal control, it was stated (November 2013) that the Collection Agent should remit the amount on the next working day as first collection along with a detailed statement showing chitty number, name of subscriber and month to which it pertains to. It was also stated that cashier and concerned Assistant Manager in charge of door collection were responsible for ensuring correctness of collection and remittance of cash by the Agent.

With regard to a query as to whether Branch issued notices to defaulters, it was replied that notices were issued. The Company admitted that laxity in taking timely action might be a reason for the lapse. The reply of the Company was not tenable as the misappropriation was noticed in 2010 and allowed to escalate by not taking corrective action in time. Had the Company diligently followed its own procedures mentioned above, the misappropriation would not have occurred and this continued laxity of the Company was exploited by the Collection Agent.

The Government accepted (January 2014) that the misappropriation was due to violation and non-compliance of procedure of daily collection and supervisory lapses at all level in the branch and stated that action had been initiated to recover the loss.

Thus, the failure of control and monitoring mechanism of the Company led to financial loss as well as damage of goodwill of the Company.

4.2.10 Financial impact

The financial impact of audit findings are summarised below:

Table 4.14 : Financial impact of audit findings

Sl. No.	Para No.	Major findings	₹ in crore
1	4.2.6.4	Enrolling defaulted subscriber/financially unsound persons in chitty	1.96
2	4.2.6.5	Loss of foreman commission due to substitution by Company	45.62
3	4.2.6.5	Loss due to substitution by Company	5.06
4	4.2.6.6	Loss due to substitution of defaulted non-prized subscriber by close relatives/business associates	0.33

5	4.2.8.1	Payment of prize money based on bogus salary certificate	0.26
6	4.2.9.1	Non-refund of subscription of defaulters removed from Chitty	51.31
7	4.2.9.2	Loss of interest due to delayed refund of Chitty Security Deposit	0.75
8	4.2.9.3	Loss due to opening of branches without proper viability study	9.43
		Total	**114.72**

The Government entered into chitty business in 1969 to bring in social control over the chitty business and to protect the public from the clutches of unscrupulous private chit fund operators, through adhering to applicable rules and regulations. However, unscrupulous subscribers were found to be still taking away prize money through dubious methods such as submitting bogus salary certificates towards security, substituting their defaulted chitties by spouse/relatives, not honouring cheques submitted towards monthly instalments, etc. The Company also violated the rules and regulations governing the conduct of chitty business and enrolled defaulters/subscribers without realising first instalment, allowed defaulters to participate in auction and get prize money. It also failed to refund the instalments of the subscribers who were removed from the chitty.

Thus, the Government by running the Chitty business violating all rules and regulations defeated the very purpose that they were supposed to achieve.

Kerala State Civil Supplies Corporation Limited

4.3 *Centralised Procurement of Essential Commodities*

4.3.1 Introduction

Kerala State Civil Supplies Corporation Limited (Company) was incorporated in June 1974 with the objective of procurement and distribution of essential commodities including food grains so as to ensure their easy availability to the public at reasonable prices. The Company sells these commodities at two different rates viz., subsidised rate fixed by the Government and higher rate fixed by the Company - 'free sale subsidy rate'[46]. The Company follows the same process for procurement of commodities meant for subsidised sale as well as free sale and the purchase price is the same.

The Government of Kerala (GoK) extends financial support in the form of grants-in-aid (GIA) to the Company to compensate the loss suffered due to sale of essential commodities at subsidised rate.

For distribution of essential commodities, the Company operated 1314 outlets[47] across the State (March 2013). The activities of these outlets are coordinated and controlled by 56 depots and five Regional Offices. Audit was conducted during February to June 2013 in selected seven Depots[48] and Head Office for scrutiny of records.

[46] **The retail price fixed by the Company for subsidised and non-subsidised commodities sold without quantity restriction.**
[47] **906 Maveli stores, 370 Super Markets, 19 People's Bazaars, four Hyper Markets, one Apna Bazaar and 14 Mobile Maveli Stores.**
[48] **Kannur, Kozhikode, Palakkad, Kochi, Kottayam, Alappuzha and Kollam depots.**

4.3.2 Procurement process

The procurement process of the Company is governed by the Purchase Manual (2005) and the Purchase Policy (2010) approved by GoK. The Company procures essential commodities centrally at the Head Office through e-tender which is a web enabled tendering system.

The various steps involved in the procurement process are as under:

i. *Registration of vendors:* The prospective bidders have to register their name with the Company for taking part in the e-tenders.
ii. *Issuance of tender notice:* The purchase division starts the tender process by uploading of the tender documents[49] with indicative quantity requirements in the website which consists of two parts viz., technical bid and commercial bid.
iii. *Collection of Indents:* All depots are required to submit their indents, in the electronic indent form created in the website, for the commodities included in the tender prior to opening of the e-tender.
iv. *The offer and its evaluation:* The vendors have to indicate rates for each commodity for each depot and the total offered quantity. On an average, one e-tender covers 18 commodities for 56 depots. Generally the vendors quote different rates for different depots according to locations. To evaluate all the offers received, the Company uses specially designed software namely Least Cost Solution (LCS).
v. *Preparation of purchase plan:* After opening the tender, considering the rate quoted, the quantity offered by the vendors and the requirements in depots as extracted from the e-tendering website, MIS division prepares a 'purchase plan' for each commodity by uploading the above details in LCS.
vi. *Finalisation of purchase plan:* Head Office Management Committee[50] (HOMC) decides the quantity to be purchased for each depot and finalises the purchase plan. The purchase decision is placed in the next meeting of Board of Directors (BoD) for ratification.

Audit analysed procurement of 22[51] essential commodities through 43 e-tenders floated during the period from April 2010 to March 2013 from the point of view of objectivity, cost effectiveness and quality aspects and the findings are discussed in the succeeding paragraphs.

4.3.3 Audit Findings

Audit noticed that though the Company invited open tenders through electronic mode, finalisation of the tenders and selection of successful bidders lacked objectivity as discussed below:-

[49] **Tender notice, terms and conditions, schedules for quality specifications, offer sheet, declaration, form of warranty, etc.**
[50] **Consists of functional heads of different divisions except Internal Audit.**
[51] **Bengalgram bold, Blackgram washed (whole), Blackgram split (with husk), Blackgram dhal (washed), Lobia, Greengram, Greengram dhal, Peas dhal, Toordhal, Toordhal fatka quality, White lobia, Chillies, Coriander, Cuminseed, Fenugreek, Mustard, Bodhana rice, Jaya rice, Kurwa rice, Matta rice, Raw rice and Sugar.**

4.3.3.1 Post tender negotiations without recording reasons

The tendering system in the Company envisaged complete transparency by avoiding scope for subjective decision making. Post tender negotiations and changing the price, quantity and depots offered vitiate transparency as the bidders get a chance to amend their bids and form cartels after knowing the rates quoted by other bidders. Hence the BoD had limited (March 2010) the post tender negotiations to certain specific situations like:

- when there is falling trend in the prices of a commodity in the market,
- when the variation in prices obtained in present tender compared with that of previous tender for a commodity is disproportionate to the corresponding change in prices reported in newspapers, etc., to the disadvantage of the Company,
- when there is wide gap in the range of prices in the LCS and
- when the total quantity offered by the suppliers is less than the requirement.

Further, Purchase Manual of the Company also restricts the negotiations with the lowest bidders. Negotiations with other bidders are permitted only if the expected results are not achieved in negotiations with lowest suppliers.

Audit, however, noticed that these restrictions were not followed by the HOMC. The Company followed a system of post tender negotiations which gave ample scope for arbitrariness and subjectivity at different stages.

Audit found that HOMC with respect to seven commodities in 43 e-tenders, floated during the period covered in audit, finalised 60 *per cent* of tenders after negotiations with suppliers included in LCS, as detailed below:

Table 4.15 : Finalisation of tenders and negotiations conducted

Sl. No.	Commodity	No. of tenders covered for each commodity #	No. of times negotiations conducted	Percentage
1	Bengal gram bold	39	22	56
2	Black gram whole (Washed)	39	20	51
3	Chillies	40	31	78
4	Green gram	39	28	72
5	Matta rice unda sortex	40	22	55
6	Sugar	42	24	57
7	Toor dhal	39	20	51
Total		**278**	**167**	**60**

 # Out of 43 e-tenders called for during the period 2010-13, the number of times these seven commodities were included in tenders is shown against each commodity.

Audit noticed that reasons for resorting to negotiations were not recorded in 55 cases out of 167 negotiations conducted.

4.3.3.2 Revision of rates and offered quantity during negotiations

Audit test checked 20 negotiations with 22 suppliers in 10 e-tenders for the seven

commodities out of the 43 e-tenders to assess the negotiation process and its impact. Audit scrutiny revealed the following:

- Bidders got in to LCS by quoting lowest rate in any one of the 56 depots. HOMC permitted these suppliers to revise their rates, increase the offered quantity and number of depots during negotiations. Hence, the share of suppliers in the LCS was increased to 233 *per cent,* on average, in the final purchase plan and in one case offered quantity increased up to 550 *per cent* in the final purchase plan. Consequently, a few suppliers cornered the entire purchase orders with the result that only 77 *per cent* of the suppliers appearing in the LCS could get purchase orders after negotiations.
- Though these negotiations were conducted for reducing the quoted rates of the commodities, the financial benefit was negligible and ranged from 0.09 *per cent* to 3.82 *per cent* of the total purchase order value. Thus, HOMC vitiated the objectivity of the e-tendering process for a meagre margin.

Government, endorsing the reply of the Company stated (January 2014) that all the vendors who qualified in the tender and became L1 in any of the depots were invited for negotiations and allowed to quote for more depots. It claimed that the increase of 233 *per cent* (average) in the share of suppliers in the ordered quantity after negotiation and reducing of the number of suppliers to 77 *per cent* from the LCS to final purchase plan showed efficiency of negotiations. The fact, however, remained that the Company invited a supplier for negotiation, who was L1 in any one of the depots, and allowed to quote for depots where he was not L1. This tantamounted to manipulation and vitiation of entire tendering process.

4.3.3.3 Negotiation with bidders other than lowest

The Company, at the time of preparing of LCS, considered quantity indented and uploaded in the e- tendering website by depots. Audit noticed that, in many of the cases, this quantity was higher than the actual requirement assessed by HOMC during evaluation of tender. This has resulted in certain suppliers with higher rates but more quantity getting into LCS who otherwise would have been left out had the LCS been prepared based on actual requirement. For instance, Dharani Sugars and Chemicals Limited had quoted higher rates for procurement of sugar but entered into LCS due to higher quantity than required given for preparation of LCS and was invited for negotiation. During negotiation the supplier reduced meagre amount ranging from two to three paise per kilogram from the lowest quoted rate of other suppliers and bagged purchase orders valuing ₹4.86 crore in two e-tenders[52].

4.3.3.4 Negotiation with bidders not in LCS

Audit found that purchase orders were issued to bidders who were not selected by LCS, but through negotiations.

[52] **No.8650/2011 (6) and 8650/2011 (8)**

HOMC held negotiations with three bidders[53] who participated in the tender (8650/2011-5) but did not find a place in the LCS and were awarded Purchase Orders (POs) valuing ₹1.22 crore for purchase of rice.

Government replied with regard to above deficiencies that regulations were followed by the Company in all the e-tenders floated during the audit period. It was also replied that all the suppliers who participated in the Tender No. 8650/2011(5) were called for negotiation for better result.

The reply was not acceptable. Inviting all the bidders for negotiation was gross violation of the sanctity of the tender procedure. The Company violated its own purchase manual and did not restrict negotiations with the lowest bidders.

4.3.3.5 Direct purchases from producing centres and local traders

Parallel to e-tendering, the Company used to depute officials to producing centres outside Kerala for collecting better offers which are also considered along with e-tenders. In addition, the Regional Managers (RMs) were also directed to collect offers from authentic local sources to compare rates received in e-tenders. This was envisaged as a means to curtail the unhealthy practices such as formation of cartels, systematic elimination of new suppliers and supply of low quality commodities at high rates, etc., by existing suppliers. However, Audit found that these checks were not at all effective as the same vendors who participated in the e-tender bagged the orders for direct purchase also. Thus, out of 107 purchase orders valuing ₹42.19 crore issued as part of the initiative to procure commodities directly, 46 purchase orders valuing ₹11.56 crore were issued to suppliers who were already registered with the Company. Further, out of these 46 POs, suppliers who won 13 POs had also participated in the same tender through e-tendering route and obtained POs under two routes (e-tender route and direct procurement route).

As this resulted in submission of multi tenders by the same bidders, collection of offers for direct procurement should be from new suppliers only.

Government stated that the intention of the Company was to make more competition in the tender and to ensure comparison of the rates received with *mandi* rates. However, the Company should not have obtained offers from registered vendors.

4.3.3.6 Evaluation of commercial bids of bidders who did not qualify in technical evaluation

The e-tender invited by the Company had two parts viz., technical bid and commercial bid. The duly filled up tender documents and Earnest Money Deposit (EMD) together with other documents constitute technical bid. The bidders are required to submit EMD separately for each commodity. Commercial bids of only technically qualified bidders are opened for further evaluation. Thus, a bid without EMD is technically invalid and cannot be considered for evaluation.

[53] **St. Antonys Modern Rice Mill, Nihana Traders and Keerthi Nirmal Marketing Limited**

Out of total 2973 bidders participating in the 43 e-tenders floated during the review period the details of EMD were not recorded in respect of 683 bidders. The financial bids of these bidders were, however, opened, evaluated and even POs were issued. A detailed scrutiny of technical evaluation sheets for the month of March 2013[54], revealed that details of EMD were not available in 18 price bids evaluated and four[55] POs were placed with three such non-qualified bidders.

The Government accepted the above audit finding and stated that an EMD register has since been opened with details of all EMD given by various vendors. It was also stated that most of the suppliers would keep the EMD on a permanent basis and they only report the details of EMD submitted earlier and failed to record the same in the particular column. Government further stated that necessary steps would be taken up with the software providers to show the details of permanent EMD automatically in the technical bid sheet.

4.3.3.7 Undue favour to defaulted suppliers - waiver of penalty for short/ delayed supply

In order to ensure prompt supply of commodities, delivery schedules were clearly stipulated in each purchase order and penal clauses were incorporated in the tender conditions for delayed/short supply. Further, tender conditions specified that commodities should not be accepted after 40 days from the date of purchase order. Audit, however, noticed that the Company diluted these tender conditions and favoured two suppliers by not levying penalty amounting to ₹1.22 crore for delayed/short supply as shown below:

Table 4.16 : Details of penalty to be recovered

Name of supplier/PO No. & Date	Ordered quantity (in quintals)	Short supply (in quintals)	Delayed supply (in quintals)	Penalty to be recovered (₹ in crore)
Dharani Sugars and Chemicals Limited, Chennai (No.9504/25.3.2011)	33500	18448	Nil	1.04
Ponni Sugars (Erode) Limited (No. 10509/25.10.2011)	11160	2702	3038	0.18
Total				**1.22**

In both the cases the Company issued fresh purchase orders directly to the defaulted suppliers for the short supplied quantity without imposing penalty.

The Government replied that the tender conditions were relaxed as sugar market was a seller's market and the Company found it difficult to get more vendor participation for supply of sugar. It was further stated that penalty was not imposed on Ponni Sugars (Erode) Limited as the delay in supply was due to labour problem in the Company's own depots. The reply was not acceptable as the Company has taken stringent measures such as blacklisting against other

[54] **Tender No.4675/2013**

[55] **PO No.12744 issued to Royal Trade Links, POs No.12766&12786 issued to KRM Ramadevi Enterprises Private Limited and PO No. 12794 issued to Kalpana Agro Mills.**

suppliers of sugar (Bannari Amman Sugars Limited and Jans Ventures) during the review period and in the case of Ponni Sugars reply was not justifiable as the labour problem in the Company referred to was due to failure of supplier to supply sugar in 50 Kg bags as per the tender conditions.

It is recommended that the tender conditions should be adhered to and penalty imposed to ensure timely supply.

4.3.3.8 Cost effectiveness

To ensure cost effectiveness in purchase, the competitiveness of the rates obtained should be ensured by generating fair competition. The Company, however, failed to ensure this due to poor market intelligence, cartel formation by bidders, dependence on few suppliers and wrong assessment of requirements as discussed below:

Poor market intelligence

Available sources of market intelligence with the Company were *mandi* rates, wholesale rates reported in newspapers, local market price reported by Regional Managers (RMs), etc. However, these were not tapped fully to get the lowest price while procuring commodities as illustrated below:-

- *Mandi* rates were not collected and compared by HOMC while finalising tenders. A test check of nine tenders[56] in respect of chillies and coriander revealed that the procurement rates were higher by five to thirty eight *per cent* and six to twenty one *per cent* respectively as compared to *mandi* rates inclusive of transportation and other charges[57]. Thus, the excess cost of ordered quantity worked out to ₹11.04 crore.
- None of the RMs collected and reported local wholesale rates regularly except the RM Ernakulam, that too for nine commodities as against 18 commodities.
- The Company compared newspaper reported rates of only nine out of 18 commodities.

The Government replied that *mandi* rates were compared for verifying the price trend but these were not comparable with tender rate since the *mandi* rates are spot rates, commodities available in *mandi* needs to be cleaned, graded and bagged for transportation which was highly expensive. The reply was not acceptable as the landed cost of commodities based on *mandi* rates was comparable as transportation cost could have been arrived at and reasonableness checked thereto, after that and purchase manual provides for cross checking with wholesale prices from various sources and locations. The *mandi* rates are available in the website of 'AGMARK' on daily basis and the landed cost of the same can be arrived at for comparison with tender rates. The Government also stated that RMs failed to report wholesale market rates due to non-availability of offers and now the Company had given a revised direction to RMs to report rates even in the absence of offers.

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[56] **Tenders opened on 08/07/2010, 04/08/2010, 22/02/2011, 05/07/2011, 28/07/2011, 18/08/2011, 04/07/2012, 20/07/2012 and 09/08/2012**

[57] **Purchase cost at *mandi* plus transportation, loading charges, CST and other miscellaneous expenses.**

Audit recommends that the market intelligence system should be revamped so as to ensure competitiveness of offers received by utilising the wholesale price of different commodities prevailing in various markets available in the website of Department of Economics and Statistics, GoK on daily basis.

Unrealistic quantity requirements shown in tenders

The tenders were invited for supply of an "indicative quantity". Indicative quantity requirement published by the Company in e-tenders varied widely from actual requirement assessed by HOMC. In e-tenders, invited for seven commodities[58], in eight out of 14 cases the tendered quantity was higher than the actual requirement. In respect of seven cases the variation ranged from 113 *per cent* to 389 *per cent* and in one case[59] it was 1428 *per cent*. Further, tendered quantity published during July to December 2012 remained the same irrespective of variations in the assessed requirement. In the event of indicative requirement remaining lower than the assessed quantity the same led to avoidable negotiations with bidders for increasing the offered quantity and consequent delay in placing purchase orders.

While accepting the audit observations the Government stated that steps were being taken to ensure that the requirement published was more realistic.

Collusion among vendors restricting entry of new bidders

Section 3(3)(d) of the Competition Act, 2002 provides that any agreement entered into between or practice carried on or decision taken by bidders which directly or indirectly results in bid rigging or collusive bidding, shall be presumed to have adverse effect on competition. It explained the term 'bid rigging' as any agreement which has the effect of eliminating or reducing competition for bids or adversely affecting or manipulating the process of bidding.

To check the extent of collusion, Audit reviewed the vendors' profile as well as the communications between the Company and the vendors. Thus, 75 vendors formed 26 subgroups consisting of two to six vendors having common email-ids, addresses, contact numbers, etc., as given below:

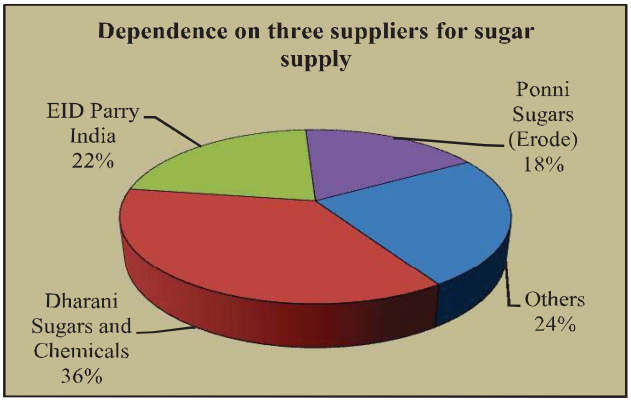
Table 4.17 : Details of vendors profile

Item	No. of Suppliers	Remarks
Common E-mail ids	42	42 vendors, who participated in bidding and received purchase orders, had common e-mail id. The Company was aware as they used to send messages to same e-mail ids for communicating with more than one supplier.
Common addresses, phone numbers and liaison officials	30	These suppliers shared common phone numbers or contact addresses and even same liaison officials for communication.

[58] **Black gram washed (whole), Chillies, Green gram, Lobia, Matta rice unda sortex, Sugar and Toordhal**
[59] **Tender No.20258/2012 for Blackgram washed whole opened on 09.08.2012.**

Disclosing rates to each other	3	Two suppliers[60] used to forward a copy of the e-mail containing their revised rates quoted during negotiations to the registered e-mail id of another supplier.
Total	**75**	

These evidenced collusion and cartel formation among bidders enabling bid rigging as well as impairing fair competition. The Company was aware of this unfair practice as evident from the minutes of 44th HOMC meeting held on 11 November 2009. The Company, however, failed to initiate any action by taking up the matter with the Competition Commission of India under the Competition Act, 2002 or blacklist such bidders.



All the above 75 vendors (26 groups) together bagged orders worth ₹1076.76 crore for supply of items other than sugar which constituted 69 *per cent*[61] of total purchase order value. Further, out of the 26 groups, suppliers belonging to 10 groups together bagged 48 *per cent* of total purchase order value. It was also seen in audit that 71 suppliers were newly registered during the year 2012-13. Of these, 20 suppliers who got purchase orders during that period, seven were either sister concerns of old vendors/related with other vendors or previously registered vendors. The Company had placed 134 purchase orders for 1.41 lakh MTs of sugar valuing ₹434.42 crore during 2010-11 to 2012-13. Out of the total order value, 76 *per cent* was placed with three private sugar producers as depicted in the graph. The average number of participants in the tender process was also limited to six suppliers. As a result, the Company was not getting competitive rates and the procurement rate was even higher than the average open market wholesale prices[62]. The Company incurred additional expenditure of ₹3.23 crore during the period from 2010-11 to 2012-13 on account of procurement at rates higher than the average wholesale market price in the State.

It was also noticed that Government of India (GoI) directed (February 2010) all State Governments to advise their Civil Supplies Corporations to participate in bidding for sugar procurement directly from sugar mills located in their States/nearby States so that they could procure sugar at more economic rates. GoK, however, did not give any direction in this regard to the Company despite

[60] **Shree Banke Bihari Enterprises and Sreeji Enterprises.**
[61] **69 % of ₹1565.67 crore = ₹1076.76 crore.**
[62] **Source: www.agmarknet.nic.in**

the availability of 103[63] sugar mills in Tamil Nadu (44 nos.) and Karnataka (59 nos.) including 42 mills in Government/Co-operative sectors during the year 2010-11. The Company though aware of the direction of GoI did not participate in the bidding for sugar directly from mills but depended on private suppliers for the procurement of sugar.

The Government stated that out of the 26 groups, none of the groups received more than 10 *per cent* of the total Purchase Order value and it was common practice that new firms were registered by the same persons for different purposes and appointing of same liaison officers by different firms. It was further stated that in respect of rice mills, many of the mills had two to six units under the same ownership.

The reply was not acceptable as 10 dominant groups alone had bagged 48 *per cent* of total purchase order value. The collusion and cartel formation among bidders was further evident from the boycott of tender by bidders in January 2011 and December 2013 (Tender No.7360/2010 (10) and 33434/2013 respectively).

It is recommended that the Company should streamline the vendor registration and tendering process to eliminate formation of cartels among bidders and to encourage new suppliers for increasing competitiveness in the tenders.

4.3.3.9 Quality Assurance Mechanism

The Company's Quality Manual prescribes a two stage quality assurance mechanism to ensure that the suppliers are delivering the commodities strictly as per the specifications prescribed in the tender.

- Primary examination[64]: This is done by the Depot Manager and the Stock Custodian by collecting three random samples from the consignment received at the depot. The quality is also cross checked with email reports from other depots for rejection of the same lot.
- Quality Assurance Committee (QAC) [65] : This is convened to decide on the acceptance of those with doubtful quality. In addition, QAC is required to meet fortnightly in each depot for reviewing the quality of all items in stock.

However, Audit found several deficiencies in the quality control mechanism as described below:

Test check of the records of Kottayam and Kochi depots for three years ended March 2013 revealed that these depots had received 1841[66] consignments from various suppliers. There were no records to show the details of quality checks except in 66 cases. Out of this, 64 test reports were prepared against consignments that were rejected due to poor quality. In the absence of records, Audit is not able to comment on the quality of remaining consignments.

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[63] **Source: Indian Institute of Sugarcane Research, Lucknow, research institute under the Indian Council of Agriculture Research, Ministry of Agriculture, Government of India.**
[64] **Tests saleability, appearance, colour, size, aroma, no obnoxious smell, etc.**
[65] **Junior Manager (QA), Depot Manager and Junior Manager (Marketing) are the members of QAC.**
[66] **1203 and 638 Goods Received Sheet in Kottayam and Kochi respectively.**

Audit also found that the consignments rejected due to poor quality by one depot were accepted by another as detailed below:

- Coriander supplied (February 2011) in same truck by one supplier[67] was accepted by Thalassery depot and rejected by Perinthalmanna depot due to poor quality.
- Palakkad depot accepted (7 February 2012) 111 bags of mustard supplied by Noble Distributors treating quality as 'Good' which was earlier rejected at Chavakkad and Wadakkanchery depots.

The Government replied that all the quality parameters of the accepted commodities were not entered in the Quality Assurance Register due to the difficulty in recording the parameters of large numbers of consignments. Since rejection is to be done carefully and justifiably and there is appeal provision against rejections, all the reasons for the rejections are recorded. It was also stated that there were possibilities of minor variations in quality analysis of same commodity done by two Junior Managers (QA).

The reply was not acceptable as consignments supplied in same vehicle accepted in one depot and rejected in another depot indicate wide variations in quality assessments done in depots.

4.3.3.10 Other Related issues

Audit found that there was "stock out" position of essential commodities during periods when the market prices were rising as shown below:-

Table 4.18 : Details of stock out period vis a vis market price

Commodity	Stock out period		Retail price in open market (₹ per kg)		Percentage of increase in rate	Maximum number of depots reporting stock out	Percentage of ordered quantity against requirement
	From	To	From	To			
Lobia	Feb-12	July-12	45.96	65.04	41.51	51	29
Chillies	Dec-10	Mar-11	75.70	108.66	43.54	31	52
Toor dhal	Dec-10	Mar-11	69.83	75.97	8.79	47	32
Coriander	Dec-10	Mar-11	51.09	68.70	34.47	47	65

It was also noticed that during 06 January to 15 March 2011, the Company had not purchased Green gram in four depots in spite of stock out position and where there was an aggregate requirement of 4200 quintals. The retail price of the commodity showed increasing trend in open market during this time period.

The Government replied that the Company cannot ensure unlimited quantity of the products due to its limitations and due to the complementary nature of the pulses to some extent. The reply was not acceptable as these pulses were included in the list of essential commodities by the Government and therefore had to be procured for distribution.

[67] **Ambica Trading Company (PO No.9265 dated 2.2.2011)**

The procurement process of the Company had several lacunae and deficiencies. It invited tenders for indicative requirements but placed orders for quantities that were vastly different from the tendered quantities and through this process allowing only a few players to get purchase orders. Though the LCS technique envisaged bringing about objectivity, transparency and fair play, HOMC resorted to extensive negotiations leading to unhealthy competition, collusion and cartel formation making the entire purpose of removing subjectivity through electronic mode of tendering ineffective. Lots rejected by one depot due to poor quality were accepted by another depot facilitating the traders to market poor quality commodities. The Company failed to ensure cost effectiveness due to poor market intelligence, cartel formation by bidders, dependence on few suppliers and wrong assessment of requirements.

Kerala State Textile Corporation Limited

4.4 Implementation of Green Field Projects

4.4.1 Introduction

Government of Kerala (GoK) approved (April 2010) the budget proposal to implement three projects in textile sector at a cost of ₹72 crore. GoK declared them as Green Field Projects[68]. The three projects were as follows:

Table 4.19 : Details of Projects in textile sector

Name of the mill	Project cost (₹ in crore)	Capacity	Activity
Komalapuram Hi-Tech Spinning and Weaving Mills, Alappuzha[69]	36.00	18,240 spindles and 30 air jet looms	Spinning and weaving
Pinarayi Hi-Tech Weaving Mills, Kannur	20.00	36 looms	Weaving
Uduma Textile Mills, Kasargod	16.00	10,368 spindles	Spinning
Total	**72.00**		

The Industries Department entrusted (April 2010) these projects to Kerala State Textile Corporation Limited (Company) and the target date for completion was fixed[70] as December 2010. The incomplete mills at Uduma and Komalapuram were inaugurated in January 2011/February 2011 while the mill at Pinarayi was not inaugurated. The projects reached a stand still after completion of civil works and partial installation of machinery due to which investment of ₹98.68 crore was idling since 2010-12. Audit reviewed the records in the offices of the Company and the Industries Department during the period from February 2013 to June 2013. Major findings are discussed below:

[68] Green Filed Projects refers to projects where no previous facility exists.
[69] By taking over Kerala Spinners Limited, a sick textile unit in private sector.
[70] Vide letter no.253/N/M(IND)/10 dated 04.06.2010 from the office of the Minister of Industries.

4.4.2 Funding

The projects were to be financed from own funds of the Company and equity participation as well as soft loan (7 *per cent* interest) from The Kerala Minerals and Metals Limited (KMML) in the ratio of 1:1:1. The Government, between February 2010 and March 2012, advanced loan of ₹35.51 crore as the Company did not have sufficient funds. Thus the project was actually funded (₹83.05 crore) by KMML (₹45 crore i.e. 54 *per cent*) and GoK (₹35.51crore i.e. 43 *per cent*) and sales proceeds (₹2.54 crore) of old machinery of Kerala Spinners Limited (KSL). Against the estimated cost of ₹72 crore, the actual expenditure up to March 2013 was ₹98.68 crore (***Annexure 24***). The increase in cost was mainly due to extra expenditure incurred on civil/electrical works and procurement of machinery.

4.4.3 Lack of planning

4.4.3.1 Lack of planning in selecting the project and implementing agency

The Industries Department took the decision to set up the projects without setting objectives or conducting feasibility studies, study of market potential, etc., and even the basis of the cost estimate of the projects was also absent. It entrusted (April 2010) the implementation of the project to the Company which was a sick industrial unit with a track record of incurring heavy and continuous operating losses. All the four[71] existing units of the Company were in the red.

Selecting the projects which involved huge investment and entrusting them to a Company whose track record of management has been poor and without adequate planning was not prudent. The Company replied (September 2013) that the performance of the existing mills could not be taken as a yardstick since they were all taken over as sick units. The reply was not acceptable since the Company could not make these units viable even after 35 years of takeover.

4.4.3.2 Unrealistic target date set for completion

The time frame for completion of the project had to be fixed keeping the project report in mind. The Industries Department, however, even before preparation (July 2010) of Detailed Project Report (DPR) set (June 2010) the deadline of December 2010 for completion of the project. Based on this, the Company allowed only four months to the contractors for completing civil works. The target dates fixed were grossly unrealistic. The delivery period of minimum 12-15 months quoted by the machinery manufacturers as well as the actual time of 13/14 months took for completion of civil constructions substantiated this.

The Company stated (September 2013) that the Government had fixed that target date after taking into account all aspects. The reply was incorrect as Government fixed (June 2010) the target even before preparation (July 2010) of DPR.

[71] **Prabhuram Mills, Chengannur, Kottayam Textiles, Kottayam, Edarikkode Mills, Kottakkal and Malabar Spinning and Weaving Mills, Kozhikode.**

4.4.3.3 Declaring a Brown Field Project as Green Field Project for making investment

Green Field Investment refers to investment in an area where no previous facility exists. The Government, however, took over Kerala Spinners Limited (KSL), a private sick textile unit under reference to Board for Industrial and Financial Reconstruction (BIFR) and paid compensation of ₹5.18 crore to the employees of KSL with an undertaking to provide employment to them. Thus, under the pretext of Green Field, the Government took up a Brown Field Project and invested ₹49.81 crore in a sick company.

4.4.3.4 Taking over Kerala Spinners Limited without following due process

A BIFR referred industrial unit was to be first brought out of BIFR reference before taking over and making further investments. The Industries Department, however, took over KSL through an Ordinance[72] without bringing it out of BIFR reference and transferred it to the Company for establishing the Komalapuram Hi-Tech Spinning and Weaving Mills. The Ordinance was subsequently passed as Act 4[73] of 2010 (Act).

The major stakeholders of KSL challenged the constitutional validity of the Act and the Hon'ble High Court directed (September 2010/February 2011) the Company not to alienate or bring about any encumbrance over the property of the unit and stated that all further steps being pursued would be subject to the outcome of the writ petition, which has not been pronounced so far (January 2014). Thus, the sustainability of the takeover of the unit and subsequent investment of ₹49.81 crore for the mill were at stake. The Company stated (September 2013) that the unit was taken over since there were demands from different corners for takeover. The reply was not acceptable as legal procedures should have been followed before making huge investment of Government funds.

4.4.3.5 Arbitrary selection of the Consultants

The Company nominated (March 2010) two firms, one Cost Accountant firm for Komalapuram mill and one Chartered Accountant firm for Pinarayi and Uduma mills for preparing project reports. Further, preparation of estimates and supervision of civil construction works costing ₹18.24 crore was entrusted (May 2010) to a retired Assistant Executive Engineer from Public Works Department. The Company paid ₹5.65 lakh to these consultants. The Company did not explain the basis for selection of these consultants. Thus, selection of consultants was adhoc and arbitrary.

4.4.4 Deficient project reports

Lack of expertise on the part of the consultants was quite evident from the deficiencies in the preparation of estimates/DPR, technology selected and market projection as discussed below:

[72] **No. 24/2009**
[73] **The Kerala Spinners, Alappuzha (Acquisition and Transfer of Undertaking) Act, 2010.**

- The consultant had not prepared estimates for the civil works at Pinarayi and Uduma mills. Thus, it was left to the contractor to finalise the estimates. During execution, the cost escalated to ₹11.95 crore as against the awarded cost of ₹5.93 crore. In the absence of estimates, Audit was not in a position to comment on the reasonability of the claim.
- Estimates prepared for the civil works at Komalapuram were not based on the actual requirements and were made without considering machine specifications. This necessitated excavation of additional trenches, construction of power house, electrical cable ducts, building for air compressor, etc., which were not envisaged at the time of estimation. Consequently, actual cost on execution increased from ₹3.51 crore to ₹6.29 crore (79 *per cent*).
- A lump sum provision for electrical installations was made in the DPRs for three mills without any drawings and estimates. The actual requirement was left to the contractor for finalisation. As against ₹3.44 crore provided in the work order, the expenditure on actual execution increased to ₹5.44 crore due to change in the size and length of HT cables, earthing materials, installation of mild steel platform covered with chequered plates, use of copper cables in place of aluminium cables originally envisaged, etc.
- The sales turnover projected in the DPR was not supported by any market study or consumer survey.
- The consultant, for Komalapuram mill, had projected a breakeven point (BEP)[74] of 71 *per cent* of capacity utilisation expecting the project cost of ₹36 crore. The cost, however, escalated to ₹51.61 crore[75] due to the deficiencies discussed above which led to increase in depreciation and interest expenditure. Audit estimated that at this cost, the project would break even only at 97 *per cent* which is very unlikely to happen as the capacity utilisation projected in the DPR was only 95 *per cent.* Thus, the project was unviable.

  The Company stated (September 2013) that the final BEP could be calculated only after deciding the mode of investment by the Government for additional project cost. The reply was not acceptable as BEP was one of the basic criteria upon which viability of the project was assessed and approved. Hence, BEP cannot be revised during the course of execution of the project.
- The project report envisaged five *per cent* of the total requirement of power to be met out of own generation. There was, however, no provision for the cost of generator to be procured for this purpose.

4.4.5 Deficiencies in implementation leading to extra expenditure of ₹2.51 crore

Civil construction, procurement and installation of machinery, recruitment of manpower, obtaining electrical connection and various statutory licences were the important aspects in the implementation. Audit found several deficiencies in these areas leading to extra expenditure of ₹2.51 crore as discussed below:

[74] **Break Even Point is the level of production at which there is neither profit nor loss.**
[75] **Including ₹1.80 crore demanded by KSEB for construction of dedicated feeder.**

4.4.6 Awarding of work without tendering

The Company, without inviting competitive bids, entrusted (July/October 2010) the construction works at Uduma and Pinarayi mills for ₹2.33 crore and ₹3.60 crore respectively to the contractor[76] at mutually agreed rates. There were no prior approvals from the Board or Government. The Managing Director, however, justified his action citing urgency and the GoK ratified (October 2010) the same.

The Company stated (September 2013) that it did not incur any loss due to awarding the work without tendering. The reply, however, was not acceptable as the Company did not adhere to the prescribed procedure for awarding contract at competitive rates and as such loss was not ascertainable.

4.4.7 Construction of factory building without acquiring necessary land and required building permit at Pinarayi

As per Kerala Municipal Building Rules (KBR), 1999, any building should be constructed only after obtaining approval of the building plan by competent authority and the ratio of coverage area to built up area should be 60:40[77] (Rule 31).

Audit noticed that:

- Only 1.58 acre of land was acquired (September 2010) at a cost of ₹35.35 lakh instead of 2 acre envisaged in the project report. As a result, the ratio of coverage area to built up area was 45:55 as against the statutory requirement of 65:35.

The Company stated (September 2013) that they started implementing the project in anticipation of acquiring additional land required. The Company, however, did not acquire the land so far (January 2014).

- The construction of the building was completed without obtaining the building permit. The building permit applied for (July 2011) was rejected (December 2011) by the Town Planning Department due to failure in complying with statutory ratio.
- As per KBR, 2011, the width of the approach road to the premises was to be six metres for obtaining occupancy certificate. The width of the approach road constructed was only 4.5 metres. The Grama Panchayat had not issued Occupancy Certificate for the building so far (January 2014) in the absence of which the mill could not function.

The Company stated (September 2013) that additional land would be purchased to increase the width of the approach road. However, the fact remained that the Company has not acquired the additional land so far (January 2014).

4.4.8 Change of technology

The project report envisaged O*pen End (OE) spinning* technology which was less labour intensive and less expensive. The Company while implementing the

[76] **Uralungal Labour Contract Cooperative Society Ltd, Vadakara**
[77] **Revised as 65:35 in the Kerala Panchayat Building Rules (KBR) 2011**

project, changed (October 2010) the technology to *Ring Spinning (RS)* which was costlier and stated that the suppliers were not ready to supply the machinery for the open end mill within the deadline of December 2010. The change in technology was, however, resorted to without conducting cost benefit analysis. The change in technology and consequent change in the Plant and Machinery led to extra expenditure of ₹1.67crore[78].

The Company stated (September 2013) that the approved project costs under both the technologies were same and hence, no extra expenditure was involved. This reply was not acceptable since the costs for *RS* technology was more by ₹1.67 crore than the *OE* technology as per the DPRs.

4.4.9 Procurement of Plant and Machinery

The project envisaged procurement of spindles, air jet looms, sectional warping, etc., at an estimated cost of ₹54.90 crore. The Company, after inviting competitive tenders, placed orders for procurement of Plant and Machinery for ₹65.75 crore from indigenous as well as foreign sources. Audit observed that:

- The suppliers of Plant and Machinery provided performance warranty for periods ranging from six months to eighteen months from the date of delivery. The Plant and Machinery received were not commissioned and tested to ensure satisfactory performance of the machines. Many of the machines (costing ₹12.07 crore) were received after the inauguration (January-February 2011) of the mills and some of the machines namely simplex machines, humidification plant, overhead travelling cleaner, splicers for cone winding machines, etc., already received were not erected or commissioned. The warranty period of all the machines expired in December 2012. Thus, the Company was deprived of the benefits under guarantee/warranty. Non-use of machinery for long periods might result in obsolescence, deterioration in quality, etc.

The Company stated (September 2013) that though the warranty/guarantee expired, they did not anticipate any obsolescence.



Unused machinery in covered condition at Komalapuram (May 2013)and Pinarayi (April 2013)

[78] **₹ 10.39 crore (Cost as per DPR of RS technology) - ₹ 8.72 crore (Cost as per DPR for OE technology)**

4.4.10 Bleak prospect of the project becoming operational

The present status of the various components of project implementation indicated bleak prospect of the project becoming operational. The major hurdles to make the mills operational are explained below:

4.4.10.1 Inability to operate mills due to absence of licences

To commence operation, the mills have to obtain licences from different authorities after complying with various legal provisions pertaining to factories. The present status (January 2014) of the licences are as shown below:

Table 4.20: Present status of licences

Sl No	Name of licence	Issuing Authority	Mills			Remarks
			Komalapuram	Pinarayi	Uduma	
1.	Factory licence	Directorate of Factories and Boilers	Received in September 2012	Received in August 2013	Received in June 2012	Pinarayi mill applied in May 2013
2.	Electrical Inspectorate approval	Chief Electrical Inspectorate, Thiruvananthapuram	Received in December 2012	Received in November 2011	Received in June 2011	Received after inauguration
3.	Panchayat Licence	Grama Panchayat	Not received	Not received	Not received	Non receipt of Fire and Safety certificate
4.	Certificate of Fire and Safety	Department of Fire and Safety	Not received	Not received	Not received	Not yet applied
5.	Consent from Pollution Control Board (PCB)	Kerala State PCB	Received in November 2013	Received in October 2011	Received in November 2011	Komalapuram mill applied in May 2011

In the absence of these licences, commencement of operations in the near future is unlikely.

4.4.10.2 Absence of man power to run the mills

The Industries Department[79] (January 2011) created 695[80] posts as per the manpower requirements envisaged in the project reports and outsourced the recruitment to Kerala State Productivity Council (KSPC). KSPC commenced the process of recruitment in January 2011 which was targeted to be completed within a short span of two months (February 2011). The Company paid ₹55.31 lakh as remuneration to KSPC.

The ex-employees of erstwhile KSL as well as other candidates challenged the fairness and transparency of the recruitment process in the Hon'ble High Court of Kerala. The major issues were:

(i) the former employees of KSL were not considered for appointment as provided in the Act[81] taking over the mill,

[79] GO (MS) No. 1/2011/ID dated 01.01.2011 of Industries Department
[80] 352 for Komalapuram, 160 for Pinarayi and 183 for Uduma mills.
[81] Act 4 of 2010 passed for taking over KSL.

(ii) procedural lapses like sending call letters after the conduct of written test, etc.

Accepting these contentions, the Hon'ble High Court stayed (February 2011) the selection process. Based on this, GoK cancelled (December 2011) the rank list[82]. Thus, the fee of ₹55.31 lakh paid to the recruitment agency also became unfruitful.

4.4.10.3 Absence of electric power at Komalapuram

The existing KSEB feeder line had spare capacity to provide only 400 KVA and the KSEB then advised the Company to draw a dedicated feeder for availing 2000 KVA at a cost of ₹1.80 crore. The Company, however, failed to deposit the money due to paucity of funds and in the circumstances, the power connection had not been obtained for operating the mill (January 2014).

4.4.11 Inauguration of mills which were not ready for commissioning

Due to issues brought out above, the Company was in no position to commence operations. Despite this, the Company took several adhoc measures to give a semblance of completion to the mills. For instance, at Komalapuram, the Company hired generator to conduct the trial run of the machines for inauguration instead of getting a permanent power connection from KSEB. Two mills - Uduma and Komalapuram - were inaugurated in January 2011 and February 2011 respectively after incurring an expenditure of ₹28.82 lakh for putting in place such temporary arrangements. After the inauguration was over, the Industries Department and the Company did not initiate any steps to make the mills operational and the position remained as such as of January 2014.

The Company stated (September 2013) that the mills were inaugurated at the instance of Government.

4.4.12 Financial Impact of unfruitful venture

Besides the investment of ₹98.68 crore in the project, the Company had incurred ₹5.18 crore towards compensation to employees of KSL and accrued interest of ₹11.71[83] crore upto March 2013. Thus, the total expenditure of ₹115.57 crore remained unproductive.

4.4.13 Drawing of ₹45 crore from the profit of KMML

As directed by the Industries Department, KMML advanced ₹45 crore (54 *per cent* of the cost) for financing the project. This advance of ₹45 crore offered by KMML, a profit making PSU to the Company which was a loss making sick industrial unit, was not a prudent financial decision as it did not yield any tangible benefit and led to diversion of scarce resource of a profitable PSU into an unproductive project.

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[82] Out of 695 candidates in the rank list 27 candidates who had joined before the order of the Hon'ble High Court were allowed to continue.

[83] Interest incurred up to 31 March 2013 excluding ₹2.43 crore already capitalised.

4.4.14 Failure to fulfill export obligations of machinery under EPCG Scheme

The Company availed concessional import duty of ₹8.25 crore under Export Promotion Capital Goods (EPCG) scheme on machinery and equipment imported for the period from November 2010 to March 2011, proposed to be utilised in Komalapuram (₹4.73 crore), Pinarayi (₹2.73 crore) and Uduma (₹0.79 crore) projects.

Scrutiny of records revealed that:

- As per the EPCG scheme of GoI, import of capital equipment used in manufacture of goods was permitted at concessional rates of duty. To avail this, the Company was to submit installation certificate of the imported machinery within six months from the date of such import and was also under obligation to export goods worth eight times the duty saved within eight years.
- The Company failed to submit installation certificates of machinery to foreign trade authorities within six months from the date of import.
- The export obligation to be fulfilled by the Company was ₹66 crore and 50 *per cent* of the same (₹33 crore) was to be fulfilled before November 2016 i.e. within six years of obtaining EPCG authorisation. The chances of fulfilling the export obligation were remote as the mills did not start commercial production till date (January 2014).

In the event of default in meeting the aforesaid obligations, the liability would arise to the Company to refund the concessional import duty of ₹8.25 crore availed with penal interest of 15 *per cent* (₹1.24 crore) per annum from the date of import.

The Company stated that since there was time upto November 2016, the question of refund of saved duty did not arise at this point of time.

4.4.15 Recurring burden on the Company

In addition to the onetime expenditure as mentioned above, the Company is saddled with a recurring expenditure of ₹7.32 crore per annum on account of the following two components *viz.* interest burden and recurring expenses.

4.4.15.1 Additional interest burden

At the time of announcement of the project, the Company was a loss making undertaking and the accumulated loss as on 31 March 2010 stood at ₹54.72 crore as against the paid up share capital of ₹58.47 crore. Further, it availed loan of ₹63.19 crore from KMML (₹22.50[84] crore) and Government (₹40.69 crore including ₹5.18 crore availed for discharging the liabilities to the employees of KSL) for implementation of the project. As the three projects were not operational, the Company could not service the loan and the debt liability on this account rose to ₹77.33 crore including accrued interest (₹14.14 crore) upto to 31 March 2013 and overburdened with additional interest liability of ₹6.27 crore[85] per annum.

[84] **KMML financed a loan of ₹45.00 crore in the ratio of 50 *per cent* as equity and 50 *per cent* as loan.**
[85] **Interest burden per annum on loan of ₹63.19 crore.**

4.4.15.2 Recurring expenses

Though the projects were not operational, the Company had engaged ten permanent personnel at the three mills incurring idle wages of ₹0.35 crore per annum. Further, it was incurring an annual expenditure of ₹0.15 crore towards expenditure on watch and ward and ₹0.55 crore towards other expenses. Thus, the Company was incurring an expenditure of ₹1.05 crore per annum for maintaining these three idle mills.

The project was taken up violating all procedures such as preparation of estimates, realistic planning, awarding contracts through tendering, etc. Government took up all liabilities of a sick textile unit, wrongly classified it as a Green Field Project and set unrealistic milestones for completion. This made the investment of ₹115.57 crore idle and the project was saddled with annual loan service/maintenance expenses of ₹7.32 crore.

The matter was reported to the Government in July 2013; their reply was awaited (January 2014).

Kerala State Industrial Development Corporation Limited

4.5 Undue favour

Loss of ₹2.00 crore due to one time settlement of outstanding loan in violation of laid down OTS Policy.

Kerala State Industrial Development Corporation Limited (Company) was incorporated in July 1961 as a fully owned Government Company and is presently engaged in term-loan financing of medium and large scale industrial undertakings, with loan period normally ranging from six to eight years. As per the latest finalised accounts, the non-current loans and advances outstanding as on 31 March 2012 was ₹322.04 crore, of which ₹54.30 crore fell in sub-standard[86] and ₹5.30 crore in doubtful[87] categories. The Company framed 'One Time Settlement' (OTS) Policy 2008 as a last resort to recover its dues, which was approved (October 2009) by Government of Kerala.

As per the OTS Policy, proposals for granting OTS were to be evaluated by the OTS Committee and approved by the Board of Directors of the Company. The eligibility criteria for OTS stipulated that the loanee should have completed five years after its incorporation and its net worth should have been eroded by its accumulated losses. Before arriving at the OTS amount, all the securities were to be revalued by an Approved Valuer to assess the Distress Value (DV) and interest for the entire period of the loan was to be recomputed at simple interest to arrive at the Recomputed Loan Payable (RLP), which would be lesser than total

[86] **Sub-standard: loans which were non-performing asset (NPA) for a period up to one year. A loan is treated as NPA when it is overdue for more than 90 days.**
[87] **Doubtful: Loan which remained in substandard category for more than 12 months.**

outstanding amount of the loan. Final decision on OTS would be guided by the following:

- OTS should not be given where the DV is greater than the total dues payable to the Company.
- Where the DV is less than the total loan payable, but greater than the RLP, the DV should be deemed to be payable as OTS.
- Where the DV is less than the RLP, the OTS should be the best negotiated figure between DV and RLP.

Audit noticed that Company settled (May 2011) outstanding loan amount of ₹8.33 crore of Ganam Hotels Limited, Ernakulam for ₹1.70 crore without assessing the RLP/DV. However, the loanee had itself assessed DV of assets as ₹3.70 crore in January 2010.

The Board approved the recommendations of the OTS Committee, though the same was a deviation from the OTS Policy. This resulted in extension of undue favour to the loanee and loss to the Company to the extent of ₹2.00 crore considering DV of ₹3.70 crore.

The Company replied (September 2013) that proposal was for reviving the old OTS Scheme sanctioned in March 2006 and hence valuation of assets was not considered.

The reply was not acceptable as the validity of earlier OTS scheme had already expired and Company deviated from Government approved OTS policy while extending OTS to the party.

The matter was reported to the Government in September 2013; their reply was awaited (January 2014).

Transformers and Electricals Kerala Limited

4.6 Avoidable expenditure

Short remittance of advance income tax due to wrong estimation of current income resulted in avoidable payment of interest of ₹ 1.17 crore.

Section 208 of the Income Tax Act, 1961 stipulates that advance tax shall be payable during a financial year where the amount of tax payable by the assessee as computed in accordance with the provisions of the Act is ₹10,000 or more (₹5,000 prior to financial year 2009-10). Further, as per Section 210 read with Section 211 of the Act, each person who is liable to pay advance tax under Section 208 shall, of his own accord, estimate his current income, compute the tax thereon and pay it in four installments during each financial year (on or before 15 June, 15 September, 15 December and 15 March). Failure of the assessee to pay advance tax or if the advance tax paid is less than 90 *per cent* of the assessed tax, or the assessee being a company, the advance tax paid in each quarter is less than

the prescribed percentage, it is liable to pay simple interest at the rate of one *per cent* per month on the amount of the shortfall (Section 234B and C).

Transformers and Electricals Kerala Limited (Company) is a profit making Public Sector Undertaking (PSU) engaged in the manufacture of power transformers. The Company earned profit of ₹50.81 crore and ₹45.58 crore during the financial years 2008-09 and 2009-10 respectively and was liable to pay advance tax in four instalments between June and March of the respective financial years. The Company, however, did not remit any advance tax during the first three quarters in 2008-09 and remitted ₹7.50 crore in March 2009 which constituted only 65.39 *per cent* of the tax due (₹11.47 crore). Similarly in 2009-10, though the Company remitted advance tax quarterly, the total tax paid upto March 2010 was ₹11.92 crore which constituted only 81.59 *per cent* of the tax due (₹14.61 crore). As the Company did not remit advance tax on due dates and the advance tax remitted was less than 90 *per cent* of the total tax due in 2008-09 and 2009-10, it had to pay (December 2009 and August 2010) interest of ₹1.17 crore under Section 234B (₹0.42 crore) and 234C (₹0.75 crore) of the Act.

Government replied (July 2013) that it was difficult to estimate precisely profitability for future periods due to external factors. It was also stated that during 2008-09 and 2009-10, on account of currency fluctuations, earnings were higher and due to change in product mix material cost during these years were less than budgeted cost.

The reply was not acceptable as the Company carried out production against confirmed orders only and there was no ambiguity regarding sales turnover and profit. Moreover, the Company did not avail the opportunity to make up the shortfall in payment of advance tax, in the succeeding quarter or in the last quarter to avoid the burden of interest.

Kerala Electrical and Allied Engineering Company Limited

4.7 Non - refund of Excise Duty

Failure to claim refund of excise duty within the time limit prescribed resulted in loss of ₹44.58 lakh

Kerala Electrical and Allied Engineering Company Limited (Company), is a registered manufacturer and supplier of transformers of different ratings to various electricity utilities including Kerala State Electricity Board (KSEB). During 2008-2012, the Company sold 16581 transformers of various capacities (25 KVA to 5 MVA) for ₹174.92 crore to bulk consumers. As per the terms of the purchase orders, the prices of transformers were variable based on the raw material price index published by Indian Electronic and Electrical Manufacturers Association (IEEMA). The Company was remitting excise duty at the purchase order price on removal of transformers. At the time of removal of the above

16581 transformers from the factory premises, the Company remitted ₹14.91 crore towards excise duty on the purchase order value.
In respect of these transformers, however, the actual sale price was to be re-fixed at a later date as the IEEMA rates for a particular month would be known only later. Thus, the actual excise duty was assessed at a later date when the final sale price was fixed. The difference in duty had to be remitted or refund claimed, as the case may be. In case of refund, the claim had to be preferred within the time limit of one year from date of payment of excise duty as stipulated in Section 11B of the Central Excise Act, 1944.

On scrutiny of the records, Audit noticed that:

- On re-fixing the price of these transformers, based on IEEMA price index, the final price of 8322 number of transformers was lower than the purchase order price by ₹538.29 lakh[88]. The excess duty paid on this difference was ₹44.58 lakh. Thus, the Company was eligible to get the duty refund from the Central Excise Department, if claimed within one year.
- The Company, however, applied (November 2010 to June 2012) for refund of the excess paid excise duty of ₹44.58 lakh belatedly after a lapse of more than one year from the date(s) of payment of duty. All the refund claims were rejected by Central Excise Department citing delay in preferring the claims. The delay in raising claim for refund beyond the time limit fixed in the Statute cannot be condoned on any account. Therefore, the chances of allowing the refund claims even in appeals are remote. As such, failure of the Company to prefer the refund claims within the stipulated time of one year resulted in loss of ₹44.58 lakh.

The Company replied (September 2013) that there was significant delay in getting information of the refixed price from KSEB on the basis of IEEMA formula. As a result of this, time limit of one year for preferring claim for refund with Excise Department could not be complied with.

The reply was not acceptable. As the IEEMA index was publicly available the Company should have itself refixed the price without depending on KSEB and preferred the claim for refund.
The matter was reported to the Government in September 2013; their reply was awaited (January 2014).

Statutory Corporations

Kerala State Electricity Board

4.8 Deficiencies in settlement of revenue arrears of HT/EHT consumers

4.8.1. One Time Settlement Scheme

Kerala State Electricity Board (KSEB) had arrears of ₹917.54 crore of electricity

[88] As worked out by Audit from the statements provided by the Company.

charges due from High Tension/Extra High Tension[89] (HT/EHT) consumers as on 31 December 2004 which included ₹496.11 crore (54 *per cent*) from private consumers. Hence, KSEB introduced (May 2005) One Time Settlement (OTS) Scheme to facilitate speedy and efficient settlement of pending disputed cases of arrears of HT/EHT consumers. Arrears of revenue included principal and interest. OTS envisaged reduction of interest rate subject to the clearance of all the arrears either in lump sum or in instalments. The Scheme was envisaged for two months from May to June 2005 and the consumer who was desired to avail the benefit of the Scheme had to apply on or before 30 June 2005. However, the scheme was further extended up to 31 March 2013 for different category of consumers with different time frame applicability conditions (***Annexure 25***).

Audit analysed the settlement of arrears under OTS Scheme during the period 2010-11 to 2012-13 and observed that:

- As on 31 March 2013, there were 1094 consumers having arrears valuing ₹1383 crore. Of these KSEB had settled arrears of 32 cases during the period 2010-11 to 2012-13 with outstanding dues of ₹85.98 crore under its OTS Scheme. KSEB, thus, could not achieve much progress in collection of arrears as only 32 out of 1094 consumers with outstanding dues of ₹85.98 crore could be settled during the period 2010-11 to 2012-13 by collecting an amount of ₹34.51 crore (₹26.31 crore towards principal and ₹8.20 towards interest).The year-wise details of cases settled, amounts outstanding, recovered and waived are shown in ***Annexure 26.***

Settlement of arrears as per Government directives

4.8.2. Waiver of Minimum Demand Charges

The Government of Kerala (GoK) introduced (February 2006) Minimum Demand Charges[90](MD) waiver scheme which was modified from time to time. As per the scheme, GoK had given special directives to clear the arrears of closed industrial and plantation units with the conditions that the industrial units likely to avail the benefit should have functioned for minimum three years and the cases which had been settled earlier would not be re-opened. The waiver of MD charges levied during the closure period was applicable only to consumers belonging to industrial and plantation category and was valid up to 31 December 2012. The closed unit should also reopen within 31 December 2012 and function for a minimum period of six months after reopening. KSEB had adopted (September 2010) the Government order on waiver of MD charges on the condition that the amount so waived should be reimbursed by the Government in accordance with Section 65[91] of the Electricity Act, 2003.

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[89] **HT consumers - consumers supplied with electrical energy at a voltage of 11000/22000/33000 Volts and EHT consumers at voltage above 33000 Volts.**

[90] **Minimum Demand charges means fixed charges levied on HT/EHT consumers based on their contracted demand.**

[91] **Section 65 states that if the State Government requires to grant any subsidy to any consumer in the tariff determined by SERC it shall be paid in advance in the manner as may be specified by the SERC provided no such direction of the State Government shall be operative if the payment is not paid in accordance with the provisions contained in this Section and the tariff fixed by the SERC shall be applicable.**

Audit analysed Waiver of MD charges during the period 2004-05 to 2012-13 and observed the following:

- Though the Government aimed at revival of defunct industrial/plantation units by waiver of MD charges, 12 out of 28 units were not functioning as on date (January 2014) defeating the very purpose of the Scheme.
- KSEB had waived MD charges aggregating to ₹15.78 crore in respect of 28 consumers. Though KSEB preferred (July 2013) the claim with the Government, it did not reimburse the amount so far (January 2014).

Government stated that KSEB had preferred the claim with the Government and the follow ups were going on for the reimbursement.

Special dispensations for two companies

KSEB settled arrears of two companies viz., Binani Zinc Limited (November 2010) and Punalur Paper Mills (August/December 2010) as per directives of GoK. In this regard Audit observed the following:

4.8.3 Binani Zinc Limited (BZL) had arrears of ₹51.69 crore as on 28 February 2011 due to a pending litigation over the authority of KSEB to revise the tariff. The Industries Department (Department) issued directions (November 2010) to settle the dues. It directed KSEB to adjust the amounts already remitted by them on previous occasions, first against principal (as against the normal practice of KSEB to adjust the amount remitted first against the penal interest) and to collect the balance in 32 instalments with nine *per cent* interest. It assured KSEB that the Department would reimburse KSEB any concession granted over and above that offered under the OTS scheme of KSEB.

Accordingly, KSEB worked out the amount to be remitted as per the Department directive at ₹27.29 crore and treated as settled (February 2011) the arrears of ₹51.69 crore. KSEB also allowed BZL to pay this amount in 32 monthly instalments commencing from 30 March 2011 without levying interest. Had the KSEB settled the arrears under its normal scheme same should have been settled at ₹40.80crore. The loss suffered by KSEB due to extension of concession over and above its normal OTS scheme was ₹19.55 crore as detailed below:

Table 4.21: Concession extended over and above the normal OTS Scheme

(₹ in crore)

Sl.No.	Item	Principal	Interest	Total
1	Amount to be remitted under normal OTS Scheme of KSEB	29.81	10.99	40.80
2	Settled amount on the basis of Department's directions*	13.60	13.69	27.29
3	Concession granted over and above normal OTS scheme of KSEB	16.21	(-)2.70	13.51
4	Differential Interest (between 15 and 9 *per cent*) due on sanctioning 32 instalments	--	6.04	6.04
5	Total dues from Government (3+4)			**19.55**

*The amounts remitted by BZL during February 2004 to October 2010 which were earlier adjusted against penal interest were re-adjusted against the principal thereby bringing down the outstanding Principal of ₹29.81 crore to ₹13.60 crore.

As against the total dues of ₹19.55 crore, KSEB later claimed (August 2011) ₹6.04 crore only being loss due to differential interest on settled amount payable in 32 monthly instalments. KSEB did not claim the concession extended over and above the normal OTS Scheme amounting to ₹13.51 crore.

The Department did not reimburse even the claimed amount of ₹6.04 crore so far (January 2014) as Finance Department rejected the claim stating that the Government Order (GO) was issued without consulting them and no provision was made in the Budget for such payments.

The Power Department stated that as per GO the amount already paid by the consumer was to be adjusted against the principal, the interest was to be charged at the rate of nine *per cent* on the balance principal and the consumer be allowed to remit the arrear amount in 32 instalments. No interest was to be charged during the instalment period. Such concession granted over and above OTS would be reimbursed by Government. It disagreed with the calculation of Audit stating that it was not matching with the accounts of KSEB.

The reply was not acceptable as the Department had assured[92] reimbursement of the amount of concession granted by KSEB over and above that offered under OTS scheme of KSEB. In this case, as KSEB adjusted the payments already made against principal and applied interest rate at nine *per cent* as per GO as against 15 *per cent* permissible in cases where payment is made in instalments this deviation should have been considered by KSEB for claiming reimbursement. Further, Audit had worked out the loss on the basis of normal practice of adjusting the payments already made in the order of priority prescribed[93] in the Supply Code and by applying 15 *per cent*, interest as the settlement was made in monthly instalments and not in lumpsum.

4.8.4 The arrears of ₹16 crore payable by Punalur Paper Mills Limited, whose service was under disconnection from October 1992 due to non-payment of electricity charges, was settled (September 2011) at ₹0.95 crore by waiving ₹15.05 crore. This settlement was made as per Government Order (August/December 2010) adopted by Full Time Members (FTM) in September 2010 and Full Board in May 2012. While adopting the GO, KSEB also decided to approach the Government to make good the loss due to implementation of the order under Section 65 of the Electricity Act 2003. Audit observed that the Government had informed (July 2011) beforehand that Section 65 would not be applicable in this case. The decision of the Board to waive the dues without ensuring reimbursement from the Government resulted in a loss of ₹15.05 crore to KSEB.

Government stated that an MOU had been signed between the Government and the Company during 2002 after a series of high-level deliberations with various departments including KSEB. Government had given waiver of MD charges,

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[92] **GO No: 1555/2010/Industries dated 6.11.2010**

[93] **As per section 22 of Supply Code 2005, payments made by the consumer will be adjusted in the following priority. 1) Interest on duty arrears 2) Duty arrears 3) Interest on electricity charge arrears 4) Electricity charge arrears 5) Current months due.**

incentive and subsidies, exemption in taxes, duties etc. in order to promote industries with a view to increase employment opportunities and such other benefit to society. The reply was not acceptable as KSEB failed to apprise the Government about the provisions of the Act and loss sustainable by giving concessions as per GO to safeguard its financial interest.

The revenue arrears as on 31 March 2013 stood at a high ₹1383 crore. Thus it can be seen from cases cited above that introduction of OTS and issue of special directives for settlement of arrears did not result in collection of even the reduced dues. Since the chance of settlement of arrears was not encouraging, stringent action against defaulters should be taken and revenue recovery proceedings initiated by KSEB as envisaged in the Codal provisions[94].

4.9 Undue favour

Undue favour of ₹0.56 crore to contractor due to non-levy of penalty

Kerala State Electricity Board (KSEB) commissioned Neriamangalam Extension Scheme (NES) in May 2008 as an addition to the series of power development projects in Mudirapuzha Basin envisaged to utilise about 40 *per cent* (167 million cubic metre) of total spill water of existing Kallarkutty Reservoir to generate 58.27 MU per annum. The Hydro Mechanical and Electro Mechanical works of the NES (1x25MW) was carried out by a Consortium of Contractors[95] at a cost of ₹35.06 crore. The Provisional Acceptance Certificate (PAC) of the project was issued on 17 September 2008. Performance of the NES station was covered by a Bank Guarantee for ₹77.40 lakh for a period of three years up to 16 September 2011 which was further extended to 30 March 2013.

As per Clause H-47 of the tender conditions, forming part of the agreement executed (May 2003) by the KSEB, the Contractor was bound to ensure performance of the power project and to guarantee repair/rectify the defects free of charge for a period of three years from the date of completion of erection of machines and final tests or date of commercial operation whichever was later. If the defects occurring during the guarantee period were not rectified by the Contractor within reasonable time, penalty for the delayed period beyond reasonable time, at the rate of ₹50,000 per day, had to be charged for compensating the loss in generation. KSEB was empowered to fix the reasonable time for rectification, taking into account various aspects.

During the guarantee period, there were two major and three minor forced shutdowns due to machine fault. Audit noticed that, there was a delay of 111 days beyond the reasonable period of 20 days determined by KSEB after 38 days of shutdown for repair as indicated below:

[94] **Clause 36 of KSEB Terms and Conditions of Supply, 2005.**
[95] **VA Tech Escher Wyss Flovel Limited, Faridabad, VA Tech Hydro (P) Limited, Bhopal and Asian Techs Ltd, Ernakulam**

Table 4.22: Details of shutdown and time taken to rectify defect

Period of shutdown	Total No. of days	Reason for shutdown	Reasonable time fixed by KSEB to rectify defect	Delay in excess of reasonable time (in days)
06.09.2011 to 23.02.2012	169	Water leakage through shaft seal	Within 20 days from 14.10.11 i.e. by 3.11.11[96]	111

As seen from the above, the Contractor took 111 days more than the reasonable time for rectification of defects. Further, there was reported generation loss of 18.716 million units of electricity and KSEB had to incur an extra expenditure of ₹ 7.26 crore[97] towards purchase of electricity from outside sources.

The penalty recoverable as per the agreement worked out to ₹0.56 crore[98] for 111 days at the rate of ₹50,000 per day. KSEB, however, did not invoke any penalty for the delays as envisaged in Clause H-47 of the agreement even when there was reported generation loss. Further, in the absence of recorded reasons, Audit could not verify the rationale behind fixing ₹50,000 per day as penalty. In this context it is worth mentioning that in a similar contract for another project awarded to the same contractor, the penalty was fixed at ₹10,000 per day per 0.5 MW capacity of the project.

The Government stated (September 2013) that the Contractor was required to make some design changes to avoid recurrence of faults of the machine and therefore 169 days taken by the Contractor was reasonable and the design modification accrued advantages to the Board in long run. It was also stated that the Chief Engineer (Generation) had recommended for recovery of penalty to the extent of ₹12.50 lakh and same was not imposed considering the above benefits to KSEB.

The reply was not acceptable as the Contractor started rectification work only on 10 February 2012[99] (157 days after shut down) and completed the work within 14 days and the machine was synchronized to grid on 23 February 2012. This indicated modification was a minor one and necessitated due to the defect in equipment.

Thus, the Board favoured the Contractor by not levying penalty amounting to ₹0.56 crore. This was despite reported generation loss of ₹7.26 crore.

[96] **The Chairman of KSEB convened a meeting with the Contractor on 14 October 2011 (after 38 days) and ordered to complete the rectification work within 20 days (i.e. by 3 November 2011).Thus, against a total delay of 169 days, 58 days were excluded and the balance 111 days only considered**

[97] **Reckoned at the average purchase price of ₹ 3.88 per unit during 2011-12**

[98] **₹ 50,000 x 111 days= ₹55,50,000**

[99] **As per the detailed report (March 2012) of the Deputy Chief Engineer (Generation), Meencut on second forced shutdown.**

Kerala State Road Transport Corporation

4.10 Avoidable payment of interest

Delay in remittance of Service Tax resulted in avoidable interest payment of ₹ 31.66 lakh

Kerala State Road Transport Corporation (Corporation), the Public Sector Transport Utility, had let out various passenger amenities like stalls, paid urinals, canteens, etc., at its 75 bus stations. Renting of immovable property was included as a taxable service with effect from 01 June 2007 vide Government of India Notification No. 23/2007 S.T dated 22 May 2007. Accordingly the Corporation was liable to collect and remit Service Tax at the rate of 12.36 *per cent* on rental income. The Chief Engineer (Project & Civil Wing) of the Corporation directed (September 2007) all Unit Officers to collect Service Tax with effect from 01 June 2007 on the rent. The Corporation collected an amount of ₹ 125.53 lakh as Service Tax on rent for the period 01 June 2007 to 31 March 2010. The Corporation, however, failed to remit it to the account of the Central Government within the time limit prescribed [100] and the delay ranged from 11 to 1028 days. As a result, the Corporation paid interest of ₹31.66 lakh.

The Chairman and Managing Director (CMD) justified the delay stating that (September 2013) the Corporation could use the tax collected for meeting its requirements of working capital and had gained by not paying Service Tax collected. The reply was not tenable as the Corporation, being a Public Sector Undertaking, all the more, should have adhered to statutory provisions in this regard.

Thus, delay in payment of tax violating the provisions of the Finance Act resulted in avoidable payment of interest of ₹ 31.66 lakh.

The matter was reported to the Government in August 2013; their reply was awaited (January 2014).

General

4.11 Follow-up action on Audit Reports

Explanatory notes*[101] *outstanding

4.11.1 The Audit Reports of the CAG represent the culmination of the process of scrutiny starting with initial inspection of accounts and records maintained in the various Government companies and Statutory corporations. It is, therefore,

[100] As per Rule 6 of Service Tax Rules, 1994 Service Tax shall be paid to the credit of the Central Government by the 6th day of the month, if the duty is deposited electronically through internet banking; and by the 5th day of the month, in any other case, immediately following the calendar month in which the service is deemed to be provided as per the rules framed in this regard.

[101] Explanatory notes refer to the explanations furnished by Administrative Departments to the Legislature Secretariat, on performance audit / paragraphs contained in Audit Reports placed before the Legislature.

necessary that they elicit appropriate and timely response from the executive. Finance department, Government of Kerala issued (April 2005) instructions to all administrative departments to submit explanatory notes indicating a corrective/ remedial action taken or proposed to be taken on paragraphs and performance audits included in the Audit Reports within two months of their presentation to the Legislature, without waiting for any notice or call from the Committee on Public Undertakings (COPU).

The Audit Reports for the years up to 2011-12 had been presented to the State Legislature but nine departments did not furnish explanatory notes on 21 out of 186 paragraphs/performance audits relating to the Audit Reports for the year 2004-05 to 2011-12 as of September 2013 of which nine paragraphs were more than three years old.

Compliance to Reports of Committee on Public Undertakings outstanding

4.11.2 As per the Handbook of Instructions for Speedy Settlement of Audit Objections issued by the State Government the replies to paragraphs of COPU are required to be furnished within two months from the presentation of the Reports by COPU to the State Legislature. Action Taken Notes (ATNs) to 250 paragraphs pertaining to 43 Reports of the COPU presented to the State Legislature between July 2000 and July 2013 had not been received as of September 2013 as shown below:

Table 4.23: Details of ATNs pending

Year of the COPU Report	Total number of Reports involved	No. of paragraphs where ATNs not received
1998-2000	2	13
2001-2004	1	3
2004-2006	4	17
2006-2008	10	55
2008-2011	15	54
2011-2014	11	108
Total	**43**	**250**

4.12 Response to Inspection Reports, Draft Paragraphs and Performance Audit Reports

Audit observations made during audit and not settled on the spot are communicated to the heads of the PSUs and the departments concerned of the State Government through Inspection Reports (IRs). The heads of PSUs were required to furnish replies to the IRs through the respective heads of departments within a period of four weeks. IRs issued up to March 2013 pertaining to 82 PSUs disclosed that 2935 paragraphs relating to 528 IRs remained outstanding at the end of September 2013. Of these, 28 IRs containing 302 paragraphs had not been replied to for one to three years. Department-wise break up of IRs and paragraphs outstanding as on 30 September 2013 is given in ***Annexure 27.***

Similarly Draft Paragraphs and Reports on Performance Audit on the working of PSUs are forwarded to the Principal Secretary/Secretary of the Administrative Department concerned demi-officially seeking confirmation of facts and figures and their comments thereon within a period of six weeks. It was, however, observed that five Draft Paragraphs and three Draft Performance Audit Reports forwarded to various departments during July-November 2013 as detailed in ***Annexure 28*** had not been replied to so far (January 2014).

It is recommended that the Government should ensure that (a) procedure exists for action against the officials who fail to send replies to IRs/Draft Paragraphs/ Performance Audit Reports and ATNs on recommendations of COPU as per the prescribed time schedule, (b) action is taken to recover loss/outstanding advances/ overpayment in a time bound schedule and (c) the system of responding to audit observations is revamped.

Thiruvananthapuram
The

(Dr. BIJU JACOB)
Accountant General
(Economic & Revenue Sector Audit)
Kerala

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New Delhi
The

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