FOURTEENTH KERALA LEGISLATIVE ASSEMBLY

COMMITTEE
ON
PUBLIC UNDERTAKINGS
(2016-2019)

TWENTIETH REPORT

(Presented on 9th March, 2017)

SECRETARIAT OF THE KERALA LEGISLATURE
THIRUVANANTHAPURAM
2017

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On

The Kerala State Financial Enterprises Limited

(Based on the Reports of the Comptroller and Auditor General of India for the years ended 31 March, 2006, 2007 and 2013)

387/2017.

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Smt. Deepa V., Under Secretary.

INTRODUCTION

I, the Chairman, Committee on Public Undertakings (2016-2019) having been authorised by the Committee to present the Report on its behalf, present this Twentieth Report on The Kerala State Financial Enterprises Limited based on the reports of the Comptroller and Auditor General of India for the years ended 31 March, 2006, 2007 and 2013 relating to the Public Sector Undertakings of the State of Kerala.

The aforesaid Reports of the Comptroller and Auditor General of India were laid on the Table of the House on 28-3-2007, 26-2-2008 and 10-6-2014 respectively. The Reports, besides other things in their findings, brought to light some functional irregularities relating to the Kerala State Financial Enterprises Limited. The Committee, in connection with the perusal of the reports, took notice of the comparability of the audit paragraphs pertaining to such irregularities and decided to examine them altogether. The consideration of the audit paragraphs included in this report and the examination of the departmental witness in connection thereto were made by the Committee on Public Undertakings constituted for the years 2014-2016.

This report was considered and approved by the Committee (2016-2019) at its meeting held on 2-3-2017.

The Committee places on record its appreciation for the assistance rendered to them by the Accountant General (Audit), Kerala in the examination of the Audit Paragraphs included in this Report.

The Committee wishes to express thanks to the officials of the Taxes Department of the Government Secretariat and the Kerala State Financial Enterprises Limited for placing the materials and information solicited in connection with the examination of the subject. The Committee also wishes to thank in particular the Secretary to Government- Taxes and Finance Departments- and the officials of the Kerala State Financial Enterprises Limited who appeared for evidence and assisted the Committee by placing their views before it.

C. DIVAKARAN,
Chairman,
Committee on Public Undertakings.

Thiruvananthapuram,
9th March, 2017.

REPORT

ON

KERALA STATE FINANCIAL ENTERPRISES LIMITED

AUDIT PARAGRAPH

4.2 (4.2.1 to 4.2.10) 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% 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 subscribers as "veethapalisa" (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

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23. Fore man 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.

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 subcribers 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.

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 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.

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 installments 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 enrollment 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.

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

- *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:

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.

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.

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 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.

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34 Section 23 (a) (I) of the Chit Fund Act, 1982, Section 18 (1) (a) of the Kerala Chitties Act, 1975, rules 27(1) of the Kerala Chit Fund 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.

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

37 Subscriber who is yet to get the prize money.

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 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 Foremen'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 chittes 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

38 As worked out by the Company

39 ₹20000/- per month and above

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 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 installments 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

40 Vide circular No. 19/2009 dated 31-1-2009

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.

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 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 certificate 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 ₹ 25,000 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

44 Chit amount means the sum-total of the subcriptions 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)

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.

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 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.

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45 Vide GO (Rt.) No. 644/2012/TD dated 4-9-2012

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 procedure 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 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.

[Audit Para 4.2 (4.2.1 to 4.2.10) contained in the Report of the Comptroller and Auditor General of India for the year ended 31 March, 2013.]

Notes furnished by the Government on Audit Paragraph are given in Appendix II.

AUDIT PARAGRAPH-**2.4 (2.4.1 to 2.4.15)**

Introduction

2.4.1 The Kerala State Financial Enterprises Limited (KSFE) was incorporated in November 1969 as a Government Company with a view to socialising Chitty* business in the State, so as to ensure safety, security and better service to the public thereby protecting them from exploitation by private financial institutions. The Company also provides other facilities such as Chitty Loan, Gold Loan, Fixed Deposit Loan, Reliable Consumer Loan, Trade Loan, Hire Purchase Loan, Loans under New Housing Finance Scheme and House Modernising

Scheme, Special Car Loan, Sugama Savings Deposit, Akshaya Deposit, Kerala Golden Jubilee Chitty (KGJC) Scheme, etc. to the public. The company with an authorized capital of Rs. 25 crore and paid up capital of Rs. 10 crore earned an operational profit of Rs. 44.12 crore based on an annual turnover of Rs. 268.32 crore during 2005-06 as per the certified annual accounts.

With a view to overcome the threat of efficient customer service by financial institutions like banks, non banking financial institutions and other local chitty institutions with their computerised environment, the Company decided (1999), to go in for complete automation to be implemented in three phases starting with the front office automation of its branch offices. The company selected (July 2000), Accel Limited for analyzing the business requirement, preparing feasibility study of the project and for developing the application software for the Front Office automation of the branch offices. The branch automation software developed by Accel Limited., installed at the two branches, viz. Thrissur Main (November 2001) and Kesavadasapuram (August 2002) was accepted by the company on 17 June 2004 after testing and was rolled out to 12 out of 269 branches as on May 2007.

The Branch Automation Software (BAS) in use in the company has been developed in Red Hat Linux Enterprise edition 3 with Visual Basic as front end and Oracle 9i / 10g as back end.

As on date (May 2007) the total outlay on computerization inclusive of computer, accessories and software amounted to Rs 8.83 crore. The number of PC/ Desktop used in the Company was 620 (HO-98; RO-25; Branches-487 and SDT-10). The additional expenditure estimated for computerization of existing/expected new branches and development of new application software for the HO and RO is Rs. 20.74 crore.

Organisational Structure

2.4.2 The Managing Director, the Chief Executive of the Company, is assisted by a Business Manager and a Finance Manager at the Head Office (H.O.) located at Thrissur. The Senior Manager (IT) reports to both General Manager (Finance) and General Manager (Business) based on functions. The Company has five Regional Offices (R.O.) located at Ernakulam, Kollam, Kozhikode, Thrissur and Thiruvanathapuram, managed by respective Regional Managers and the business is carried out through a network of 269 branch offices (as on 30 April 2007) spread all over the State. The total staff strength of the Company as on 31 March 2006 was 4115, consisting of 1089 Officers, 2397 Assistants, 306 Subordinate Staff and 323 Part-time Employees.

Audit objectives

2.4.3 To increase efficiency and competence in all areas of operations and to overcome the threat of efficient customer services by other financial institutions by;

- Establishing connectivity between all the branches, regional office and head office.
- Introducing internet remittance facilities in selected branches in tie up with selected banks to exploit business from NRI customers.
- Introducing debit cards and virtual branch concept.

Scope and Audit methodology

2.4.4 Considering the investment of Rs 8.83 crore and the anticipated expenditure of Rs. 20.74 crore in the Automation of Business Critical Operations, audit felt it necessary to evaluate the IT governance framework of the project to assess the adequacy of General IT Controls and Application Controls using COBIT framework and Computer Aided Audit Techniques (CAAT).

The audit was conducted during the period March 2007 to May 2007. The branches located at Kesavadasapuram, Thrissur Main, Thrissur Evening and Patturaikkal, the Regional Offices at Ernakulam and Thrissur and the department of IT at Head Office were covered during the review. The detailed audit findings are as given in the succeeding paragraphs.

Audit criteria

2.4.5 The criteria considered for assessing the achievement of audit objectives were

- Targets set up and their achievements regarding project implementation
- Guidelines provided in the functional manuals in respect of chitties,loans etc.,
- Rules and procedures prescribed for the conduct of chitties and sanction, disbursement, follow up as well as recovery of loans.

Project implementation

Absence of IT strategy

2.4.6 The company decided (March 1999) to go in for full computerisation of its branches, to call open tender for providing consultancy services covering system study, programming, implementation etc., and to constitute an expert committee for monitoring the computerisation project. The expert committee selected Accel Limited, the lowest tenderer and awarded (25 July 2000) the firm, the work of conducting feasibility study, developing the most suitable software and implementing the software at the two branches selected for pilot study at their quoted rate of Rs. 10 lakh. The contract period stipulated was five months from the date of order (ie. software to be delivered by December 2000).

As per the original project plan the software developed for front office automation was proposed to be on trial run upto 15 March 2000 and the full automation was proposed to be achieved by 2002-03 including the development of upgraded software for the regional office and head office. The application software developed by Accel Limited was handed over in March 2001 and the cash transactions at Thrissur Main and at Kesavadasapuram were made online in November 2001 and August 2002 respectively. The final acceptance of the Branch Automation Software (BAS) was however effected only on 17 June 2004. Owing to the inordinate delay in acceptance of the 'Branch Automation Software,' the initial plan for total computerisation by 2002-03 failed to materialise. The reasons attributable for the inordinate delay in freezing the software were

- Delay in procurement
- Fragmented implementation/testing of various modules in the software
- Incorrect/ delayed data capturing
- Frequent revision of user requirement specification
- It was observed in audit that
- Though the Board resolved (27 October 2004) to roll out the freezed software to 66 branches (inclusive of 35 existing branches and 31 new branches) and though the hardware and software were ready by April 2006, the company did not succeed in rolling out automation as planned and the Hardware/Software costing Rs. 5.42 crore was kept idle at 56 branches for more than one year as on May 2007. The reasons attributable were the delay in procurement of hardware, site preparation, deciding on branches to be computerised and legacy data capture. Had the 36 new branches launched since June 2004 been automated at the beginning itself, the delay in automation due to the delay in legacy data capture could have been avoided.

- The company procured (January 2005) Oracle Enterprises License (50 User) for head office, Oracle Standard Licenses (355 user) for branches and regional offices, one copy each of Red Hat Linux (Advanced Server Premium) for head office and regional offices and Red Hat Enterprises Server standard Edition for branches at a total cost of Rs. 49.63 lakh inclusive of Annual Technical Support fee. Owing to the delay in procurement of hardware (April 2006), its installation expenditure to the extent of Rs. 8.95 lakh incurred against the Annual Technical Support fee on software licenses procured for 66 branches proposed to be made online became infructuous as the period of technical support expired by February 2006.
- As per the feasibility study and other management reports the manual operation and parallel run was expected to be concurrent only for 6 months and thereafter the surplus manpower was proposed to be redeployed at branches identified for computerisation in the next phase. It has, however, been noticed that in all automated branches, except in Thrissur Main, parallel run and manual accounting are being continued including the four branches which were online for more than six months namely, Kesavadaspuram, Thrissur Evening, Patturaikkal and Kadakkavoor. As such, the envisaged benefit of 40 per cent reduction in employee cost failed to materialise.
- As per the agreement dated 28 September 2004 with Accel Limited the developer assured KSFE all technical support based on agreed rates for maintenance of the BAS and implementation in new office for three years. KSFE has not yet acquired the technical expertise to install, implement and maintain BAS and the agreement will expire by September 2007. As such the company will have to depend upon external agency to implement the BAS, which is legally the property of KSFE when it goes for implementation in other branches in future.

Management stated (September 2007) that the Ist Phase of Branch Automation covering 66 branches was over by June 2007 and that the warranty provided by Accel Limited was extended by one year from 1 August 2007 to 31 July 2008.

Improper testing, Acceptance of BAS

2.4.7 As per the work order (25 July 2000) issued to Accel Limited for the development of application software for the front office computerisation of branches, KSFE reserved the right to suggest necessary changes in the application software developed till trial runs are completed and the application software accepted finally. It was also specified that all modules of the software should be subjected to three level acceptance test. The time schedule for system analysis, prototyping, submission of interim reports, trials and final reports to be furnished by the supplier were however not decided upon and a test plan for acceptance of the software were not formulated.

The final user acceptance test of the Branch Automation Software was conducted at Thrissur Main branch (June 2004) and it was certified that the developed application software is user-friendly, agree with the systems followed by the company, contains sufficient security measures and controls to check manipulation as well as tampering of data, supports the company's information system processing and business requirements efficiently and effectively and that the system is ready to be deployed in other existing/ new branches. However on a scrutiny of change request pending clearance by the Developer, it was observed that certain modules were not developed according to business rules and that certain provisions essential for day to day operation were lacking in the software as detailed below:

- Fixed deposits pledged against chitties could not be closed to the chitty in default based on a previous effective date, though such closing was permitted by the Chitty Rules being followed.
- One Time Settlement and like schemes were not incorporated in the software.
- Every personal surety offered were considered new and consolidated figure for the total liability of a surety could not be traced out.
- Closing of Terminated chitty was not possible through the system.
- Lack of log of modification/ deletion in operational accounts leading to possibility of deletion of an account after accounting collection.

These defects though pointed out to Accel Limited for rectification, are yet to be rectified (May 2007). It was reported that (February 2007) the developer was not clearing/ checking/ modifying the corrections at their end to the satisfaction of the end user.

Thus the Branch Automation Software installed at the pilot study branches, freezed after 4.5 years, and rolled out to other branches, failed to stabilize even after three years from the date of freezing.

General IT controls

2.4.8 The controls in IT process and services ie., the policies, procedures, practices and organizational structures designed to provide reasonable assurance that business objectives will be achieved and undesired events will be prevented or detected and corrected are referred to as General IT controls. Though the Company initiated their computerisation process in 1999, even till today, i.e., after eight years they have not formulated any IT strategy covering the investment/operation budget, funding sources, sourcing strategy, acquisition strategy and legal as well as regulatory requirements; defining how IT will contribute to the enterprise's strategic objectives (goals) and related costs and risks. They also do not have any

- IT Security policy,
- IT Password policy,
- Change Management Policy, and
- Version Control procedure.

Absence of these policies make the entire process of computerisation vulnerable.

Results of Data Analysis

Inadequate validation controls

2.4.9 Audit observed that the business rules of the company were not properly incorporated in the system. This resulted in inadequate inbuilt validation controls as follows:

Gold loan for public

2.4.10 The gold loan scheme of the company provides that where the total loan required is Rs. 30,000 or below, the loanee is permitted to pledge the ornaments in two to three accounts. If the loan required is above 30,000 the pledge should be in one account and request for further loan, on the same day, should not be entertained. The rate of interest on Gold Loan for amount exceeding Rs. 50,000 applicable was simple interest of 11 per cent and 12 per cent (for default) w.e.f. 1 June 2005 vide Cir. No. 82/2005 dated 27 May 2005.

A scrutiny of records at Kesavadasapuram branch and Patturaikkal branch revealed that the BAS did not have adequate controls to comply with the above two conditions as detailed below:

- The Kesavadasapuram branch had issued 423 gold loans to 157 customers, on a given day pledging the gold in more than one account, where the total amount of loan advanced to a single customer exceeded ₹ 30,000 in violation of gold loan scheme envisaged by the Company. The BAS did not have a control to prevent issue of loans pledging gold in 'more than one account' where the total loan amount advanced to a customer exceeded ₹ 30,000.
- User level selectable controls were introduced in the system only on 1 June 2005 for provision of control for higher rate of interest which provided for 11 per cent and 12 per cent for loan amount exceeding ₹ 50,000 per loan
- On an analysis of the BAS data in audit using CAAT it was noticed that where the total amount advanced per day per customer under gold loan scheme exceeded ₹ 50,000 it was paid as multiple loans enabling extension of undue benefit by application of lower rate of interest. The system did not have control measures to ensure pledging of gold in only one account when the total amount advanced exceed ₹ 30,000 and limiting the issue of multiple loans wherein the total amount paid to a customer per day exceeded ₹ 50,000 as higher rate of interest was due to the Company in such cases.
- Due to sanctioning of 271 multiple loans to 94 customers at Kesavadasapuram branch and 8 Multiple loans to 4 customers at Patturaikkal branches on a given day, wherein the advanced amount in total exceeded Rs. 50,000 the Company has lost interest amounting to ₹ 22,059 (Kesavadasapuram ₹ 20,725 and Patturaikkal ₹ 1,334) where the interest installments were repaid by customers.

- At Kesavadasapuram branch it was observed that Gold Loan 12 numbers to Customer No. 10,644 on 18 January 2007 and 15 numbers to Customer No. 10,023 totaling ₹ 2,00,800 and ₹ 2,64,400 were issued on consecutive numbers and that on various dates issue of multiple loans to Customer No. 10,023, 10,644, 6,852 and 9,268 continued, where the total amount issued as loans exceeded ₹ 50,000, selecting the higher interest rate control.

The company stated (September 2007) that the flexibility to open more accounts has been provided in the BAS to bring about a judicial and practical flexibility in the conduct of Gold Loan business in a highly competitive environment. However, this was not supported by any management decision and the rules in force are being violated.

Gold loan to employees

2.4.11 As per the Gold Loan scheme operated in the Company, interest concession to employees of the Company is limited to an advance of ₹ 50,000 at anytime at all branches taken together. Though the Company has developed application software, "Gold Loan Liability Verification" to verify the extension of reduced interest rates to employees and to limit per person liability to a specified level to outsiders the system has not been updated and is not in use. The Branch automation software developed for the automation in branches failed to incorporate such laid down controls in the programme and the employees/outsiders split the loans and accommodate themselves for lower rate of interest and higher amount of loan than entitled, even at the branches which are automated.

The Gold Loan Scheme in BAS does not have control to evaluate the amount outstanding to a single employee on a given date. Interest rate controls are limited to a single loan and this enables employees to draw multiple loans exceeding Rs. 50,000 at concessional rate of interest as the total amount outstanding is not considered for working out the interest.

Pre-closing of the deposit account against chitty default

2.4.12 As per the Handbook of schemes, at KSFE, "a chitty subscriber can offer fixed deposit at KSFE as security towards future liability against prized chitties. If default occurs in remittance of chitty installment, the subsequent FD interest credited to sugama account may be adjusted to chitty installments by forfeiting the dividend and charging penal interest. If the default exceeds three installments and the subscriber fails to respond to the registered intimation, such fixed deposit should be closed prematurely on the due date of the fourth defaulted installment itself. Even if such closure is actually done at a later date it should be given effect to retrospectively on the due date of the fourth defaulted installment".

Normally, the pre-closing of FD to chitty installment due was not done on the due date of the fourth defaulted instalment. At Kesavadasapuram branch, as the 'Branch Automation Software' restricts premature closing of FD at a prior date, the closing is being done manually and the FD had been left open in the system. At the Thrissur Main branch penal interest is being charged on the dues and FD interest is being given till the date of FD closing, and the FD is closed through the system. Charging of penal interest on dues and payment of interest on FD for the periods beyond the due date of the defaulted fourth installments are beyond the scope of existing rules and regulations in the company and as such procedure followed is unauthorised.

Adoption of incorrect logic in computation of interest on Sugama Account

Interest computed in excess

2.4.13 Sugama Deposit scheme aims at providing a deposit facility similar to SB account in banks. Initial deposit and minimum balance to be maintained at any time should not be less than ₹ 100. For interest eligibility a minimum amount of ₹ 250 should be maintained by a customer other than KSFE employees (wherein the minimum balance amount required was ₹ 100). Interest calculated at the rate notified by the board was credited twice in a year, on 30 September (interest relating to the period March to August) and 31 March (interest relating to the period September to February). The interest was calculated on the minimum balance maintained in the account between sixth and the last day of any month.

Audit scrutiny revealed that the system adopted wrong logic for computation of interest resulting in excess payment of interest on sugama amounting to ₹ 1,52,616. The calculation logic followed by the program (as informed by the management during September 2007) was (A) (Minimum Balance x Rate of Interest) / (12 x 100) as against the correct logic of (B) (Minimum Balance x Interest rate per annum x No. of Days in the Month) / (100 x No. of days in a year). The importance of days in each month and in each year was totally ignored which has resulted in extending excess interest over the notified rate to customer in the month of February and months having only 30 days. The table only kept records in respect of minimum balance for the month arrived at and the date of reckoning of minimum balance was not captured in the table, as such the audit trail to check the functioning of the program was lacking.

Audit also observed that the system did not have proper control over computation of interest of account holders maintaining minimum balance of less than ₹ 250 but more than Rs. 100 violating the scheme.

Incorrect data entry

Improper maintenance of Customer Register

2.4.14 Customer Register is the basic and most important part of the software in which the information about the appropriate facts and figure of a customer available to from Chitty Variola, Fixed Deposit Application Form, Loan Application etc., is entered. All the fields in this register are to be entered correctly to enable classification of the customers based on their Age, Sex, Marital Status, Economical Status, Category, Social Status, Annual Income etc., in the MIS module of the Software. In case a Customer is already in the Customer Register modification of the Customer register for Address difference or any other reason shall be carried out avoiding duplicate entry. On an analysis of the data table following were noticed:

- The customer number though should have been generated by the system consecutively, without allowing gaps between two numbers, the register contained 114 gaps in case of Thrissur Main and 2 gaps in the case of Kesavadasapuram Branch.

- The Dates of Birth entered in the table were erroneous in 5,939 out of 7,403 records in Thrissur Main, 9,174 out of 10,842 records in Kesavadasapuram and 4,529 out of 5,597 records in Patturaikkal branch. The incidence of erroneous Dates of Birth, which was on an average of 82 *per cent* largely occurred during legacy data capture due to lack of data validation. The wrong entry of date of birth has led to inability to compare the customer based on his age profile and to ensure whether any loan was given to minors.
- The column Electoral Id, Passport No., Driving License No, PF No., PAN which were incorporated in the customer register for unique identification of a customer based on documents issued by Government authorities were not validated with rule that 'at least one of them should not be blank' and this has resulted in more than 99 *per cent* customer remaining without unique identity.
- The details of Date of Birth were erroneous in most of cases and the details of unique document number were blank in most cases out of 30 Employee customer accounts in Thrissur Main branch, Patturaikkal branch and 20 Employee customer accounts in Kesavadasapuram Branch.
- More than one account was being maintained for the customers whose Name, Permanent Address and Communication Address entered in the Customer register table are identical. There were 241 customer records in Kesavadasapuram Branch, 149 customer records in Thrissur Main branch and 45 customer records in Patturaikkal Branch which were duplicates based on Name, Permanent address and Communication address fields.
- Actual duplication of customer records could not be quantified as the Names were recorded placing the initials before/after names or expansion/ contracting of part of the name and variation in Permanent and Communication address due to expansion or contraction of part the address.

Non reconciliation of Sugama Balances

- Audit verified the sugama opening account in comparison with sugama operative account, sugama non-operative account and found that, the closing balance of sugama accounts as on 31 March 2006 did not tally with the balance appearing in the sugama operative account, sugama non-operative account due to the presence of negative balance in table Sugama Opening Account as detailed in table below :

Name of Branch	Sugama opening Account	Sugama operative Account	Sugama non operative Account	Total of Schedule
(Amount in Rs.)	A	B	C	D=(B+C)
Thrissur Main Branch	1,39,88,519.22	1,68,16,712	56,170	1,68,72,882
Kesavadasapuram	(13,04,37,870.56)	1,94,74,671	71,071	1,95,45,742
Patturaikkal	1,67,45,480	1,67,10,112	35,368	1,67,45,480

- The balance of sugama operative account (₹1,94,74,671), sugama nonoperative account (₹71,071) as per system did not tally with the audited trial balance of sugama operative account (₹ 1,93,05,089) and sugama non-operative account (₹ 71,081) at Kesavadasapuram.
- The difference was due to existence of negative balance of one record at Thrissur Main and 59 records at Kesavadasapuram and existence of duplicate records for 14 sugama account totaling ₹ 3,344 at Kesavadasapuram. The fact remains that there should not be negative balance in sugama, as it is a deposit account and customer is not allowed to overdraw.

Name of Branch	Positive Balance of records in Sugama Opening	Negative balance of records in Sugama Opening	Sugama Opening
	(Amount in Rupees)		
Thrissur Main Branch	1,68,72,882	(28,84,362.78)	1,39,88,519.22
Kesavadasapuram	1,95,49,086	(14,99,86,956.56)	(13,04,37,870.56)
Patturaikkal	1,67,45,480	Nil	1,67,45,480

- As on 31 March 2006 there were 667 Zero Balance Accounts at Kesavadasapuram, 533 Zero Balance Accounts at Thrissur Main and 319 Zero Balance Accounts at Patturaikkal Branch in the table *Sugama*

Opening Balance and on an analysis of these zero balance with the table *sugama account closing* it was found that 254 accounts at Kesavadasapuram, 188 accounts at Thrissur Main and 199 accounts at Patturaikkal were not closed in system but were having Zero balance. The presence of negative balance in sugama scheme table maintained in BAS and difference in the balance of *sugama opening balance* with total of *sugama operative account and sugama non-operative account* points to fact that the BAS system is not self reconciling in respect of sugama.

- Further though Kesavadasapuram branch was made online during August 2002 the table of *sugama interest amount* contained 3335 records relating to 280 sugama accounts pertaining to the period June 1990 to July 2002 and the interest on these accounts worked out to Rs. 1,14,908 on minimum balance of Rs. 2,08,07,628. The fact remains that parallel manual accounting is being continued at Kesavadasapuram branch and the sugama account in total shows negative balance. The cause and effect of the working of interest as discussed above could not be ensured in audit.

Difference between the system generated and the manually arrived at Trial Balance

2.4.15 The Thrissur Main branch, Kesavadasapuram branch and Thrissur evening branch of the company were made online on 1 November 2001, 1 August 2002 and 1 April 2005 respectively. Parallel manual accounting is being continued at Kesavadasapuram and Thrissur evening branch and the same was lifted at Thrissur Main Branch. The Branch Automation software developed by Accel Limited based on the SRS prepared by Accel Limited was accepted by the company and declared production ready satisfying all documented requirements in line with the business objectives of the company on 17 June 2004. However the Trial balance as on 31 March 2006 generated from the system varied widely with the Trial Balance generated manually at the Kesavadasapuram branch. According to the company, the difference was due to errors in legacy data capturing.

[Audit Paragraphs 2.4 (2.4.1 to 2.4.15) contained in the report of the Comptroller and Auditor General of India for the year ended 31 March, 2007.]

AUDIT PARAGRAPH-**2 (2.1 to 2.20)**

Introduction

2.1 Internal Control is an integral part of the process designed and put in place by the management of an organisation to achieve its specified objectives effectively, economically and efficiently. It helps in creating a reliable financial and management information system besides facilitating effective decision making. Internal Control System is most effective when it is built into the entity's infrastructure and is an integral part of the essence of the organisation. Internal control in Government financial institutions assumes greater significance in view of the fact that they deal with public money and therefore these institutions have to transact business in such a manner that the risk of default by the borrowers is reduced to the minimum.

Kerala State Financial Enterprises Limited (KSFE) was incorporated in November 1969 as a Government Company with a view to socializing chitty business in the State, so as to ensure safety, security and better service to the public thereby protecting them from exploitation by private financial institutions. The Company also provides other facilities such as consumer/vehicle loans and short/medium term loans such as Chitty Loan, Trade Loan, loans for Hire Purchase and House Modernization Scheme, Housing Finance Scheme, Special Car Loan, etc., to the public. The Company also started accepting deposits from the Public from 1975.

The Company is managed by a Board consisting of five Directors including the Managing Director as on 31 March 2006. The Managing Director is the Chief Executive of the Company and is assisted by a Business Manager and a Finance Manager at the Head Office. There are five Regional Offices located at Thiruvananthapuram, Kollam, Ernakulam, Thrissur and Kozhikode managed by respective Regional Managers. The business of the Company is being carried through a network of 266 branches (as on 31 March 2006) spread all over the State.

Scope and coverage of Audit

2.2 The present Performance review examined the internal control system prevalent in the Company during the period from 2001-02 to 2005-06. Since the characteristics of sample data was not homogeneous, the activities/transactions of the Head Office and six main branches undertaking chitty business and granting all types of loans under each of the five regional offices were covered during November 2005 to January 2006. Further, 280 default cases out of a total of 2331 such cases were also examined by audit.

Audit Objectives

2.3 The Performance review was conducted with the objective of analysing the effectiveness of the internal control mechanism prevalent in the Company by examining whether;

- the budget prepared served as a tool of financial control;
- functional manuals were available and served the intended purpose;
- a proper financial control system had been evolved and was functioning effectively;
- the role of the Audit Committee and Internal Audit was adequate in ensuring internal control;
- there was a proper system in the Company for conduct of chitty business and for appraisal, sanction, disbursement, follow-up and recovery of loans;
- effective steps were taken for controlling the Non-Performing Assets (NPA); and
- computerisation was adequate and effective.

Audit criteria

2.4 The criteria considered for assessing the achievement of audit objectives were as follows:

- timeliness in preparation of annual budgets, analysis of variance with actuals and corrective action taken;
- guidelines provided in functional manuals in respect of chitties, loans and for effective functioning of the Company;
- financial control system in respect of cash and bank balances, receipt books, inter-unit accounts, control accounts, etc;

- provisions of Companies Act, 1956 relating to formation and functioning of Audit Committee ;
- Rules and Procedures prescribed in the Kerala Chitties Act and Rules 1975 as well as Hand Book of Schemes for conduct of chitties, sanction, disbursement, follow-up and recovery of loans;
- State Government orders and directions on setting up of Vigilance Wing;
- Reserve Bank of India prudential norms for classification and provisioning for NPA.

Audit Methodology

2.5 Audit methodology adopted for attaining the audit objectives was;

- review of minutes book and agenda papers of the meetings of the Board of Directors, Annual Reports, Manual of procedure and various circulars issued in respect of various schemes;
- scrutiny of Internal Audit Reports, Internal Audit Plan, files in respect of branch automation, records relating to Revenue Recovery, Business, etc., kept at the Head Office of the Company; and
- review of chitty ledgers, documents, loan files, stock registers of receipt books and stationery, register of revenue recovery cases and progress reports kept at six branches of the Company.

Audit findings

2.6 Audit findings emerging from the performance review were reported to the Management/Government in July 2006 and discussed in the meeting of the Audit Review Committee on Public Sector Enterprises (ARCPSE) held on 4 August 2006, which was attended by the Additional Secretary, Taxes Department, Government of Kerala and Managing Director of the Company. The views expressed by the Management/Government have been taken into consideration while finalising the review.

Audit findings are discussed in the succeeding paragraphs.

Budgetary Control

2.7. Budget is a quantitative, financial expression of a programme of measures planned for a given period. The Budget is drawn up with a view to plan future operations and to make *post-facto* checks on the results obtained. Timely preparation of Budget and analysis of the variations noticed with reference to actual execution serve the purpose of Internal Control. The Company prepared an annual budget for each financial year. The budgeted and actual figures in respect of various schemes operated by the Company during the five years up to 2005-06 were as indicated in Annexure 9. The following deficiencies in the preparation and analysis of the budget were noticed in audit:

- The Company did not prepare the annual budgets in time. The budgets for all the years (2001-02 to 2005-06) were prepared and got approved after delays ranging up to six months after commencement of the relevant financial year.

- The Management stated (July 2006) that since the accounts were maintained manually, the collection of data from the branches and compilation of the same in the Corporate Office was a cumbersome task which led to the delay. The reply is indicative of the fact that the Company did not devise any system for timely preparation of budgets.

- It would be seen from the Annexure that there were short-falls in disbursement of loans as compared to budgeted figures particularly in respect of New chitty/Pass book loans in which the percentage of short-fall ranged from 12.28 (2002-03) to 46.88 (2004-05). In the new housing finance scheme it ranged from 6.28 (2003-04) to 23.81 (2005-06). In trade loan the same was as high as 71.38 *per cent* in 2005-06. Similarly, short-fall in actuals for sugama deposit scheme ranged between 3.52 *per cent* (2002-03) and 19.74 *per cent* (2004-05). The Company did not conduct any detailed analysis of the variance between the budgeted figure and the actual performance.

The absence of proper analysis of the variances resulted in fixation of unrealistic targets.

Functional Manuals

2.8 Functional Manuals provide guidance to the personnel in-charge of appraisal, disbursement and recovery of loans and also enable them to proceed with legal action as per the prescribed terms and conditions.

The Company prepared a Manual of Procedure (MOP) in 1984 which was updated in April 1991. No updation of MOP after 1991 was done with a view to incorporating the detailed procedure, terms and conditions, etc., of new schemes launched subsequently. The changes/modifications effected in schemes and the delegation of powers (modified) issued were available only in circulars issued from time to time. The Manual, thus, did not serve the intended purpose.

The Management stated (July 2006) that earnest efforts would be made for the publication of an updated edition incorporating all the schemes and its procedures.

Financial Control

Non-maintenance of Stock Accounts of Receipt Books

2.9 Except in four branches (three branches in Thrissur Town and the Kesavadasapuram Branch) where computerisation was done, in all other branches (262) of the Company, receipts/cash challans were being issued manually on receipt of money from the customers. In two branches.

(Ernakulam and Trivandrum Main) it was noticed that :

- no stock account of receipt books, giving details such as the opening number of books, number of books issued and the closing balance was maintained ;
- the names of persons to whom the receipt books issued were also not recorded ;
- the receipt books did not contain serial numbers ; and
- the receipt books were not kept under safe custody.

Non-maintenance of proper stock account of receipt books/cash challans and their safe custody reflects the absence of control over accounting of receipts as the misuse of receipt books/leaves thereof, if any, can go undetected.

The Management stated (July 2006) that stock register for cash challans was maintained in the Head Office and that a parallel cash register was also maintained in the branches and there was adequate internal control. The reply is not tenable because there was no stock account of cash challans and their safe custody at the branch level. In the Audit Review Committee meeting (4 August 2006) the Management assured that the Challans would be kept under safe custody and numbering them would be considered.

Reconciliation of control accounts with personal ledger balances

2.10 The Company was not reconciling the balances as per the General ledger control account with the personal ledgers in respect of 'Hire Purchase (HP) advance' and chitty subscribers. This irregularity in respect of chitty subscribers persisted inspite of it being pointed out by the Statutory Auditors every year.

In the Company's main branch at Thrissur it was observed in audit that there was an unreconciled difference of Rs.0.95 lakh between 'HP advance' as per General Ledger and personal ledger balances. Though the difference was cleared by taking the same to a Suspense Account, no adjustment had been effected in the personal ledger balances.

The Management stated (January 2006) that on computerisation of branch accounting, cumulative schedules of non-prized and prized subscribers would be taken and tallied with the control accounts. In the absence of timely reconciliation, malpractices, if any, in respect of chitty transactions would go unnoticed.

Audit Committee

2.11 As per Section 292A of the Companies Act, 1956 (amended in December 2000), the public Companies having paid up capital of not less than Rs. five crore shall form an Audit Committee. The Audit Committee should discuss with the Auditors periodically about the internal control systems, the scope of audit including the observations of the Auditors and review the half yearly and annual financial statements before submission to the Board of Directors and ensure compliance of internal control systems.

In the formation and functioning of Audit Committee the following deficiencies were noticed in audit;

- The Committee which was to be constituted in January 2000, was formed only in July 2004 i.e., after a delay of 4½ years
- The first meeting of the Committee was held in December 2005 only after a delay of 17 months wherein it simply noted the scope and coverage/terms of reference of the Audit Committee. The second meeting which was held in April 2006, discussed only the Annual Accounts.
- No review on the internal control system prevalent and its adequacy was conducted.

The Management stated (July 2006) that conduct of periodical meetings and other provisions pertaining to Audit Committee would be complied with in future.

Internal Audit

2.12 The Internal Audit Department (IAD) carries out the function of independent appraisal of the control mechanism in the Company with the objective of assisting the management by furnishing appraisals/ recommendations/pertinent comments on various activities. IAD also has the responsibility to report on the financial position of branches and bring to notice wasteful expenditure.

A scrutiny of the Internal Audit functions revealed the following deficiencies:

- The Company had not prepared any Internal Audit Manual prescribing its area, scope, coverage, quantum, etc.
- Internal Audit Reports were not being submitted to the Board of Directors/Audit Committee.

- The Company's decision (October 2001) to implement the concurrent audit system has not yet been implemented. As on 1st August 2006, the IAD could complete the inspection of only 58 *per cent* of the branches planned up to 30 September 2005.

- There was considerable delay in settling internal audit objections, largely due to non-furnishing of clear and complete replies.

- Verification of outstanding observations by the inspecting team was not being done with the result that compliance of audit observations was not ensured.

The Management stated (July 2006) that verification report was included in the summary report. The reply is not correct as the Audit scrutiny confirmed that no such report was being included.

- The Statutory Auditors had commented (2001-02 to 2004-05) about the inadequacy in the scope and coverage of the Internal Audit System prevalent in the Company, but no remedial action had been taken.

The Internal Audit system in the Company, thus, did not serve as an effective tool of Internal Control.

Vigilance Cell

2.13 The State Government directed (1997) all the State PSUs to set up Vigilance Cells in various departments and Public Sector Undertakings. Accordingly a Vigilance Cell headed by one Deputy Superintendent of Police as Vigilance Officer (appointed by the Government of Kerala) was set up in 1998 by the Company. In January 2003, the officer had to relinquish charge as he was not found suitable and since then a Senior Manager from the Company has been serving as Vigilance Officer. The following deficiencies were noticed in respect of the Vigilance cell:

- Though the Government directed (1997) that the Vigilance Cell be provided with supporting staff for office as well as field work, the Cell was functioning without any supporting staff since inception.

- Proper documentation of activities/liaisoning with the Administrative Department/sending of periodical reports / returns, etc., was not being done. Details of number of cases detected, referred to Vigilance and action taken thereon were not being maintained. In the absence of proper documentation and follow-up, the Vigilance mechanism in the Company had been rendered ineffective.

Branch Automation

2.14 The Company operates various schemes (13 major schemes) through 266 branches functioning throughout the State. Considering the volume of business along with the number of branches and in order to minimise the lapses in the areas of preparation of demand, collection and balance statement (DCB) of chitties and loans, reconciliation of inter-office accounts, verification of multiple liability of loanee/surety/subscriber, etc., the automation of various functions/ online net working of branches was necessary. Though the Company started the computerization process in 1995 it has not completed the process even after 10 years.

The Management stated (July 2006) that systems/accessories had been delivered in 66 branches during April 2006 and that it expected to complete the installation by 30 September 2006. It further stated that single PCs had also been supplied to 186 branches where full automation was to be done in the 2nd phase. The reply does not explain as to why the computerisation process initiated in 1995 still remains incomplete though it is extremely important for enabling/ strengthening the control function.

Internal control in major activities

2.15 The lending function in the Company involve the following major activities:

- Enrolment of subscribers and conduct of Chitties;
- Sanction of various types of loans detailed in paragraph 2.1 supra;
- Disbursement (obtaining security and documentation) and monitoring; and
- Demand and recovery.

The deficiencies in the internal control procedures in respect of the above activities are discussed in the succeeding paragraphs:

Enrolment of subscribers and conduct of Chitties

2.16 The main business of the Company is confined to conduct of chitties where it acts as a foreman. Chitty business is being regulated by the Kerala Chitties Act, 1975. The rules/procedures formulated on the basis of Kerala Chitties Act and Rules, 1975 for conducting chitty *inter alia* included the following:

- First instalment could be remitted by cheque subject to realization before registration of chitty.
- A subscriber cannot hold more than 10 *per cent* of the total tickets in a chitty.
- Every non-prized subscriber of chitties would be eligible for availing New Chitty Loan up to 50 *per cent* of sala after remittance of 10 *per cent* of the total instalments, provided the remittances were up to date.
- In case the subscriber committed defaults in remitting three consecutive chitty instalments, he should be removed from the chitty as per chitty rule.

In addition to the above the procedure to be followed and securities to be accepted were also provided for under the Hand Book of Schemes formulated by the Company. In the absence of proper internal control over chitty transactions and deviation from prescribed procedures, there was default in the payment of chitty subscriptions.

The default position in prized (both running and terminated) chitties and the collectable demand from 2000-01 to 2004-05 was as under:

Year	Collectable demand	Default
	(Rs. in crore)	
2000-01	1619.79	31.97
2001-02	2085.46	51.62
2002-03	2684.29	44.80
2003-04	2845.50	39.22
2004-05	3156.59	40.65

It would be seen from the above that the default during the five years ended 2004-05 ranged between Rs.31.97 crore and 51.62 crore. Audit scrutiny revealed the following deficiencies in the system of chitty management which contributed to the default in chitties and non-recovery of overdues.

- The Manual of Procedure requires preparation of statements showing default in respect of non-prized subscriptions. No such statements were, however, prepared on the ground of non-availability of information in the absence of automation of branches. As such the default in payment in the case of non-prized chitties was not ascertainable.
- In the case of chitty default the Company had to substitute the tickets of defaulters and bear the liability of subscriptions for the purpose of payment of chitty prize money to successful bidders. For this purpose cost bearing funds collected by the Company (from the public towards sugama savings bank deposit and fixed deposit) had to be diverted. The borrowed funds so diverted for payment of prize money during the period 2000-01 to 2004-05 were Rs.60.51 crore, Rs.155.09 crore, Rs.214.10 crore, Rs.171.67 crore and Rs.84.70 crore respectively.
- Although the Company had 266 branches there was no system in place to ascertain the status regarding the number of tickets held by a person in various chitties in various branches. This was due to absence of on-line networking among the branches.
- No checks/procedures were formulated for ensuring the paying capacity of persons admitted to chitties. In all the 111 cases test checked in audit this deficiency was noticed.

The Management stated (July 2006) that they could not restrict the enrolment to chitties based on income criteria of the applicants and, based on the recommendations of Audit, strict directions were given to the managers to ascertain the paying capacity of the persons proposed to be enrolled in high denomination chitties.

- In the case of payment of first subscription money by way of cheque the encashment had to be ensured before commencement of chitty. It was, however, noticed that this was not being ensured. This irregularity persisted inspite of the Statutory Auditors having also commented about this.

- Although, as per Handbook of Schemes formulated by the Company subscription of tickets in a chitty was to be restricted to a maximum of 10 *per cent* of total number of tickets, subscribers were being allotted tickets in a chitty beyond the limits prescribed, and there was default by such subscribers in payment of subscription.
- Subscribers who defaulted payment of subscription in one class of chitty were allotted tickets in other chitties as well disregarding their default status. The aggregate default in such cases amounted to Rs.21.90 lakh.
- For canvassing chitties agents were eligible for 20 *per cent* commission. Such agents were being paid the major portion (15 *per cent* to 17 *per cent*) of the commission in cash at the time of remittance of the first instalment itself. In the case of remittance by cheques, the Company did not monitor the realization of cheque. This resulted in loss on account of payment of agency commission by the Company to the agents when the cheques were ultimately dishonoured. Audit scrutiny revealed that 16 subscribers enrolled through agents had remitted only the first instalment and thereafter defaulted. The arrears amounted to Rs.28.37 lakh (March 2006). The agent should have been paid the commission proportionately based on the instalments realised instead of paying the entire amount in the first instance itself, so as to avoid loss.

The Management stated (January 2006) that the progressive payment system for paying commission to chitty agents would not be attractive, since enrolment to chitties had become a tough job. The reply is not tenable as the Company should have devised a suitable system for payment of commission with a view to curtailing avoidable payments.

- As per guidelines a non-prized subscriber could be allowed to transfer/ assign his rights in a chitty to any other person, with prior consent in writing from the Company. It was noticed that a non-prized subscriber with five tickets in a chitty assigned two tickets to third parties after receiving Rs. 3.10 lakh as consideration towards the subscription remitted for the two tickets. While granting the permission for assignment, the Company did not reckon the dues (Rs.6 lakh) of the subscriber in the remaining three tickets of the same chitty and adjust the amount of Rs.3.10 lakh against the dues.

Management replied (July 2006) that it would be looking into the matter seriously.

- The Company paid prize money on the security of salaried persons. However, there was no system in place to ensure that recovery from salary was enforceable through the employers. Due to this, recovery from salary could not be enforced. This deficiency was noticed in six cases involving an amount of Rs.3.77 lakh paid towards prize money.

Loans

2.17 Till 1993 the Company was conducting the business of chitty only. Thereafter for meeting the urgent needs of non-prized chitty subscribers a New Chitty Loan (NCL) scheme was introduced. Under this scheme the subscriber would be eligible for a loan of 50 *per cent* of the total chitty amount on remitting 10 *per cent* of chitty instalments without default. In addition to this the Company provides loans to the public under various schemes as detailed in paragraph 2.1 *supra*. The Hand Book of Schemes formulated by the company prescribes the procedures to be followed in respect of these Loans which *inter alia* provide for purpose, eligibility, securities, disbursement procedure, repayment, etc. Instructions through circulars are also being issued from time to time to ensure better control. The following deficiencies arising from non-observance of rules and procedures in the case of sanction/disbursement of such loans were noticed in audit:

- The Hand Book of Schemes prescribed sanction and disbursement of loans on personal securities. Loans were, however, sanctioned on the security of personal surety of salaried persons, the recovery against whom was not enforceable. Out of 72 cases test checked, nine cases in 3 branches (involving Rs.1.57 lakh) were found with such deficiency.

- The Company did not have in place a system to ascertain the liability of a loanee/surety, if any, in any other branches except in Reliable Customer Loan where the liability report of the loanee/surety was being obtained from the Head Office.

It was further noticed in audit that the same person was accepted as surety in the same branch itself even without considering the liability (in other loans) or inadequacy of net salary to effect recovery. This indicated that even routine control procedures were not being followed before sanction of loans.

The Management stated (July 2006) that it was considering introduction of a centralised liability verification system at Head Office with the help of computers, after full computerisation of branches. The reply is not acceptable as in the case of Reliable Customer Loan the Company could get the details where the details of liability of surety are furnished by Head Office itself and the same system could have been evolved in respect of other loans also.

- In order to avoid acceptance of forged salary certificates in the case of loanees and sureties, the Company had issued directions for verification through telephonic contact/direct contact (over and above the usual postal enquiry) with the officers who issued the certificates. However, in none of the 29 cases test checked, involving loan amount of Rs.13.98 lakh, this procedure was followed. The default in 16 cases out of these 29 cases amounted to Rs.4.63 lakh as on March 2006. It was further noticed that the Company advanced a loan of Rs.0.74 lakh during 2004-05 on the strength of a fake salary certificate.

The Management stated (July 2006) that stringent directions were given to the managers concerned to personally verify the genuineness of the sureties in future.

- In 26 cases involving loan amount of ₹ 22.04 lakh, many columns in the agreements executed with the loanees and sureties were kept blank. In some cases, even the signatures of the loanees and sureties were not got witnessed. The dues in these cases amounted to ₹ 12.08 lakh as on 31 March 2006. This deficiency defeated the purpose of execution of the agreement itself.

The Management replied (July 2006) that strict directions would be given not to repeat the lapse in future.

- As per the guidelines in force, a non-prized chitty subscriber who had availed of Chitty Loan and defaulted remittance of three consecutive chitty instalments should be removed from the chitty as per chitty rules and recovery proceedings to realise the chitty loan amount with interest and cost should be initiated. It was, however, noticed that this procedure was not followed in four cases where the dues amounted to ₹ 1.84 lakh (March 2006).

- The Management stated (July 2006) that from the very inception the non-prized defaulted subscribers were removed and substituted by the Company and recovery action taken against such subscribers. The reply is not tenable since in the cases mentioned, the Company financed the tickets of the defaulted subscribers after their termination and again allowed them to remit the arrears after two years and regain their status as subscribers.

Demand and Recovery

2.18 Defaults are common in the chitties and it would be possible to minimise these through formulation of an effective control mechanism. Judicious screening at the time of enrolment, prompt action at the initial occurrence of default and continuous follow up with subscribers would go a long way in reducing default. Recovery of loans and dues against chitties were important to the Company in order to plough back funds for recycling for operations of the various schemes.

The following deficiencies in the demand and recovery of loans were noticed in audit:

- The Company was not issuing notices and reminders to the loanees/sureties/Drawing and Disbursing Officers at intervals prescribed in the Manual of Procedure for remittance of dues.
- Direct contacts were seldom resorted to. The Company also did not have a regular system of sending teams to the field for effective follow up as prescribed for realization of dues. This lapse was noticed in all the six branches test checked.
- The Company was not preparing the Demand, Collection and Balance (DCB) statements in respect of chitties conducted and loans granted, due to which the Management could not exercise any control over demand and recovery.

The Management stated (July 2006) that the system pointed out by Audit would be introduced in full measure along with full computerisation of branch activities within a couple of years.

Management of Non-performing Assets (NPAs)

2.19 The percentage of NPA in the loan outstanding under various schemes for the period 2000-01 to 2004-05 were as under:

Schemes	2000-01	2001-02	2002-03	2003-04	2004-05
New Chitty Loan(Gross NPA)	39.32	35.49	40.99	38.01	34.29
New Chitty Loan(Net NPA)	31.45	30.94	34.11	35.38	27.23
New Fixed deposit Loan, Reliable Customer Loan	0.85	26.42	18.32	10.62	5.08
Hire Purchase, consumer vehicle loan	0.66	16.75	20.37	26.50	27.70
Trade finance scheme	2.09	31.97	37.05	39.40	35.75
New housing finance scheme	0.66	24.56	22.73	21.46	21.35

It would be seen from the above that the NPA under Hire Purchase and Consumer vehicle loan, Trade Finance Scheme and New housing finance scheme increased from 0.66 *per cent*, 2.09 *per cent* and 0.66 *per cent* in 2000-01 to 27.70 *per cent*, 35.75 *per cent* and 21.35 *per cent* respectively in 2004-05.

The Company did not make borrower-wise classification of NPA as required under the prudential norms prescribed by the Reserve Bank of India. Statutory Auditors had also commented about this lapse in their reports for the period 2000-01 to 2004-05, but no action was taken by the Company.

Audit scrutiny further revealed that the high incidence of NPA in New Chitty Loan was on account of the following :

- Granting loans even before the remittance of ten *per cent* of the total instalments of chitty and Disbursement of loans without ascertaining the repaying capacity of the subscribers;
- Allotment of more than 10 *per cent* of total tickets to the same persons;

- Non-removal of defaulters (more than three instalments) and non-initiation of recovery proceedings in time;
- Granting loans on the security of personal surety of salaried persons from whose salary the recovery was not enforceable;
- Absence of a mechanism to verify the multiple liability of loanee/surety; and of an effective system to verify genuineness of salary certificates.

Revenue Recovery Proceedings

2.20 After failure of the normal course of recovery action, the next option available to the Company is to initiate Revenue Recovery (RR) proceedings under the Kerala Revenue Recovery Act, 1968. The provisions of the Act were made applicable to the Company from June 1970. The Deputy Tahsildars (SDT) on deputation from the State Government were authorised to exercise the powers under this Act.

The amount pending under RR increased from ₹ 55.89 crore (8717 cases) in 2001-02 to ₹ 81.53 crore (17355 cases) in 2005-06. A review of the RR registers maintained in the branches covered and other documents revealed the following deficiencies:

- The RR registers maintained at the branches lacked vital information such as the number of accounts referred for RR and the amount due, number of accounts closed during the year and amount realised, cases pending for RR and the balance pending recovery, etc.
- The Management stated (July 2006) that it was taking steps to prepare and tally RR schedule of branches with those maintained at the Head Office, for which some more reconciliation of accounts was required.
- As per the instructions of the Head Office, cases of default exceeding 12 instalments should be reported for RR proceedings. Though the defaults ranged up to 26 instalments involving total dues of ₹ 16.42 lakh (30 cases), these were not referred to RR.

- Abnormal delay in initiating RR action, ranging between 19 and 148 months, was noticed in reporting 339 cases (above 18 months default) involving an amount of ₹ 1.86 crore.
- Delay in disposal/non-disposal of attached properties was noticed on the ground of low offers received. This was due to, among other reasons, overvaluation of the respective properties at the time of granting loans (₹ 3.34 crore).
- The Management stated (July 2006) that the proportion of non-collection of dues owing to overvaluation was relatively small (8.6 *per cent*). Factors like recession, involvement of white money in RR auction sale, psychological hesitation to purchase RR property, procedural problems in the conduct of auction sale, etc., had contributed to failure of auction sales. The reply is not tenable since one of the reasons was the overvaluation of securities and substantial amount (₹ 3.34 crore) was involved in this. The locational disadvantages of land accepted as security and other factors also contributed to non-disposal of securities.
- No scientific system had been evolved by the Company for valuation of property offered as security. There were no guidelines regarding fixation of value for different types of properties situated at various locations. There was also no system in place to countercheck the valuation report of the property by other agencies with a view to avoiding overvaluation, if any.

These matters were reported to Government in July 2006; their reply is awaited (August 2006).

[Audit Paragraph 2(2.1 to 2.20) contained in the Report of the Comptroller and Auditor General of India for the year ended 31 March, 2006.]

1. The Committee enquired the reason for negative cash flow from chitty business. The Managing Director replied that the cash flow was positive as audited by Chartered Accountant. He further added that net cash flow could be arrived only after calculating incremental deposits and advances. But, the difference occurred due to further deduction from the net cash.

2. To a query relating to the high debt equity ratio of 16:1, the witness replied that this ratio is not relevant or applicable in the case of institutions in financial sector.

3. The Committee noticed that negative cash flow from chitty business forced the company to borrow more funds from outside sources. The Committee wanted to know the action taken against the officers responsible in this regard. The witness informed that in cases of high incidence of defaults in prized and non prized chitties and low progress in the recovery from defaulters, strict action such as barring of increments had been taken against the responsible officers.

4. The Committee enquired whether any sanction was obtained from the Registrar for the commencement of chitties. The witness replied that necessary permission was obtained from concerned authorities before the commencement of Chitties and tickets which were not realized were substituted after realizing penal interest.

5. When the Committee raised doubt about the `transparency in the substitutions, the witness replied that to make substitutions more transparent necessary publicity is being given by publicising the details in the website. He further added that in case when the Company substitutes by itself the loss due to diversion of cost is made good by the dividend gain. The Committee recommends that proper rules must be formulated for substitution and these rules must be strictly complied with and also published on the website.

6. To a query of the Committee regarding the disciplinary actions taken against the Branch Managers who were found guilty for substitution, which led to loss, the witness replied that necessary disciplinary action had been taken against officials in Edappal, Paruthippara, Nanthancode and Statue branches.

7. The Committee enquired why the company didn't conduct a proper fiscal analysis and study of ongoing chitties before fixing targets for new chitties. The witness responded that targets were fixed after ascertaining the potential of each branch by the respective regional managers. The witness added that the Company could achieve only 10% market share despite the fact that there were so many affluent families who could have been brought in as subscribers.

8. When the Committee expressed its apprehension over the increasing number of default cases and enrollment of subscribers without realizing the first instalment, the witness replied that the number of defaulters were reduced considerably by offering some incentives to the persons making the substitution. He further informed that according to the new Chitty Act, substituted person gets dividend from the beginning of the chitty itself.

9. The Committee criticized the Company for not maintaining proper registers containing the address and other details of chitty subscribers and enquired about the reason for non-maintenance of chitty subscribers register and non-implementation of KYC norms. The witness informed that subscriber registers are being properly maintained from 2010-11 onwards after the completion of computerization and the subscriber profile is kept in record after the introduction of KYC norms.

10. Regarding non-maintenance of proper registers in Kesavadasapuram and Manacaud branches of Thiruvananthapuram District, the witness replied that at present the registers were maintained properly and that necessary instructions were issued to Kesavadasapuram branch to find out the register which was missing. The Committee asked whether disciplinary action was taken against those officers responsible for not maintaining proper registers during the period when registers were kept manually. The witness assured that proper actions would be taken against responsible officers of all branches with regard to the improper maintenance of registers.

11. The Committee enquired the reason for registering the chitties without realizing first instalment. The witness replied that strict directions were issued to all branches to register the chitties only after realizing the first instalment. Strict action was also taken against erring officials in this regard.

12. The Committee, while mentioning about the enrollment of persons who had defaulted in payment of monthly instalments of earlier chitties, criticized the company for not ensuring the credibility of subscribers before enrolment and asked for the reason which forced the Company to enroll earlier defaulters and financially unsound persons in Chitties in violation of Chitty Act. The Committee opined that if the officers had disallowed the enrolment of defaulted persons of

earlier chitties, an amount of ₹ 19.13 crore which had remained blocked up as default payment could have been profitably utilized by the Company. The witness replied that steps were taken for implementing Centralized Liability Verification(CLV) system to ascertain and prevent multiple chitty enrolment by blocking further allotment of tickets to defaulters.

13. The Committee observed that the Company was forced to self-substitution due to its failure to find out new subscribers and thereby incurred loss by foregoing Foreman's commission. The witness replied that the loss of Foreman's commission was compensated by dividend earned in remaining tickets contributed by regular subscribers. Expressing dissidence with the reply furnished by the Government, the Committee expressed its concern in the loss incurred due to self substitution and pointed out that before enrolling the subscribers, the Company had to ensure their payment capacity.

15. The Committee noticed that substitution by relatives or friends of defaulted subscribers resulted in loss to the company towards penal interest. The Committee was surprised to note that the Company permitted substitutions despite knowing the person's relationship with the defaulted subscribers which was detrimental to the financial interest of the Company. The Committee opined that if the Company had not acted against the financial interest, it could have gained ₹ 32.92 lakhs towards penal interest. The witness informed the Committee that appropriate steps were taken to reduce the dues of defaulters and also the process of substitution was made more transparent by giving wide publicity through website.

16. The Committee observed that the company failed to recover the commission paid to the agents in cases where 2nd and 3rd instalments of the chitty were defaulted. The witness replied that in such cases strict measures are taken to recover the amount from agent commission and the commission already paid were recovered. Besides, the initial advance from agents was enhanced to ₹ 1 lakh. The agents had filed cases against the Company regarding recovery of the commission.

17. The Committee suspected whether the Branch Managers unduly favoured the agents by overlooking the directions of the Circular No. 19/2009 dated 31-1-2009 which, inturn, resulted in a loss of ₹ 6.56 lakh to the Company.

18. The Committee enquired why the defaulted subscribers / substituted subscribers who remitted the dues by cheque were allowed to participate in the auction before realisation of the cheques/dues. The Committee opined that by violating 8.4.2 (d) and 8.3.2(b) of MOP, the Branch Managers illegally helped the defaulted subscribers to obtain prize money which resulted in a loss of ₹ 23.95 crore to the Company.

19. The Committee criticized the action of the company and also enquired the status of cases regarding bounced cheques. The witness replied that strict action was taken against the responsible Officers and in Mavelikkara, the Branch Manager was terminated from service. To a query of the Committee, the witness explained that expenses related to Court cases would be recovered from the managers. He added that as of now, cheques are not needed for remittance since online remittance is being implemented by the Company.

20. The Committee noticed that in many branches bogus salary certificate was accepted as personal surety for release of prize money to successful bidders. This resulted in a loss of ₹ 25.48 lakh to the Company. The Committee remarked this as the laxity on the part of the Branch Managers who failed to ensure the genuineness of the salary certificates and obtaining confirmation from offices concerned. The Committee was astounded to note that no penal action was taken against those Branch Managers.The witness replied that strict instructions were given to all branches to ensure the genuineness of the salary certificates and to obtain confirmation from officers concerned via phone or letter. In the case of telephonic confirmation, instructions were given to avail the service of nearby office or regional office to avoid fraud.

21. The Committee enquired why the Branch Managers didn't refer the subscribers who defaulted payments in prized chitties for revenue recovery even though standing instructions under Kerala Revenue Recovery Act 1968 were issued by the Company in August 2011. The witness replied that directions were given to compulsorily initiate revenue recovery action against all defaulted cases of 12 months or more.

22. The Committee enquired whether any criminal case had been registered by the Police towards any customers. The witness replied that in addition to the filing of cases, the details of it had also been circulated for information of the fraudulent activity.

23. The Committee observed that in many cases of terminated chitties, the money due to the subscribers was seen retained by the Company and sought explanation regarding this. The witness replied that on production of necessary I.D. proof, the amount will be given back.

24. The Committee noticed that due to delay in completion of formalities, the chit amount deposited as security in Treasury was released belatedly resulting in loss of interest. The witness informed that necessary measures were taken to ensure the speedy release of security deposit after completing all necessary formalities.

25. The Committee observed that out of 95 new branches opened between 2009-10 and 2011-12, 75 branches (79%) were running in loss leading to a cumulative loss of ₹ 9.43 crore. The Committee enquired the reason for opening new branches without conducting study on commercial feasibility/economic viability. The witness answered that hence forth new branches will be started only after conducting feasibility study.

26. To a query of the Committee regarding the objection raised by the Reserve Bank of India with respect to the other businesses conducted by the Company, the witness informed that the State Government vide G.O.(Rt.) No.644/ 2012/TU dated 4-9-2012 permitted the Company to do lending/loan business along with the chitty business. The witness further added that since the company received an unconditional permission to do other business as per rule 12 (1), there is no point of section 12(2) which forbids company to do additional business being applicable which is for 5 years only.

27. Hence it is stipulated in section 12(2) of Chit Funds Act, 1982 that the Company could not conduct chit and lending business simultaneously, the Committee directed the Government to re-examine the relevance of G.O. (Rt.) No.664/2012/TU dated 4-9-2012.When the Committee wanted to be furnished with the copy of the above Government Order, the witness assured to submit the same.

28. Regarding the lapses in the door to door collection system of the Company, the witness informed that the lapses/misappropriation were reported in

5-6 branches of the Company and the major one was at Thiruvalla branch where in misappropriation of ₹ 1.82 lakhs by a collection agent by not remitting the amount collected in the branch was detected and action had been taken against responsible officers and a court case is pending in this regard. The witness also informed that steps were taken to attach 21 cents of land through Revenue Recovery proceedings.

29. The Committee expressed its concern in not implementing any penal action for such a grave offence which helped the agents to continue with the misappropriation which increased from ₹1.82 lakh to ₹98.39 lakh. The Committee criticised the officials responsible for it and remarked it as an example of sheer negligence and supervisory lapse.

30. The Committee observed that in order to retain the credibility of the Company, necessary action has to be taken by rectifying the irregularities detected. Officers responsible may also be fixed with liability and the collection agents may be monitored and there should not be any nexus between collection agents and officials. The witness explained that out of 540 branches of the company, rate of irregularities reported came to only 7.2 per cent of the branches and steps were taken to rectify the irregularities reported. Online remittance is being implemented and Auditors were given necessary instruction regarding monitoring of collection agents. The witness also informed that the Company is presently making an increase in profit.

Conclusions/Recommendations

31. The Committee is concerned about the negative cash flow from the Chitty business of KSFE which is forcing the Company to borrow funds from outside sources. Given that the Chitty business contributes to a major share in the total turnover of the Company, incidence of snowballing defaults of chitties and a disdained progress in the recovery proceedings of the Company makes the entire exercise frustrating and meaningless. The Committee, in this situation, urges that the company should make a credible effort in fixing the responsibility upon the officers who committed such serious lapses and a detailed report on action taken against responsible officials should be made available to the Committee at the earliest.

32. The Committee expresses its apprehension with regard to the increasing number of defaulters and the imprudent enrolment of subscribers in new chitty schemes without realizing even the first instalment. Committee while probing the reason for such an increase in the number of defaulters, understands that some branches, in order to attain the impractical targets of new chitties fixed on them, were forced to enrol subscribers without conducting prechecks on their repayment capacity. Therefore, Committee recommends that targets for the branches should be fixed only after proper analysis based on scientific study of ongoing chitties. Also a judicious screening of the fiscal status of persons should be conducted by the branches before their enrolment.

33. The Committee is distressed to know that some branches of the Company show reluctance in following 'Know Your Customers' (KYC) norms overtly. This has to be seen as a serious dereliction perniciously affecting the company. The Committee, therefore recommends that, action should be taken against the officers responsible for the non-maintenance of comprehensive chitty subscriber registers. The Committee also demands that the Company should strictly follow KYC (Know Your Customer) norms while enrolling subscribers in new chitties. The Committee also expects the Company to 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.

34. The Committee observes that the company was lax to realise the first instalment of a number of chitties by tarnishing the sanctity of the Chitty Act. The Committee, therefore, recommends that the realisation of first instalment of chitties should be done meticulously by strictly adhering to the provisions of the Act and transgressions if any, surfacing against it should be viewed seriously and stringent action should be taken against officers responsible for it.

35. It is bewildering that the company is intentionally slothful by enrolling defaulted subscribers/financially unsound persons in chitties in line with an imprudent task of slot filling, and thus bringing a huge loss to the company. Besides, the Company's practice of self substitution of defaulted chitties resulting in loss by foregoing foreman's commission is highly condemnable. In this scenario, the committee is putting forward its opinion that the company should

ensure the fiscal competence and repayment capacity of the subscribers under proposal in an authentic way well in advance of their enrollments.

36. It is seen that the company was unwisely indulging in the substitution of high denomination chitties of defaulting subscribers by their relatives or friends resulting in loss to the company. In the event of substitution of defaulters, the rules may be framed keeping in mind the need to attract fresh subscribers without compromising the profitability of the Company. Rules must strike a balance between making substitution an attractive proposition and retaining the Company's Cash flows. Therefore the committee strongly recommends that this debilitating practice of substitution should thoroughly be wiped off.

37. The Committee observes that the company failed to recover commission paid to canvassing agents in cases where 2nd and 3rd instalments of the chitty were defaulted. The Committee suspects that the Branch Managers unduly favoured the agents, by overlooking the Company directions in this regard which, in turn, resulted in a loss of ₹ 6.56 lakh to the Company. The Committee, at this juncture, recommends that the commission should be paid to the agents only by taking in to account of the volatile economic credentials of the subscribers empanelled by them . It is also recommended to raise, if necessary, the advance garnering from them, reasonably. The Committee also opines that instead of excessive dependence on agents, the company may offer discounts to direct joinees as well as incentives to existing subscribers for referrals. This would help to grow the business without advertising cost and commission outflows.

38. It is deplorable that some Branch Managers give green lights to subscribers to take part in auction proceedings before ensuring that the cheques presented by them are not bogus. The Committee, in knowing about this impoverishing situation, vehemently recommends that the Company should take measures to ensure that subscribers are allowed to participate in auction only after realising the amount. In the event of collusion between officers and defaulters/swindlers, the Committee recommends that strict action be taken against officers and employees after detailed inquiry. The Company should also devise methods to plug the loopholes that enable such malpractices.

39. It has been a rampant phenomenon seen in almost all the branches of the Company that the prize money is being released on bogus salary certificate. Also, a condemnable laxity is seen looming large in the area of initiating revenue recovery proceedings against defaulting prize subscribers. The committee, on perusal of these matters in detail, recommends that strict action should be initiated against those who deceives the Company with bogus salary certificates and disciplinary action against those Branch Managers who were responsible for releasing prize money in such manner. It is also recommended that those Branch Managers who are in hibernation in initiating Revenue Recovery proceedings in time, should ruthlessly be fixed the fiscal onus in this regard.

40. It is condemnable that in many cases of terminated chitties, money due to be returned to subscribers is retained by the company unauthorisedly. Therefore, the Committee recommends that the company should speed up the release of such retained money to the eligible subscribers at the earliest.

41. It is noted that the inception of new branches is being made by blindly disregarding some established norms. The Committee, therefore recommends that the Company should conduct a proper survey and feasibility study before opening new branches in order to avoid branches making loss. The Company may consider diversification of its product base in view of the vast network of branches statewide. This would go a long way towards ensuring fiscal growth and profitability.

42. It is noted that there has been a legal discrepancy for the Company in respect with the conduct of chit and lending business simultaneously. The Committee doubts whether the Govt.Order (Rt)No.644/12/TD dated 4.9.12, permitting the Company to run chit and loan at a time is running counter to the relevant provisions of the Kerala Chit Fund Act, 1982, as observed by the Reserve Bank of India. The Committee, in this situation, demands that a clarification in this regard should be made at the earliest.

43. It is seen that some Branch Managers are unscrupulous in dealing with the perjuries and misappropriation of the collection agents. The Committee learns that had they duly complied with the procedure of daily collection, the flaws would not have occurred. The Committee, in this situation, urges that the company should take strong action against the tainted collection agents and against the company officials who maintains an unholy relation with such agents.

44. The Committee expresses dissatisfaction over the company's failure to fully automate its branches 8 years since the idea was mooted. The Committee observes that the Branch Automation Software (BAS), a proactive automation project facilitating a flawless and congenial customer service, is yet to be materialized in full. The Committee further observes that the lack of full computerization in the Company leads to a lack of effective control of the Company over the conduct of chitties and sanction, disbursement, monitoring and recovery of loans. Therefore, the Committee recommends that the Company should take immediate measures to modify the BAS by suitably rectifying the defects occurred in mapping of Business Rules and incorporation of validation controls, arrange to test the software adopting a standard testing methodology before the expiry of AMC agreement with the vendor and frame strategies/policies as required for the implementation of BAS in the remaining branches of the Company.

45. It has also come to the notice of the Committee that due to the absence of proper scrutiny mechanism, every personal surety was considered new and consolidated figure for the total liability of a surety could not be traced out. This has led to granting of loans to salaried persons from whose salary the defaulted recovery was not enforceable due to previous recoveries and Company faces loss due to non-recovery of dues. Therefore Committee recommends to check the feasibility of linking Aadhaar or any unique ID with the subscribers so that the Company can scrutinize the previous liability, if any, of the subscriber and thereby prevent any defaulter to obtain further loans or enrolling to new chitties.

46. It is also observed that non-issue of timely recovery notices of salaried defaulters to DDO's, who have issued NLCs and who are responsible/authorised to recover dues, has resulted further issue of fresh NLCs to the defaulter. Also belated notices gave way to accumulation of dues which make recovery impossible. The Committee taking a grave view on this, recommends that strict instructions must be given to all concerned officers to issue recovery notices at the initial occurrence of default and this ensure that the notices are served to the DDO's in time and recoveries are effected accordingly.

47. The Committee finds that the annual budgets prepared by the Company cannot be used as an effective tool of internal control as those were not finalised in time. The Committee is concerned that the Functional Manuals are not updated and stock records for receipt books are not maintained. The Committee also observes that the Audit Committees are not constituted in time and the Company has no effective vigilance set up. Overall, the Committee is dissatisfied with the Internal Control of the Company in respect of conduct of chitties, sanction, disbursement, monitoring, demand and recovery of loans which have resulted in increase in NPAs and accumulation of dues. The Committee recommends that the Budgets should be prepared in time and on a more realistic basis with a view to using it as an instrument of internal control. The Committee also recommends that the functional manual of procedure should be updated to ensure incorporation of latest schemes and adoption of best practices in the field. The Company should maintain proper control over stock of receipt books to prevent defalcation/misappropriation. The systems and procedures for loan sanction, disbursement and recovery of loans should be made more effective. The Committee recommends that the Company must adopt innovative methods and better use of technology to streamline operations. The Committee opines that it is time for the Company to adopt 'best practices' from the banking sector after due consideration and internal deliberations if possible.

C. DIVAKARAN,
Chairman,
Committee on Public Undertakings.

Thiruvananthapuram,
9th March, 2017.

APPENDIX I

SUMMARY OF MAIN CONCLUSIONS/RECOMMENDATIONS

Sl. No.	Para. No.	Department Concerned	CONCLUSIONS/ RECOMMENDATIONS
1	2	3	4
1	31	Taxes	The Committee is concerned about the negative cash flow from the Chitty business of KSFE which is forcing the Company to borrow funds from outside sources. Given that the Chitty business contributes to a major share in the total turnover of the Company, incidence of snowballing defaults of chitties and a disdained progress in the recovery proceedings of the Company makes the entire exercise frustrating and meaningless. The Committee, in this situation, urges that the company should make a credible effort in fixing the responsibility upon the officers who committed such serious lapses and a detailed report on action taken against responsible officials should be made available to the Committee at the earliest.
2	32	Taxes	The Committee expresses its apprehension with regard to the increasing number of defaulters and the imprudent enrolment of subscribers in new chitty schemes without realizing even the first instalment. Committee while probing the reason for such an increase in the number of defaulters, understands that some branches, in order to attain the impractical targets of new chitties fixed on them, were forced to enrol subscribers without conducting prechecks on their repayment

			capacity. Therefore, Committee recommends that targets for the branches should be fixed only after proper analysis based on scientific study of ongoing chitties. Also a judicious screening of the fiscal status of persons should be conducted by the branches before their enrolment.
3	33	Taxes	The Committee is distressed to know that some branches of the Company show reluctance in following 'Know Your Customers' (KYC) norms overtly. This has to be seen as a serious dereliction perniciously affecting the company. The Committee, therefore recommends that, action should be taken against the officers responsible for the non-maintenance of comprehensive chitty subscriber registers. The Committee also demands that the Company should strictly follow KYC (Know Your Customer) norms while enrolling subscribers in new chitties. The Committee also expects the Company to 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	34	Taxes	The Committee observes that the company was lax to realise the first instalment of a number of chitties by tarnishing the sanctity of the Chitty Act. The Committee, therefore, recommends that the realisation of first instalment of chitties should be done meticulously by strictly adhering to the provisions of the Act and transgressions if any, surfacing against it should be viewed seriously and stringent action should be taken against officers responsible for it.

5,	35	Taxes	It is bewildering that the company is intentionally slothful by enrolling defaulted subscribers/ financially unsound persons in chitties in line with an imprudent task of slot filling, and thus bringing a huge loss to the company. Besides, the Company's practice of self substitution of defaulted chitties resulting in loss by foregoing foreman's commission is highly condemnable. In this scenario, the committee is putting forward its opinion that the company should ensure the fiscal competence and repayment capacity of the subscribers under proposal in an authentic way well in advance of their enrollments.
6	36	Taxes	It is seen that the company was unwisely indulging in the substitution of high denomination chitties of defaulting subscribers by their relatives or friends resulting in loss to the company. In the event of substitution of defaulters, the rules may be framed keeping in mind the need to attract fresh subscribers without compromising the profitability of the Company. Rules must strike a balance between making substitution an attractive proposition and retaining the Company's Cash flows. Therefore the committee strongly recommends that this debilitating practice of substitution should thoroughly be wiped off.
7	37	Taxes	The Committee observes that the company failed to recover commission paid to canvassing agents in cases where 2nd and 3rd instalments of the chitty were defaulted. The Committee suspects that the Branch Managers unduly favoured the agents, by overlooking the Company directions in this regard which, in turn, resulted in a loss of ₹ 6.56 lakh to the

			Company. The Committee, at this juncture, recommends that the commission should be paid to the agents only by taking in to account of the volatile economic credentials of the subscribers empanelled by them. It is also recommended to raise, if necessary, the advance garnering from them, reasonably. The Committee also opines that instead of excessive 'dependence on agents, the company may offer discounts to direct joinees as well as incentives to existing subscribers for referrals. This would help to grow the business without advertising cost and commission outflows.
8	38	Taxes	It is deplorable that some Branch Managers give green lights to subscribers to take part in auction proceedings before ensuring that the cheques presented by them are not bogus. The Committee, in knowing about this impoverishing situation, vehemently recommends that the Company should take measures to ensure that subscribers are allowed to participate in auction only after realising the amount. In the event of collusion between officers and defaulters/swindlers, the Committee recommends that strict action be taken against officers and employees after detailed inquiry. The Company should also devise methods to plug the loopholes that enable such malpractices.
9	39	Taxes	It has been a rampant phenomenon seen in almost all the branches of the Company that the prize money is being released on bogus salary certificate. Also, a condemnable laxity is seen looming large in the area of initiating revenue recovery proceedings against defaulting prize subscribers. The committee, on perusal of these matters in detail, recommends that

			strict action should be initiated against those who deceives the Company with bogus salary certificates and disciplinary action against those Branch Managers who were responsible for releasing prize money in such manner. It is also recommended that those Branch Managers who are in hibernation in initiating Revenue Recovery proceedings in time, should ruthlessly be fixed the fiscal onus in this regard.
10	40	Taxes	It is condemnable that in many cases of terminated chitties, money due to be returned to subscribers is retained by the company unauthorisedly. Therefore, the Committee recommends that the company should speed up the release of such retained money to the eligible subscribers at the earliest.
11	41	Taxes	It is noted that the inception of new branches is being made by blindly disregarding some established norms. The Committee, therefore recommends that the Company should conduct a proper survey and feasibility study before opening new branches in order to avoid branches making loss. The Company may consider diversification of its product base in view of the vast network of branches statewide. This would go a long way towards ensuring fiscal growth and profitability.
12	42	Taxes	It is noted that there has been a legal discrepancy for the Company in respect with the conduct of chit and lending business simultaneously. The Committee doubts whether the Govt.Order (Rt)No.644/12/TD dated 4.9.12, permitting the Company to run chit and loan at a time is running counter to the relevant provisions of the Kerala Chit Fund Act, 1982, as observed by the

			Reserve Bank of India. The Committee, in this situation, demands that a clarification in this regard should be made at the earliest.
13	43	Taxes	It is seen that some Branch Managers are unscrupulous in dealing with the perjuries and misappropriation of the collection agents. The Committee learns that had they duly complied with the procedure of daily collection, the flaws would not have occurred. The Committee, in this situation, urges that the company should take strong action against the tainted collection agents and against the company officials who maintains an unholy relation with such agents.
14	44	Taxes	The Committee expresses dissatisfaction over the company's failure to fully automate its branches 8 years since the idea was mooted. The Committee observes that the Branch Automation Software (BAS), a proactive automation project facilitating a flawless and congenial customer service, is yet to be materialized in full. The Committee further observes that the lack of full computerization in the Company leads to a lack of effective control of the Company over the conduct of chitties and sanction, disbursement, monitoring and recovery of loans. Therefore, the Committee recommends that the Company should take immediate measures to modify the BAS by suitably rectifying the defects occurred in mapping of Business Rules and incorporation of validation controls, arrange to test the software adopting a standard testing methodology before the expiry of AMC agreement with the vendor and frame strategies/policies as required for the implementation of BAS in the remaining branches of the Company.

15	45	Taxes	It has also come to the notice of the Committee that due to the absence of proper scrutiny mechanism, every personal surety was considered new and consolidated figure for the total liability of a surety could not be traced out. This has led to granting of loans to salaried persons from whose salary the defaulted recovery was not enforceable due to previous recoveries and Company faces loss due to non-recovery of dues. Therefore Committee recommends to check the feasibility of linking Aadhaar or any unique ID with the subscribers so that the Company can scrutinize the previous liability, if any, of the subscriber and thereby prevent any defaulter to obtain further loans or enrolling to new chitties.
16	46	Taxes	It is also observed that non-issue of timely recovery notices of salaried defaulters to DDO's, who have issued NLCs and who are responsible/authorised to recover dues, has resulted further issue of fresh NLCs to the defaulter. Also belated notices gave way to accumulation of dues which make recovery impossible. The Committee taking a grave view on this, recommends that strict instructions must be given to all concerned officers to issue recovery notices at the initial occurrence of default and this ensure that the notices are served to the DDO's in time and recoveries are effected accordingly.

17	47	Taxes	The Committee finds that the annual budgets prepared by the Company cannot be used as an effective tool of internal control as those were not finalised in time. The Committee is concerned that the Functional Manuals arẻ not updated and stock records for receipt books are not maintained. The Committee also observes that the Audit Committees are not constituted in time and the Company has no effective vigilance set up. Overall, the Committee is dissatisfied with the Internal Control of the Company in respect of conduct of chitties, sanction, disbursement, monitoring, demand and recovery of loans which have resulted in increase in NPAs and accumulation of dues. The Committee recommends that the Budgets should be prepared in time and on a more realistic basis with a view to using it as an instrument of internal control. The Committee also recommends that the functional manual of procedure should be updated to ensure incorporation of latest schemes and adoption of best practices in the field. The Company should maintain proper control over stock of receipt books to prevent defalcation/misappropriation. The systems and procedures for loan sanction, disbursement and recovery of loans should be made more effective. The Committee recommends that the Company must adopt innovative methods and better use of technology to streamline operations. The Committee opines that it is time for the Company to adopt 'best practices' from the banking sector after due consideration and internal deliberations if possible.

APPENDIX - II

NOTES FURNISHED BY GOVERNMENT ON THE AUDIT PARAGRAPHS

Sl. No.	Audit Paragraph	Reply Furnished by Government
1	4.2.1	During the three years 2008-09, 2009-10 and 2010-11, the profit as per audited accounts are Rs. 31.26 crore, Rs. 36.79 crore and Rs.52.22 crore respectively. The profit was arrived at after considering interest expenses on different types of deposits received by the Company in respective years. Hence it is not required to consider the interest amount on fund to be utilised for dues. Company has taken all steps to clear dues. ➢ The amount to be collected in every three months in respect of dues on various schemes have been calculated and informed to all branches. ➢ Directions were given to all branches for reducing chitty dues by collecting chitty dues or by including subscribers. It was also directed to contact defaulted subscribers over phone on the day of auction or previous days. Company also decided to take special efforts for reducing dues. ➢ Directions were given to take prior permission from regional heads before starting Chitties with large installments. Besides, before including substitute subscribers, the policy of KYC norm were also implemented. ➢ Details regarding chitty dues is published in its websites and also displayed in notice boards of respective branches. ➢ Region wise meeting of branches with large dues are conducted and managers in charge of dues in regional offices were directed to visit branch offices and report to

Head Office. Actions are being taken on such reports.

Through these means Chitty dues can be substantially reduced.

2 | 4.2.5 | Increase in Secured borrowings (Overdraft on Fixed Deposit) and unsecured deposit received from public are seen as reduced from net cash flow in Cash flow statement.

Then increase in interest on loans give by the Company should also be considered. Accordingly net inflow from Chitty business will be as follows.

Particulars	2008-09	2009-10	2010-11
Cash from operating activities	144.30	458.37	-15.10
Less Increase in unsecured deposits	383.59	713.41	162.69
Balance	-239.29	-255.04	-177.79
Add Increase in various loans	892.64	1438.35	1377.30
Net cash flow	653.35	1183.31	1199.39

As per this the increase in various deposit is less than the increase in loans, as such it can be seen that increase in deposit was utilised for further loans and creating other assets. Audit observation that Cash from operating activities during the three years is insufficient to meet the activities of the Company is incorrect. As per audited cash flow statement company has made operating profits in all the years. It shows that the operating profit was utilised by the Company for working capital and long term investments. In 2010-11 the audited book profit of the Company is Rs. 52.15 crore and cash profits is Rs.81.91 crore. In previous years also company made operating profit and cash profit. These profits were also used for working capital and long term investments. It shows that for addressing this the Company has to depend on increase in capital or long term sources.

3	4.2.6	At the time of conducting internal audit/branch inspection, if the staffs are found guilty in following of procedures/rules and regulations, action is initiated against them. Branches were advised not to include defaulters in Chitties again. Action is being taken against branch mangers who admit subscribers without paying first installment. Dues are more in long term chitties of 100 months and chitties with large instalments. It was directed to take prior permission from Head Office on the basis of recommendations from regional heads for starting such chitties. Company sets its annual targets based on the business achieved in previous years, increase in expenses, new branches and dues in Chitties. Besides the basic principle for the growth of any organisation is achieving its targets. The ratio of net profit and annual turnover of the Company is low like any other financial institutions including banks. So increase in turnover is essential for sustaining profit and enhancing profitability. All instalments dues are recovered through revenue recovery action, Adalaths and other recovery measures. Non prizes dues are not a real loss to the Company. Instead they are turned out to be a source of income and asset for the Company. In that respect of non prized chitties Company has got three sources of income. 1. Profit from substituted tickets. 2. Interest on advance prize money 3. Interest dues on chitties. Through these sources the income generated by the Company is as follows:

Sl No.	Source	2013-14	2012-13	2011-12	2010-11
1	Profit from substituted tickets.	467354095	381065441	323754042	142537732
2	Interest on advance prize money	77261131	52263268	38846554	30507813
3	Interest dues on chitties	531609227	443808984	363878573	248727775
	Total	1076224453	877137693	726479169	421773320

The policies like reducing targets based on increase in dues will adversely affect the growth of the Company. As such in the opinion of the Company, Company should be advanced by collecting dues and sustaining growth rate.

Kerala Chitties Act, 1975 was followed by the KSFE up to June 2012. The Para mentions about non maintenance of Form No. XIII/Form NO. XVIII registers in Kesavadasapuram and Manacaud branches of Trivandrum district. The Manacaud branch informed that they are maintaining Form XVIII as specified in the Act. Instructions/directions have been issued to Kesavadasapuram branch to find out the register. Strict instructions have been issued to all branches to follow KYC norms.

Moreover, to reduce dues, the action is taken as mentioned in the reply of para 4.2.4.

4	4.2.6.3	Directions have been issued to all branches to register the chitties only after realizing the first installment as mentioned in the act.
5	4.2.6.4	Implementation of Centralised liability Verification (CLV) system to ascertain and prevent the multiple chitty enrollment defaulted subscribes and liability creation is in the final stage. Moreover, Directions has been issued to all branches to avoid enrolling financially unsound persons in chitties.
6	4.2.6.5	Directions are given to take action to find substitutes by removing defaulters in respect of non-prized tickets by giving legal notices.

		This stipulations are not applicable to Chitties started before June 2012 as they were registered under KERALA Chitty Act 1975. However directions were given to reduce dues in these chitties. As from the beginning itself it was directed to substitute itself in tickets with dues where 60% of term of chitties were expired. Company gets profit during the period from defaulted instalments to substitution. So company can reduce atleast partially the loss incurred due to use of deposits collected by the Company for payment of Chitty amount by clearing dues. However it is not practical to conduct Chitty business without incurring dues.
7	4.2.6.6	Instructions have been issued to all branch managers to take appropriate steps to reduce the dues of defaulted non-prized subscribers. Moreover, to avoid revenue loss in the form of interest at the time of substitution, instructions has been issued to all branches to take earnest effort to remit the dues by the defaulters themselves instead of substitution.
8	4.2.6.7	In respect of 142 tickets out of 213 tickets from 17 branches either dues were collected or commission was recovered. It was directed to recover agency commission in the balance 71 defaulted tickets. In respect of commission paid for two chitties in Thiruvananthapuram Branch cannot be recovered as it was before issuing of Circular by the Company.
9	4.2.7	Strict instructions have been issued to all branches to allow the subscribers/defaulted subscribers to participate in the auction only after realizing the cheque amount. The failure cases would be viewed seriously.
10	4.2.8	To reduce dues, the action is taken as mentioned in the reply of para 4.2.4.
11	4.2.8.1	Strict instructions has been issued to all branches to ensure the genuineness of the salary certificate (at the time of accepting it as

		personal surety for getting prize money) besides obtaining confirmation from concerned offices via phone or letter. Retirement benefits of those officers (who were found responsible for releasing money based on bogus surety thereby causing loss to the company) were withheld by the company.
12	4.2.8.2	Strict directions have been given to all branch managers to take RR procedures against all defaulted/pending cases of 12 months or more. Moreover, the managers in charge of chitti dues in regional office are monitoring all branches in this matter. As mentioned in the para 4.2.4, regional managers in charge of chitti dues has been given direction to visit the branches, to check the pending dues, give appropriate directions to the branch in collecting the dues and sent the inspection reports to the head office. If the reports mentions about any negligence explanations will be called for against those branch managers. This will help to reduce dues to some extent.
13	4.2.9.1	Instructions have been given to branches to take immediate steps for the intimation and release of such amount to the concerned subscribers.
14	4.2.9.2	Strict Directions has been issued to all branches for speedy release of chitty security deposits following all formalities. More over, instructions have been issued to all regional heads to check the same at the time of branch inspections. Internal audit has also given importance to the matter. These steps will help to avoid the interest loss in future.
15	4.2.9.3	New branches will be started only after conducting feasibility study as mentioned in the audit report.
16	4.2.9.4	Collection of deposits and lending business were started by the Company as per G.O.(RT) 644/2012/TD. dt: 04-09-2012. As per section 12(1) new Chitty fund Act 1982 Government has the power

		to give such permission. Government issued order on the basis of this authority.
17	4.2.9.5	Action had been initiated to recover the loss occurred due to misappropriation by the Collection Agent. Financial misappropriation has not been reported by the special audit conducted during 2010 & 2011. Instead, some deviations/ non-compliance in the procedures was reported. Special audit report only mentions about extra expenditure of Rs. 1.82 lakh incurred in door collection commission etc. For solving this, the MD & Regional AGM, in 2010 November, visited Thiruvalla branch and suggested measures to correct the deviations mentioned in the special audit report. Financial misappropriations were reported in another special audit held in 2012. Based on the report, steps had been taken to recover the loss incurred and to repay the amount to those subscribers who had suffered loss of money. Action has been taken against the staff responsible for this incident. The 21 cent property including a house of Collection agent and his sister has been pledged to the company for recovering the loss.
18	4.2.10	Company has got 31 lakh subscribers. The present business turnover of the Company is Rs.22727 crore. Kerala Government formed KSFE for protecting the public from unscrupulous private chit fund operators. KSFE stands for achieving this objective. KSFE provides service for fulfilling this objective. So far an amount of Rs.542 crore as dividend, guarantee commission and service charge was paid to GoK. An amount of Rs. 812 crore is in treasury as fixed deposit besides an amount of Rs. 1539 crore as security deposit on Chitties. The total of four years was shown in Audit Para 4.14. KSFE as a PSU stands as a role model in

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conducting Chitty business by following all stipulations in Chitty act.

Compared to achievements of the Company so far deficiencies are small percentage. The Company is committed to resolve these deficiencies and grow.

Annexure 22

Statement showing total turnover of Kerala State Financial Enterprises Limited

(Referred to in paragraph 4.2.4.)

(₹ in crore)

Particulars	2008-09	2009-10	2010-11	2011-12
Chitty turnover	3680.78	6278.42	6896.45	8195.86
Advances	1249.4	1476.34	1941.79	1928.28
Total turnover	4930.18	7754.76	8538.24	**10124.14**
% of Chitty turnover to total turnover	74.66	**80.96**	**80.77**	**80.98**

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Annexure 23

Statement showing profit and loss in Chitty business of Kerala State Financial Enterprises Limited

(Referred to in paragraph 4.2.4)

(₹ in crore)

Item	**2008-09**	**2009-10**	**2010-11**
Income from chitty business			
Foreman Commission	162.99	234.49	313.93
Interest on Deposit with Treasury/Bank	37.49	53.17	73.50
Dividend[5] income on statutory ticket	8.80	12.67	15.97
Profit on substituted chitty	16.59	19.60	14.25
Writing fee	2.88	3.71	4.87
Default interest on chitty	14.91	19.13	24.87
Total Income from chitty business	**243.66**	**342.77**	**447.39**
Total income from chitty and lending business	**432.78**	**594.12**	**716.74**
% of chitty income to the total income	**56.30**	**57.70**	**62.42**
Expenditure in chitty business			
Promotional Expenses	32.63	36.12	40.65
Registration & filing charges	12.97	17.98	17.14
Service charges paid to State Govt.	20.37	29.31	39.24
Administrative Expenses	8.80	10.90	12.85
Staff expenses	79.51	119.43	181.46
Interest and finance charges	99.06	135.80	152.95
Total Expenditure in chitty business	**253.34**	**359.54**	**444.29**
Profit/(loss) in chitty business	**(9.68)**	**(6.76)**	**3.10**
% of profit in chitty business to total profit	**–**	**–**	**6**

5 Dividend (Veethapalisa / Auction dividend) means Sala – (discount foregone + Foreman commission).

Annexure 9

(Referred to in paragraph 2.7)

Statement showing the budgeted and actual figures under various schemes of Kerala State Financial Enterprises Limited during the five years up to 2005-06

(Rs. in crore)

Sl No	Name of the scheme	2001-02			2002-03			2003-04			2004-05			2005-06		
		Budget	Actual	Percentage of variation	Budget	Actual	Percentage of variation	Budget	Actual	Percentage of variation	Budget	Actual	Percentage of variation	Budget	Actual	Percentage of variation
1	New chitty loan/ Pass book loan	418.33	328.17	(-) 21.55	311.89	273.86	(-) 12.20	259.67	202.40	(-) 22.06	254.74	135.32	(-) 46.88	138.86	1[illegible]9.27	(-) 14.11
2	Trade loan	17.74	13.34	(-) 24.78	14.99	10.59	(-) 29.33	11.03	7.29	(-) 33.88	6.69	4.64	(-) 30.66	8.76	2.51	(-) 71.38
3	Sugama deposit scheme	146.11	129.92	(-) 11.08	179.71	173.38	(-) 3.52	244.45	206.89	(-) 14.55	286.07	229.61	(-) 19.74	263.13	[illegible]	(-) 9.[illegible]
4	Reliable customer loan	16.31	16.41	0.63	22.87	27.26	19.18	37.22	44.04	18.34	140.19	70.39	(-) 49.79	88.61	159.34	79.82
5	Newhousing finance scheme	50.31	47.03	(-) 6.52	52.49	44.24	(-) 15.71	45.53	42.67	(-) 6.28	42.31	39.17	(-) 7.43	51.15	38.97	(-) 23.81
6	Car loan/ Two wheeler loan	0.00	0.00	....	0.00	0.00	-	0.00	5.47	.	93.57	1.43	(-) 98.47	23.14	1.39	(-) 93.97
7	Fixed deposit /New fixed deposit loan	38.56	30.77	(-) 20.22	26.92	24.59	(-) 8.66	27.42	27.82	1.43	27.62	23.65	(-) 14.38	24.45	25.84	5.68

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