Chapter-XI

Finance Department

Evaluation of the Internal Control System in Jammu and Kashmir Sate Financial Corporation

11.1 The Jammu and Kashmir State Financial Corporation was established (December 1959) under the State Financial Corporations Act, 1951 for promoting/developing industrial growth in the State by providing financial assistance in the form of Term Loan to industries (medium and small scale units including artisans), hotels, houseboats, transport sector etc. for acquiring capital assets like land, building and plant/machinery. The Company arranges its finances by raising loans from financial institutions and through private placement of public bonds depending upon its requirement.

The management of the Corporation is vested with the Board of Directors comprising 10 directors including the Chairman and the Managing Director. The Managing Director is responsible for day-to-day functioning of the Corporation and is, *inter alia* assisted by two General Managers, three Deputy Managers and a Secretary.

Up to March 2005, the Corporation financed Rs.155.50 crore to 9361 Small Scale Industrial units and Rs. 4.56 crore to 23 Medium Scale Industrial units out of total 71570 units registered with the Industries and Commerce Department, Government of Jammu and Kashmir, representing 13 *per cent* of the total SSI units.

Internal Control System is a management tool used to provide assurance that Management's objectives are being achieved. An effective internal control system is a pre-requisite for efficient functioning of any organisation. It comprises long and short term planning for achievement of objectives, periodical review of plans, budgetary control mechanisms, and control for each responsibility area and accounting procedures to ensure the accuracy and reliability of accounting data.

An attempt was made in audit to evaluate the effectiveness of the Internal Control System of the Corporation. The results of audit findings are discussed in succeeding paragraphs.

Budgetary control

11.2 Budget is a quantitative financial expression of a programme of activities planned for a given period. The budget is drawn to plan future operations and to make *ex-post facto* checks on the results obtained. Timely preparation of budget and analysis of the variations noticed in the actual execution, serves as an effective tool of internal control.

The Corporation annually prepares Business Plan and Resource Forecasting (BPRF) for submission to Small Industries Development Bank of India (SIDBI). The Corporation, based on the BPRF, raises funds from financial institutions and through private placement of public bonds depending upon its requirement.

It was noticed in Audit that the Corporation did not finalise/approve the BPRF before commencement of the financial year. The Board belatedly approved the BPRF for the years 2000-01, 2001-02, 2002-03, 2003-04 and 2004-05 in April 2000, July 2001, June 2002, July 2003 and September 2004, respectively. The Management stated (October 2005) that steps would be taken to prepare the BPRF before commencement of the next financial year.

The data regarding budget estimates, actuals and the variations (between the budget estimates and the actuals) noticed in audit during each of the five years up to the end of 2004-05 are given in the *Appendix-38*. As can be seen from this *Appendix*, the variations between the budget estimates and the actuals ranged between Rs. 1 lakh (0.2 *per cent*) and Rs. 45.40 crore (66.67 *per cent*) during this period. The Corporation did not analyse the reasons for variations between the actual and budgeted figures to take corrective action. Continuation of variations year after year indicated that the projections in BPRF were unrealistic. The Management stated (March 2005) that due care would be taken to formulate BPRF on realistic basis. Delay in finalisation/approval by BPRF and lack of analysis of variations in the projections indicated that the Corporation was unable to use the budget as an effective tool of internal control.

Operational controls

Functional Manuals

11.3 The functional manuals provide guidance to the personnel incharge of appraisal, disbursement/recovery and also provide guidelines to proceed for taking legal action against the defaulters. Audit noticed (February 2005) that the manuals were not prepared, indicating that the Corporation had not formulated Internal Control Systems for these activities even after more than four decades of its existence.

The Management assured (October 2005) that steps would be taken to prepare the functional manuals which could provide guidelines to the personnel concerned to discharge their duties more effectively.

Internal control in major activities

11.4 The lending function involves three major activities viz., (i) appraisal and sanction (ii) disbursement (obtaining of security and documentation) and monitoring and (iii) demand and recovery. Each of these functions is discussed in the following paragraphs:

Appraisal and sanction

11.5 Appraisal is the critical examination of technical, financial and commercial feasibility of a project and judging the managerial competence of the promoters to implement and run the project successfully. Appraisal of the projects is necessary to determine whether it would be worthwhile to make investment in these projects. The quality of appraisal depends upon the degree of accuracy of estimates on which the project is based. Preparation of appraisal report becomes easier if the project report is prepared after considering all the relevant information/data, giving due importance to the different relevant factors.

The Corporation did not prepare any manual for project appraisal for providing directions to the appraising officers to proceed on generally accepted norms. Audit noticed following deficiencies in the appraisal system:

Table 11.1

S. No.	Nature of Deficiency	Number of cases of deficiency/total checked	Percentage to cases checked
1.	Credit worthiness of the applicant was not ascertained from banks/financial institutions	29/34	85
2.	Genuineness of the applicant/guarantors not verified	11/15	73
3.	There was no evidence in support of projections in the applications	8/19	42
4.	Promoters background/track record not evaluated properly	18/34	53
5.	Improper technical/commercial appraisal	6/19	32
6.	Statutory clearances not obtained at the time of appraisal	5/19	26
7.	Strength, Weakness, Opportunities and Threat (SWOT) analysis not done properly	6/19	32
8.	Improper managerial appraisal	6/19	32
9.	Assets of the applicant/guarantors neither verified nor evaluated properly	9/15	60

From the above table it would be observed that the project appraisal system in the Corporation was defective and needed improvement. The Management while admitting the above facts assured (October 2005) that due care would taken to improve the appraisal system.

Disbursement and monitoring

11.6 Monitoring system devised by the Corporation, required preparation of project completion report after the final disbursement of loan instalment. It is required to contain information on whether the assets created by the assisted units are as stipulated at the time of sanction, and serves as an important evidence for creation of assets. In 10 out of 19 cases reviewed, the report was not prepared.

Inspections

11.7 In accordance with the administrative instructions, post disbursement inspections of units are to be conducted once in a financial year. Audit noticed that the post disbursement inspections were not conducted as required. Against 7622 existing units in respect of four branches, the post disbursement inspection of 3138 units only was conducted during 2000-01 to 2004-05. The shortfall ranged between 29 to 100 *per cent* as shown in *Appendix-39*. Besides, proper Inspection Register for recording the details of inspections conducted was not maintained.

Although an amount of Rs. 82.66 crore was recoverable in 647 transport cases (March 2004), Chief Manager Large Branch Office, Jammu, noticed that there was negligible recovery from this sector. According to him, the recovery was not forthcoming, as the vehicles were either non-existent/untraceable or the borrowers/guarantors were not available. In 99 *per cent* cases, the notices issued by the Corporation for recovery of its dues returned undelivered and in some cases, the borrowers denied having availed of any loan from the Corporation. This not only showed an ineffective monitoring mechanism but also deficient verification procedures existing in the Corporation.

Audited accounts

11.8 Administrative instructions require that audited accounts, bringing out details of production and sale should be obtained at periodical intervals from assisted units to ascertain their financial health and for taking appropriate timely action against defaulters. These were not obtained in 14 out of 19 cases reviewed.

Nominee directors

11.9 According to the terms of sanction of the loans, the Corporation is empowered to nominate directors in the assisted units to ascertain the status of the assisted unit and to have a control over their affairs. Audit noticed that directors were nominated only in 15 out of 60 units (March 2005). Non-invoking of this control measure was fraught with increased risk of default. Audit noticed that in case of 41 units, where no directors had been nominated, the amount of default aggregated Rs. 91.02 crore as on March 2005. The Management stated (April 2005) that steps would be taken to appoint directors wherever required.

The following deficiencies were also noticed:

Table: 11.2

S. No.	Deficiency	No. of cases of deficiency/ total checked	Percentage to cases checked
1.	Non-fulfillment of terms of sanction before first disbursement	11/19	58
2.	Relaxation of terms of sanction in respect of creation of security	2/19	11
3.	Non-fulfillment of first investment clause	4/19	21
4.	Non-insurance of assets	14/19	74
5.	Non-verification of accounts during implementation and moratorium period	11/19	58
6.	Sale of assets/investment of funds in other concerns by the loanee without the approval of the Corporation	4/34	12

The Management admitted (October 2005) the above points, but did not intimate any remedial measures that it contemplated to improve its disbursement and monitoring system.

Demand and recovery

11.10 Recovery of dues is an important operation of the Corporation to plough back the funds and to recycle them for development of industrial activity. The position of demand and recovery during 2000-01 to 2004-05 was as follows:

Table: 11.3 (Amount: Rupees in crore)

Year	Demand			Recovery			Percentage of recovery		
	P	I	T	P	I	T	P	I	T
2000-01	104.82	411.74	516.56	14.72	6.89	21.61	14	2	4
2001-02	112.12	477.57	589.69	9.98	5.58	15.56	9	1	3
2002-03	113.57	562.04	675.61	10.75	5.68	16.43	9	1	2
2003-04	124.72	623.89	748.61	16.67	7.52	24.19	13	1	3
2004-05	130.01	689.27	819.28	13.24	8.87	22.11	10	1	3

(P: Principal; I: Interest; T: Total)

The Management Stated (October 2005) that steps would be taken to improve the recovery performance. The following deficiencies were also noticed:

Table: 11.4

S. No.	Deficiency	No of cases of deficiency/total checked	Percentage to cases checked
1.	Reasons for default not recorded and not analysed	10/34	29
2.	No concrete action against persistent defaulter to recover overdues	25/34	74
3.	No periodical inspection of assisted units to verify security and health of the unit	32/34	94
4.	Non-invoking of collateral/personal guarantee	19/34	56
5.	Demands not sent to the loanee at regular periodicity	26/34	76
6.	Non-comparing list of assets taken over with project completion report to ensure that no assets were missing	6/6	100
7.	Issue of No Objection Certificate for renewal of permit/release of vehicle without recovery of dues in full	6/15	40

Management of non-performing assets

11.11 Non-performing Assets (NPAs), as per IDBI norms during the period 2000-01 to 2004-05 were as follows:

Table: 11.5

(Amount: Rupees in crore)

	2000-01	2001-02	2002-03	2003-04	2004-05
Total assets/loan value	125.13	130.76	132.90	126.64	128.00
Standard assets	20.18	28.58	25.75	20.43	28.95
Non-performing assets	104.95	102.18	107.15	106.21	99.05
Percentage of NPA to total assets	84	78	81	84	77

The percentage of NPAs ranged between 77 and 84 during 2000-01 to 2004-05, against the desired level of less than 10.

High percentage of NPAs was due to defective appraisal system, non-monitoring of assets and inability of the Management to recover its dues. This resulted in heavy accumulation of NPAs, thereby adversely effecting its financial viability. There was an imperative need for the Corporation to strengthen its internal control mechanism so as to evolve an efficient and effective appraisal system of loan cases, monitoring of the financial health and verification of the assets of the assisted units and improve its recovery performance, which could reduce the percentage of NPAs. The Management admitted (October 2005) the above facts and stated that steps would be taken to reduce the percentage of NPAs.

Management of assets taken over

11.12 Section 29 of the State Financial Corporations Act, 1951, empowers the Corporation to take over the management and/or the assets of the defaulter units and to realise the property pledged, mortgaged, hypothecated or assigned to the Corporation. As of March 2005, assets in 21 cases had been taken over for recovery of dues amounting to Rs. 22.65 crore. Of these 12 cases (amount due Rs. 6.90 crore) were more than one year old and accounted for 57 *per cent* of these cases. Delay in disposal of assets would result in diminution in their value and consequent low realisation. The Corporation had not fixed any maximum period within which the taken-over assets should be disposed of. The Corporation had also not maintained any consolidated register/list of assets indicating the value of assets taken over, in absence of which the quantum of security available could not be ascertained in audit.

There was no prescribed system to safeguard the acquired assets against abuse. Out of 21 units (Srinagar: 5, Jammu: 16) only 3 units of Srinagar were insured while no unit from Jammu was insured on the plea that it involved drainage of funds

Internal Audit

11.13 Internal Audit is an appraisal activity established within an entity. Its functions *inter alia* include examination, evaluation and monitoring the adequacy and effectiveness of the accounting and Internal Control Systems. Effective Internal Audit ensures greater efficiency and provides concurrent feed back to the Management for bringing improvement in systems and procedures.

The Corporation did not establish any Internal Audit Wing. As a result, neither the Audit Plan was framed nor was the audit of sanctions, disbursements and financial transactions conducted during the period 2000-01 to 2004-05. The Management stated (March 2005) that the inspection team constituted in

August 2004 took care of these aspects by issuing directions on the spot. Audit, however, noticed that the inspection team had issued no written directions.

The Management stated (October 2005) that the proposal for creation of the Internal Audit Cell had been sent to the Government for approval. Further developments in the case were awaited (October 2005).

Summary

11.14 The Corporation failed to utilise Internal Control mechanism as an effective management tool to achieve its objectives efficiently. The project appraisal system was defective and there existed no functional manuals to provide guidance for appraisal/sanction, disbursement, monitoring and recovery of its dues.

The Corporation should take steps to prepare the functional manuals and improve the appraisal system/disbursement policy/monitoring mechanism and also reduce the percentage of NPAs and improve its recovery performance.

The above findings were reported to the Government (June 2005); its reply had not been received so far (October 2005).

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