CHAPTER IV
PROMOTIONAL MEASURES

Executive Summary

The audit review of the three duty free credit entitlement schemes for (i) status holders, (ii) service providers and (iii) vishesh krishi upaj yojana (VKUY) under the Foreign Trade Policy was conducted, to evaluate whether internal control mechanism instituted in the department to ensure compliance with the provisions of the Act/Rules/Regulations/Schemes and Policy for issue of these certificates/scrips and its subsequent utilisation for imports of goods, were adequate and effective.

The audit review has revealed system as well as compliance weaknesses relating to the issue of duty credit certificates/scrips and in ensuring their appropriate utilisation.

There was no mechanism to correlate declared export performance/foreign exchange earnings with other statutory records like annual accounts, foreign inward remittance certificate (FIRC), bank realisation certificate (BRC), income tax (IT) returns, etc. This facilitated issue of excess duty credit certificates/scrips in a few cases. The Government needs to amend the schemes by requiring additional documents like annual accounts to be enclosed and verified before tax benefits based on export performance are determined.

The compliance issues noticed in audit related to (a) incorrect issue of duty credit certificates/scrips and (b) inappropriate utilisation of the certificates/scrips. The credit certificates/scrips were incorrectly issued mainly due to (i) non-achievement of prescribed incremental growth, (ii) certificates/scrips to importers/exporters who were not status holders or were not service providers or were not registered, (iii) incorrect computation of eligible export turnover/foreign exchange earning, (iv) inclusion of supplies from a status holder to another, (v) reckoning of exports against free shipping bills, (vi) consideration of export performances of closed companies for determining credit entitlement of a new company, (vii) incorrect computation, (viii) scrips being issued for un-notified ports, etc. The inappropriate use of duty credit certificates/scrips subsequent to these being issued related to (i) cases where end-use of the goods imported under the certificates was not verified, (ii) payment of additional duty incorrectly through the certificates, (iii) payment of duty through the credit certificates/scrips despite having insufficient credit, and (iv) import of inadmissible goods, etc. The duty credit incorrectly granted/used in the deficiencies noticed in the test check by audit was Rs. 349.67 crore. The Government needs to recover the applicable duty foregone wherever these credits had already been utilised inappropriately, in addition to initiating appropriate penal actions.

Specific recommendations designed to address the system deficiencies and mitigate the risk of similar irregularities in future, have been included in the report.

4.1 Highlights

System issue:-

- **Absence of mechanism to correlate declared export performance/foreign exchange earnings with annual accounts resulted in grant of excess duty credit of Rs. 10.25 crore.**

(Paragraph 4.6.1)

Compliance issues:-

(i) Incorrect issue of duty credit certificates/scrips

DFCE scheme for status holders

- **In eight cases, incorrect duty credit of Rs. 45.37 crore was granted even though the requisite incremental growth in exports had not been achieved.**

(Paragraph 4.7.1.1)

- **One hundred and eighteen certificates with a total duty credit of Rs. 36.09 crore were incorrectly issued to exporters who were not status holders.**

(Paragraph 4.7.1.2)

- **Excess duty credit of Rs. 11.04 crore was granted in 59 cases due to incorrect determination of eligible export turnover.**

(Paragraph 4.7.1.3)

- **Excess duty credit of Rs. 8.83 crore was granted in 29 certificates by wrongly reckoning the supplies made by one status holder to another.**

(Paragraph 4.7.1.4)

- **Excessive duty credit of Rs. 8.47 crore was granted in 10 cases by incorrectly reckoning the exports made under the free shipping bills.**

(Paragraph 4.7.1.5)

- **In ten cases, importer-exporter codes of closed firms were issued to newly formed companies enabling the latter to obtain duty benefits of Rs. 7.62 crore, based on the export performance of the former.**

(Paragraph 4.7.1.6)

DFCE scheme for service providers/SFIS

- **Regional licensing authorities had issued 58 duty credit certificates of Rs. 34.74 crore based on ineligible remittances.**

(Paragraph 4.7.1.9)

- **Forty eight duty credit certificates with duty credit of Rs. 18.31 crore were issued incorrectly to service providers who did not have the requisite registration with the Tourism department.**

(Paragraph 4.7.1.10)

- **Duty credit of Rs. 16.77 crore was granted to exporters who did not have the requisite registration-cum-membership certificate (RCMC) with the export promotion councils (EPCs).**

(Paragraph 4.7.1.11)

- **Regional licensing authorities granted duty credit of Rs. 14.54 crore incorrectly to Software Technology Park (STP) units.**

(Paragraph 4.7.1.12)

- **In 14 certificates, duty credit of Rs. 12.65 crore was granted in excess by considering incorrectly the earnings that did not pertain to the year of claim.**

(Paragraph 4.7.1.13)

Vishesh krishi upaj yojana (VKUY)

- **Duty credit scrips of Rs. 10.82 crore was issued in 137 cases based on ineligible exports.**

(Paragraph 4.7.1.17)

(ii) Inappropriate use of certificates/scrips

DFCE scheme for status holders

- **Additional duty totalling Rs. 2.27 crore was paid incorrectly through debit in the DFCE certificates.**

(Paragraphs 4.7.2.2)

DFCE scheme for service providers/SFIS

- **Duty of Rs. 1.77 crore needs to recovered in four cases where duty was incorrectly paid through DFCE certificates having insufficient credit.**

(Paragraph 4.7.2.5)

Vishesh krishi upaj yojana

- **In 364 cases, duty credit scrips of Rs. 22.53 crore were inappropriately utilised on import of inadmissible items.**

(Paragraph 4.7.2.8)

4.2 Introduction

A: Duty free credit entitlement (DFCE) scheme for status holders

The Government of India introduced DFCE scheme for status holders[8] with effect from 1 April 2003, as a part of promotional measure for exports, through the Export and Import (Exim) Policy 2002-07. The objective of the scheme was to 'accelerate the incremental growth in exports and to facilitate India in emerging as a major base for sourcing different products and services for the rest of the world by rewarding status holders who have achieved a quantum growth in exports'. The DFCE scheme allowed exporters, who had

[8] Exporters with annual export turnover of Rs. 45 crore and above

achieved a quantum growth in exports, duty free credit based on incremental export turnover. All status holders (paragraph 3.7.2 of the Exim Policy 2002-07) who had achieved a minimum export turnover in free foreign exchange of Rs. 25 crore or more in the previous licensing year, were eligible for consideration for issue of duty free credit entitlement (DFCE) certificates. These certificates could then be utilised for duty free imports upto the prescribed duty credit in the certificates. The entitlement under this scheme was ten per cent of the incremental growth of the 'Free on Board, (FOB)' value of exports in the current licensing year over the previous licensing year. According to the Exim Policy 2002-07, incremental growth in exports over 25 per cent was eligible for duty credit certificates.

The Government had estimated the revenue foregone under the scheme for the year 2006-07 at Rs. 837.10 crore. Rs. 1,653.86 crore was foregone during the years 2003-04 to 2006-07.

The scheme was withdrawn with effect from 1 September 2004. However, the utilisation of the credits for imports would continue for the certificates, which had already been issued, as these were valid for use upto two years from the date of issue of certificate.

B: DFCE scheme for service providers/served from India scheme (SFIS)

The Government of India introduced the 'DFCE scheme for service providers' with effect from 1 April 2003, as a part of promotional measure for exports, through the Export and Import (Exim) Policy 2002-07. The objective of the scheme was to 'accelerate the growth of export in the service sector with a view to increase India's share of global trade' by rewarding service providers who had achieved average foreign exchange earning of over rupees ten lakh in the preceding three licensing years. The scheme allowed duty free imports equivalent to ten per cent (five per cent in case of hotels) of the average foreign exchange earned by the service providers in preceding three years. The DFCE certificate issued under the scheme could be utilised for duty free imports upto the prescribed duty credit in the certificates. In the Foreign Trade Policy (FTP) 2004-09, introduced with effect from 1 September 2004, the above scheme was renamed as 'SFIS' with a few modifications. The objective of SFIS was to "accelerate the growth in export of services to create a powerful and unique 'served from India' brand, instantly recognised and respected the world over".

The Government had estimated the revenue foregone under the scheme for the year 2006-07 at Rs. 854 crore. The revenue foregone during the years 2003-04 to 2006-07 was Rs. 2,967 crore.

C: Vishesh krishi upaj yojana (VKUY)

The Government of India introduced the VKUY with effect from 1 September 2004, as a part of promotional measure for export of agricultural products (fruits, flowers, vegetables, forest produce and their value added products), through the Foreign Trade Policy (FTP) 2004-09. The objective of the scheme

was to promote export of fruits, vegetables, flowers, minor forest produce, and their value added products by giving incentives to the exporters of such products. The exporters of such products were entitled for duty credit scrip equivalent to five per cent of the 'Free on Board (FOB)' value of exports for each licensing year commencing from April 2004. The scrip and the items imported against it were freely transferable. The duty credit could be used for import of inputs or goods including capital goods. Imports from a port other than the port of export were allowed under 'Telegraphic release advice, (TRA)' facility. The scheme was in operation for two years and was subsequently expanded, modified and renamed as 'Special Agricultural Produce Scheme' with effect from 1 April 2006.

The Government had estimated the duty foregone under the scheme for the year 2006-07 at Rs. 800 crore.

The certificates/scrips issued under the three aforesaid schemes were valid for a period of 12/24 months. The certificate holder was required to submit, within one month of the expiry of the certificate, a statement of imports made under the certificate to the jurisdictional regional licensing authority (RLA). For any violation of the schemes, the Director General of Foreign Trade (DGFT) or the authorities empowered under the Act were required to initiate action under the Foreign Trade (Development and Regulation) Act, 1992, which included issue of show cause notice (SCN), levy of penalty, suspension/cancellation of importer-exporter code (IEC) licences, etc. The applicable customs duty foregone was, however, required to be recovered by the revenue department.

4.3 Audit objectives

The review was conducted to evaluate whether internal control mechanisms had been instituted and were effective in ensuring compliance with the provisions of the Act/Rules/Regulations/Schemes and policy for issue of these duty credit certificates/scrips and their subsequent utilisation for import of goods.

4.4 Scope of audit

Audit examined the implementation of the schemes with reference to the Exim Policy 2002-07/FTP 2004-09 and the procedure laid down in the Handbook of Procedures (HBP). With reference to the DFCE scheme for status holders, audit reviewed 1,324 certificates with duty credit of Rs. 1,204.99 crore. These were selected out of the population of 1,670 certificates through which duty credit of Rs. 1,653.86 crore was granted by the licensing authorities from 2003-04 to 2006-07.

For the DFCE for service providers/SFIS, 1,770 certificates with a total duty credit of Rs. 2,912.15 crore were reviewed in audit out of a total of 1,862 certificates through which duty credit of Rs. 2,967.41 crore was granted by the licensing authorities upto 31 March 2007.

Of the 8,859 scrips with a total duty credit of Rs. 3,674 crore issued under the VKUY upto March 2007 by the licensing authorities, audit reviewed 4,849 scrips with duty credit of Rs. 1,370 crore.

4.5 Acknowledgement

The Indian Audit and Accounts Department acknowledges the cooperation extended by the Ministry of Finance and the Ministry of Commerce and Industry in providing the necessary information and records for audit. The draft review was forwarded to the Ministries in December 2007 and an exit conference was conducted with the Ministry officials in December 2007. The conclusions and recommendations were agreed to be examined and referred to policy wing by the Ministries, wherever appropriate. While the written responses to the draft review from the Ministries have not been received, responses of the department, wherever received, have been incorporated appropriately.

AUDIT FINDINGS AND RECOMMENDATIONS

The audit review revealed a number of system and compliance deficiencies which are discussed in the subsequent paragraphs of this chapter. **While recommendations that are specific to a type of deficiency have been indicated, the audit findings in a broad way point to the urgent need to put in place control mechanisms to plug the loopholes/lapses pointed out in the cases discussed in the report. Further, the existing controls to verify data furnished by exporters to obtain duty free benefits should be strengthened. The Ministry of Commerce in coordination with the Ministry of Finance needs to strengthen the internal controls governing issue of duty credit certificates/scrips under DFCE/SFIS/VKUY as well as those relating to subsequent utilisation of these credit certificates/scrips, to ensure that the benefits derived by the importers/exporters are the intended ones and commensurate with the duty foregone.**

4.6 System issue

4.6.1 Absence of mechanism to correlate declared export performance/foreign exchange earnings with annual accounts to determine duty credits under DFCE/SFIS

As per paragraph 3.7.2.1 of the Exim Policy, 2002-07, the DFCE certificate for status holder was admissible only if the status holder had achieved an incremental growth of more than 25 per cent in FOB value of exports subject to achieving minimum export turnover of Rs. 25 crore in free foreign exchange. As per paragraph 3.2.5 of the HBP, Volume-1, (2002-07), a status holder shall be entitled for duty credit of ten per cent on the incremental growth of the value of exports over the previous year.

Similarly, in relation to DFCE scheme for service providers/SFIS, paragraph 3.8 of Exim Policy 2002-07 (as on 1 April 2003), service providers (other than

hotels) are entitled to duty free imports to the extent of ten per cent of average foreign exchange earned in the preceding three years. Similarly, as per paragraph 3.6.4.3 of the FTP 2004-09, service providers (other than hotels and restaurants) are eligible for duty credit of ten per cent of foreign exchange earned in the preceding financial year. Such duty credit is issued by the licensing authority based on foreign exchange remittances certified by CA.

Scrutiny of records of licensing authority at Mumbai, Chennai and Delhi revealed grant of excess duty credit of Rs. 9.16 crore in 30 certificates by not taking into account the actual exports made by these exporters as declared in their annual accounts which was different from the export performance declared in the applications made which were also certified by chartered accountants (CAs).

Similarly, scrutiny of records relating to service providers in the offices of the licensing authorities at Bangalore, Ahmedabad, Vadodara and Chennai revealed grant of excess duty credit of Rs. 1.09 crore in six cases by not taking into account the actual foreign exchange earned by these service providers as reflected in their annual accounts/foreign inward remittance certificate/BRC which was different from the declared earnings (certified by CA).

The main cause of the irregularity pointed out in these cases is the complete reliance of the scheme on the declarations furnished by the exporters and certified by the CAs for grant of duty credit certificates. The non-correlation of these declarations with other statutory documents like annual accounts, BRCs, IT returns and foreign inward remittance certificate, was a risk area which was left unmitigated by the department.

A few illustrative cases are mentioned in the following paragraphs:-

(i) M/s Satnam Overseas Ltd. was granted DFCE certificate for Rs. 2.77 crore by the RLA Delhi, on the basis of export turnover declared in the application as Rs. 105.84 crore and Rs. 136.01 crore respectively for the years 2002-03 and 2003-04. This was also certified by a CA. However, as per the annual accounts of the firm, the export value of direct exports for 2002-03 and 2003-04 was only Rs. 307.57 crore and Rs. 306.58 crore respectively, indicating negative growth in exports. Since benefit under the scheme was available only to those status holders who had achieved a minimum of 25 per cent incremental growth, grant of duty credit of Rs. 2.77 crore to M/s Satnam Overseas Ltd. was irregular. This excess duty credit of Rs. 2.77 crore needs to be withdrawn/recovered.

(ii) Thirteen duty free credit entitlement certificates for Rs. 1.23 crore were issued to M/s Rattha Overseas Co. Pvt. Ltd. under the DFCE scheme for status holders by the RLA Chennai. The licensing authority had considered the FOB value of exports for the year 2002-03 and 2003-04 as Rs. 40.64 crore and Rs. 52.95 crore respectively. Audit scrutiny revealed that the export performance made by the exporter as per the profit and loss (P&L) account was Rs. 54.18 crore and Rs. 63.69 crore for 2002-03 and 2003-04 respectively and, therefore, the incremental growth was only 17.56 per cent. Thus, the exporter had not achieved the minimum incremental growth of 25 per cent during the year 2003-04 and was not eligible for availing any benefit under the

scheme. The department nevertheless allowed it duty credit of Rs. 1.23 crore. The duty credit allowed incorrectly is required to be withdrawn/recovered.

(iii) M/s BPL Mobile Cellular Ltd. was granted (December 2004) SFIS certificate by the RLA, Bangalore for duty credit of Rs. 2.41 crore on the basis of the CA's certificate indicating foreign exchange earning of Rs. 24.14 crore in the year 2003-04. Audit scrutiny revealed that foreign exchange earning as per the annual accounts for the year 2003-04 was only Rs. 19 crore. This reliance solely on a certificate provided by a CA resulted in grant of excess credit entitlement of Rs. 51 lakh.

Recommendation

- *The Ministry may consider prescribing additional documents (like annual accounts, FIRC, BRC, IT returns etc.) to be enclosed and verified before determining the duty credit entitlements under the existing or future similar schemes, where tax benefits are given based on export performance. This would mitigate the risk of obtaining ineligible benefits under the FTP/schemes.*

4.7 Compliance issues

4.7.1 Incorrect issue of duty credit certificates/scrips

A. Duty free credit entitlement (DFCE) scheme for status holders

4.7.1.1 Prescribed incremental growth not achieved

According to the Exim Policy (as amended through DGFT notification no. 28 dated 28 January 2004) supplies made or export performance effected by a non-status holder to a status holder, were not to be taken into account for the purpose of calculating the value of exports, if the applicant as well as the non-status holder have less than 25 per cent incremental growth over their respective previous years direct export turnover.

Scrutiny of the records of the licensing authority at Mumbai revealed grant of incorrect duty credit of Rs. 45.37 crore in eight certificates by wrongly taking into account the supplies made by a non-status holder group company, with less than 25 per cent incremental growth.

An illustrative case is discussed in the following paragraph:-

M/s Viraj Impo Expo Ltd., M/s Viraj Forging Ltd. and M/s VSL Wires Ltd. were group companies and status holders as well. They were granted duty credit certificates of Rs. 5.11 crore, Rs. 4.42 crore and Rs. 4.67 crore respectively based on supplies effected by M/s Viraj Alloys Ltd. (part of group company) as a supporting manufacturer for the entire export of these exporters during 2003-04. Audit scrutiny revealed that M/s Viraj Alloys had not made any export during the year 2002-03 and 2003-04, but was registered as a status holder as on 1 April 2004.

Since M/s Viraj Alloys Ltd. had not exported during 2002-03 and 2003-04 and had achieved no growth in exports, the supplies effected by M/s Viraj Alloys Ltd. to other group companies for export of goods were not eligible for duty

credit entitlement certificate in terms of the above notification. Additionally, the grant of 'status holder' status to him was also incorrect. This resulted in irregular grant of DFCE certificates of Rs. 14.20 crore. The department replied (May 2007) that as there was a growth of 25 per cent for the entire group, credit certificates were correctly issued.

The department's reply is not tenable in view of the specific requirement of 25 per cent incremental growth both individually as well as by the entire group of companies, under the Exim Policy.

4.7.1.2 Certificates to non-status holders

According to paragraph 3.2.5 of the HBP, Volume-1, 2002-07, status holders with an annual incremental growth of more than 25 per cent in the FOB value of exports in free foreign exchange, shall be entitled to the facility of duty free credit entitlement subject to achieving a minimum annual export turnover of Rs. 25 crore in free foreign exchange. Such status holders shall be entitled to duty free credit entitlement certificate to the extent of 10 per cent of the incremental growth in exports. Further, paragraph 3.5.3 of the FTP 2004-09 states that all status certificates issued or renewed on or after 1 September 2004 shall be valid from 1 April of the licensing year upto 31 March 2009.

Scrutiny of the records of the licensing authorities at Mumbai, Kolkata, Chennai and Delhi revealed that in 118 DFCE certificates, duty credit of Rs. 36.09 crore was granted to exporters who were not status holders on the date of the implementation of the scheme i.e. as on 1 April 2003.

An illustrative case is mentioned below:-

Four certificates for total duty credit of Rs. 3.98 crore were issued to M/s India Cements Ltd. by the RLA, Kolkata. Audit scrutiny revealed that the exporter had obtained the status holder certificate on 19 January 2005, which was effective from 1 April 2004. Thus, the exporter was not a status holder as on 1 April 2003 and was, therefore, not eligible for the DFCE certificate. The duty credit of Rs. 3.98 crore allowed was incorrect and needs to be withdrawn/recovered.

The department replied (May 2007) that no effective date of status holder was indicated in the scheme and in the case of M/s India Cements Ltd., the status holder certificate was valid for the year 2003-04. The reply of the department is not tenable as the scheme itself is meant only for status holders and the status holder certificate is to be furnished alongwith the application form. In the case of M/s India Cements Ltd., the status holder certificate was issued on 19 January 2005 and according to the FTP, it was valid from 1 April 2004.

Similarly, 13 duty credit certificates for Rs. 3.39 crore were issued incorrectly to three exporters by the RLA, Chennai, who were not status holders as on 1 April 2003 which needs to be withdrawn/recovered.

4.7.1.3 Incorrect determination of eligible export turnover

As per paragraph 3.7.2.1 of the Exim Policy 2002-07, the duty free credit under the DFCE scheme would be ten per cent of the incremental growth of exports.

Scrutiny of the records of the licensing authorities at Kolkata, Delhi and Chennai revealed grant of excess duty credit of Rs. 11.04 crore in 59 certificates due to incorrect determination of eligible export turnover.

A few illustrative cases are mentioned in the succeeding paragraphs:-

(i) A DFCE certificate for Rs. 74.58 crore was issued (10 August 2005) to M/s Hyundai Motor India Ltd. by the RLA, Chennai. Audit scrutiny revealed that the export turnover of Rs. 891.61 crore for 2003-04 had been computed incorrectly by taking into account the export of Rs. 35.01 crore made during 2002-03. This resulted in excess grant of duty credit of rupees seven crore.

(ii) M/s Welco Overseas, a DFCE certificate holder under the RLA, Delhi, had included export turnover of Rs. 8.36 crore pertaining to 2004-05 in the export turnover of 2003-04. This resulted in excess computing of incremental growth of 2003-04 over 2002-03 by Rs. 8.36 crore and consequent excess grant of duty credit of Rs. 83.64 lakh.

4.7.1.4 Incorrect inclusion of supplies from one status holder to another status holder

According to paragraph 3.7.2.1 of the Exim Policy 2002-07 (as amended through the DGFT notification no. 28 dated 28 January 2004), supplies made by one status holder to another status holder and export performance made by one status holder on behalf of any other status holder shall not be taken into account for calculating the value of exports for the purpose of working out the duty credit entitlement. In this regard, the applicant was required to furnish a declaration-cum-undertaking in the prescribed application form alongwith a CA's certificate in support of the declaration.

Test check of records of the RLA, Kolkata revealed that excess duty credit of Rs. 8.83 crore was granted in 29 certificates by taking into account the supplies and export performance made by one status holder to another status holder.

An illustrative case is mentioned below:-

The RLA (Kolkata) granted (August 2006) a DFCE certificate to M/s Supreme and Company, Kolkata for Rs. 2.38 crore against a total export of Rs. 44.09 crore made during the year 2003-04. The certificate was based on the exporter's declaration supported by a CA certificate to the effect that all ineligible exports had been excluded before claiming the duty credit. Audit scrutiny revealed that the exports made during the year 2003-04 included 11 consignments valuing Rs. 22.19 crore of third party exports of a manufacturer-exporter (M/s Apar Industries Ltd., Vadodara, a status holder). Since export performance by one status holder on behalf of another status holder was not eligible for being counted towards duty credit entitlement, this amount should have been reduced from the export performance for the year 2003-04. The incremental growth would then have fallen below the threshold limit of 25 per cent and the exporter was, therefore, not eligible for any DFCE certificate. The incorrect issue of duty credit for Rs. 2.38 crore needs to be recovered/withdrawn from the exporter.

4.7.1.5 Irregular grant of duty credit against free shipping bills

As per the DGFT notification no. 38 dated 21 April 2004, the items exported under free shipping bills were not eligible for duty credit under the DFCE scheme.

Scrutiny of the records of the licensing authorities at Chennai and Mumbai revealed award of excessive duty credit of Rs. 8.47 crore in ten certificates by incorrectly taking into account the value of exports made under free shipping bills.

An illustrative case is mentioned below:-

Seven certificates for Rs. 7.11 crore were issued (29 May 2006) in violation of the above provisions, to M/s Gimpex Ltd. by the RLA, Chennai under the DFCE scheme for status holders. Audit scrutiny of the shipping bills revealed that the entire exports of Rs. 105.18 crore for the year 2003-04 considered for determining the DFCE certificate entitlement, was made under free shipping bills. Thus, the exporter was not eligible for any duty credit under the scheme. The entire duty credit allowed irregularly is required to be withdrawn/recovered.

4.7.1.6 Certificates issued to new companies based on export performances of closed companies

As per paragraph 9.1 of the HBP, Volume-1, 'constitution' for the purpose of amendment of 'importer-exporter code (IEC)', would mean the change in partners in a partnership firm, trustees of a trust, members of the board of a society and directors of a private limited company and only in such cases the continuation of the IEC code is admissible to the firm. Also, as per the DGFT circular no. 9 dated 14 June 2005, the export performance is not transferable and the export proceeds realisation should be in the name of the applicant.

Ten DFCE certificates for Rs. 7.62 crore were issued incorrectly to four exporters (newly formed companies) by the RLA, Chennai by extending the IEC of closed firms. Based on these, the export performances of the closed units were counted for granting duty credit certificates.

The department replied (May 2007) that the IEC code had been properly updated with the change of constitution and necessary amendment had also been done in the status holder certificate by the concerned licensing authority.

The reply is not tenable as a closed firm and subsequent formed company with a changed name are legally separate entities even though for all practical purposes the company may retain the character of the firm in matters like nature of activities, composition of board of directors, share holding patterns, etc. As per paragraph 9.1 of the HBP, Volume-1, extending the IEC code of the firm to the newly formed company treating it as mere change in name and issuing status certificate to the company by treating the export performance of the firm as that of the company, was not in order. Hence, the company was not eligible for the benefit under the scheme and the duty credit allowed incorrectly is required to be withdrawn/recovered.

Recommendation

- *Extension of IEC code of a closed unit to a newly formed company constitutes a major risk, as it is likely that in a few cases export performance were purchased at a premium from others in order to avail the benefits under the DFCE scheme. The Government needs to address this risk while formulating similar schemes under the FTP.*

4.7.1.7 Incorrect computation of duty credit entitlement

As per paragraph 3.2.5 of the HBP, Volume-1 (2002-07), a status holder is entitled to duty credit of ten per cent of incremental growth in export. Further, as per appendix 17D of the HBP, Volume-1, the eligible duty free credit should be proportionate to the percentage of foreign exchange realised.

Scrutiny of the records of the licensing authorities at Delhi, Mumbai and Chennai revealed grant of excess duty credit of Rs. 4.71 crore in 36 cases due to incorrect computation.

An illustrative case is discussed below:-

M/s CIPLA Ltd. was issued duty free credit certificate of Rs. 14.38 crore by the RLA, Mumbai. While arriving at the entitlement, the department for the year 2003-04 considered realisation to the extent of 95.62 per cent of the FOB value instead of 92.77 per cent actually realised. This resulted in grant of excess duty credit of Rs. 1.99 crore.

4.7.1.8 Export performance counted of ineligible export oriented units (EOUs)

As per paragraph 3.7.2.1 of the Exim Policy, 2002-07, the DFCE certificate for a status holder was admissible only if it had achieved incremental growth of more than 25 per cent in FOB value of exports subject to achieving minimum export turnover of Rs. 25 crore in free foreign exchange. Further, as per the provisions of the scheme, exports made by the EOUs were not eligible for benefit under the scheme.

Scrutiny of the records of the RLA, Delhi revealed that four DFCE certificates were issued to four exporters for Rs. 2.44 crore despite not achieving minimum incremental growth/minimum turnover.

An illustrative case is discussed below:-

M/s Secure Meters Ltd. was granted (13 November 2006) DFCE certificate of Rs. 1.08 crore by the RLA, Delhi. The exporter had included eight shipping bills with a combined FOB value of Rs. 8.25 crore of goods exported by the EOUs in the eligible exports for the year 2003-04. Since exports made by the EOUs were not to be counted for any benefit under the scheme, the value of these exports were to be excluded. Had this export turnover been excluded, then the eligible exports of the firm would have worked out to Rs. 19.80 crore only which was less than the required minimum export turnover of Rs. 25 crore. Therefore, the entire duty credit of Rs. 1.08 crore granted was irregular and should be withdrawn/recovered.

B. DFCE scheme for service providers/SFIS

4.7.1.9 Grant of duty credit based on ineligible remittances

'Exports' for service providers means 'export of services' (DGFT circular no. 6 dated 8 June 2005). Any payment received from export earners foreign currency (EEFC) account will not be counted for DFCE scheme for the service providers (DGFT circular no. 29 dated 9 March 2004). Moreover, in terms of paragraph 3.18 (i) of the HBP, Volume-1 (2004-09), only foreign exchange remittances earned as amounts in lieu of the services rendered by the service exporter would be counted for computation of the entitlement under the SFIS scheme. Other sources of foreign exchange earning such as equity or debt participation, repayment of loans and any other inflow of foreign exchange unrelated to the service rendered would not be counted for computation of entitlement under SFIS. Scrutiny of the records of the licensing authorities at Chennai, Mumbai, Delhi, Kolkata and Bangalore revealed incorrect grant of duty credit of Rs. 34.74 crore in 58 certificates, owing to incorrect inclusion of ineligible remittances.

A few illustrative cases of such incorrect grant of duty credit are discussed in the following paragraphs:-

(i) A duty credit certificate for Rs. 55.66 lakh was issued by the RLA, Chennai to M/s Prasad Corporation Pvt. Ltd., Chennai, under SFIS, for the foreign exchange earned during 2004-05. Audit scrutiny revealed that the foreign exchange earned by the service provider was towards (a) advance for export of Indian feature films by way of film reels, digital versatile discs (DVDs) and cassettes, (b) cost of feature films exported by way of film reels, DVDs and cassettes, (c) transfer of funds, and (d) other remittances (without specific reasons).

As the foreign exchange earned was not from any service rendered but from cost of goods etc., the duty credit of Rs. 55.66 lakh allowed was incorrect and should be withdrawn/recovered.

Similarly, duty credit for Rs. 3.02 crore, allowed in 19 more cases under the RLA, Chennai, for similar receipts, was required to be withdrawn/recovered.

(ii) A duty credit certificate for Rs. 1.45 crore was issued (March 2005) under the SFIS by the RLA, Chennai to M/s FL Smith Pvt. Ltd. Audit scrutiny revealed that the foreign exchange earning of Rs. 14.51 crore in 2003-04 included reimbursement of travelling expenses of Rs. 9.09 crore. In the case of reimbursement of travelling allowance, there was no net foreign exchange earning. Since this could not be construed as charges for a service rendered, including this component in the total foreign exchange earning resulted in excess allowance of duty credit of Rs. 90.94 lakh.

Similarly, two duty free credit certificates totalling Rs. 1.63 crore were issued (14 November 2005) to M/s Apollo Hospitals Enterprises Ltd. under the SFIS by the RLA, Chennai. It was noticed that the above duty credit was issued taking into account the foreign exchange earning by way of pharmaceutical sales of Rs. 29.07 lakh and reimbursement of expenses of Rs. 4.30 crore of the pharmacy division. As there were no net earning of foreign exchange in the case of reimbursement of expenses and as such earning was also not for services rendered, these amounts were not eligible for any benefit under the

SFIS. The excess allowance of duty credit in this case was Rs. 45.91 lakh, which should be withdrawn/recovered.

(iii) As per paragraph 9.52 of the FTP, 2004-2009, 'services' include all the tradeable services covered under General Agreement on Trade in services and earning free foreign exchange.

Board of Control for Cricket in India (BCCI), Mumbai was granted (18 November 2004) duty credit certificate under SFIS for Rs. 1.20 crore by the RLA, Mumbai on the basis of foreign exchange of Rs. 36.10 crore earned during 2003-04 by way of participation fee from the International Cricket Conference (ICC), guarantee money by other cricket playing countries and prize money earned in tournaments. The DGFT, New Delhi had clarified (29 October 2004) that these services and foreign exchange earnings were in the nature of non-tradeable services and did not qualify for the scheme. However, on representation from the BCCI, the DGFT, New Delhi allowed this foreign exchange earning as eligible for the scheme. As neither the activities of the BCCI were in the nature of providing services nor were the foreign exchange received by the BCCI earned for providing any service, the grant of duty credit entitlement certificate under SFIS was irregular. The certificate for Rs. 1.20 crore should, therefore, be withdrawn/recovered.

4.7.1.10 Grant of duty credit to ineligible service providers under the tourism sector

Hotels of star category, approved by the department of Tourism and other service providers in the tourism sector registered with this department, are entitled to duty credit equivalent to five per cent of the foreign exchange earned in the preceding financial year. In case of stand-alone restaurants, such entitlement is 20 per cent (Paragraph 3.6.4.4 of the FTP, 2004-09).

Scrutiny of the records of the licensing authorities at Pune, Delhi, Hyderabad, Kolkata and Trivandrum revealed that in 48 cases duty credit of Rs. 18.31 crore was incorrectly granted to the service providers under the tourism sector who were not approved or registered with the department of Tourism.

A few of these cases are illustrated in the following paragraphs:-

(i) Twenty three certificates for a total duty credit of Rs. 15.07 crore, were issued to the hotel 'Excelsior' and seven others by the RLA, Delhi, under star hotel category. Audit scrutiny revealed that classification of these hotels as star or otherwise, had not been decided by the department of Tourism. In respect of the hotel 'Excelsior', RLA, Delhi was advised by the DGFT that the benefit might be granted only after verifying the date of recognition as one star and above by the department of Tourism. However, the licensing authority issued the certificates without verifying the date of recognition. This resulted in incorrect grant of duty credit of Rs. 15.07 crore.

(ii) M/s Blue Water Hospitality Ltd. and M/s Classic City Investment Pvt. Ltd., Pune were granted five duty credit certificates for Rs. 1.01 crore by the RLA, Pune. Audit scrutiny revealed that these service providers under the tourism sector were not registered with department of Tourism. Also, the foreign exchange remittance certificates were not in favour of these service

exporters. These resulted in irregular issue of duty credit certificates of Rs. 1.01 crore.

4.7.1.11 Duty credit to unregistered service providers

As per paragraph 2.44 of the Exim Policy 2002-07 and the FTP 2004-09, an exporter, applying for any certificate for import/export, is required to furnish a 'Registration Cum Membership Certificate (RCMC)' from the competent authority. Further, to obtain the RCMC, an exporter has to declare his main line of business in the application to be made to Export Promotion Council (EPC). As per paragraphs 3.8 of the Exim Policy and 3.6.2 of the FTP, service exporters are required to register themselves with the Federation of Indian Exporter Organisation (FIEO). RCMC is deemed to be valid for five years from 1 April of the licensing year in which it was issued.

Scrutiny of the records of the licensing authorities at Kolkata, Bangalore, Delhi, Chennai and Hyderabad revealed incorrect grant of duty credit of Rs. 16.77 crore through 36 certificates issued to service providers who did not have valid RCMC or were not registered with FIEO.

A few of these cases are illustrated in the following paragraphs:-

(i) M/s Jaiprakash Associates was granted two certificates under SFIS by the RLA, Delhi for Rs. 5.31 crore and Rs. 8.13 crore, on 'construction engineering services' during 2004-05 and 2005-06. Scrutiny of records of licensing authority revealed that the exporter was registered with the FIEO as a 'manufacturer exporter of cement'. As the applicant was not registered as a service provider, grant of certificates for Rs. 13.44 crore was irregular.

In six similar cases involving grant of duty credit of Rs. 1.18 crore, by the RLA, Delhi, the applicants had not registered themselves with the FIEO during the period of export. Since these service providers were not registered with FIEO at the time of export, duty credit of Rs. 1.18 crore granted was irregular.

(ii) A duty credit certificate for Rs. 90.26 lakh was granted (20 January 2006) under SFIS by the RLA, Chennai to M/s PSTS & Sons for service export made during 2004-05. Audit scrutiny revealed that the service exporter had registered with the FIEO only on 18 June 2005 and thus the RCMC was valid from 1 April 2005. Therefore, the service provider was not eligible for the duty credit under SFIS as there was no valid RCMC during 2004-05 and the duty free credit allowed should be withdrawn/recovered.

4.7.1.12 Incorrect grant of duty credit to Software Technology Park (STP) units

As per the DGFT circular no. 29 dated 9 March 2004, 100 per cent Export Oriented Units (EOUs) and the units operating under Special Economic Zone (SEZ)/Software Technology Parks of India (STPI)/Electronic Hardware Technology Park (EHTP) schemes can not avail of the DFCE scheme for service providers. Further, as per paragraph 3.6.4.8.1 of the FTP 2004-09 (as on 1 April 2005), SFIS scheme too was not available to these units.

Scrutiny of the records of the licensing authorities at Pune, Mumbai and Bangalore revealed incorrect grant of duty credit of Rs. 14.54 crore to STPI units in five certificates.

An illustrative case is discussed below:-

M/s Intel Technology India Pvt. Ltd., registered as an STPI unit, was issued duty credit certificate under SFIS (March 2005) by RLA, Bangalore for Rs. 4.42 crore on sales and support services (Rs. 44.24 crore) rendered during the year 2003-04. The issue of certificate was contrary to the DGFT's clarification (March 2004) that the scheme benefits were not available for STPI units.

4.7.1.13 Duty credit not restricted based on earnings of the relevant year

As per paragraph 3.8 of the Exim Policy 2002-07, as on 1 April 2003, service providers (other than hotels) were entitled to duty free credits for imports equal to ten per cent of the average foreign exchange earned in preceding three licensing years. However, from 1 September 2004, paragraph 3.6.4.3 of the FTP 2004-09 came into effect and accordingly, the service providers (other than hotels and restaurants) became entitled to duty credit equal to ten per cent of foreign exchange earned in the preceding financial year. Therefore, the service providers applying for duty credit certificate after 1 September 2004, were eligible for duty credit certificates under SFIS where credit was to be restricted to ten per cent of FE earned during the preceding financial year.

Scrutiny of the records of the licensing authorities at Chennai, Pune, Delhi, Hyderabad, Vadodara and Rajkot revealed grant of excess duty credit of Rs. 12.65 crore in 14 certificates due to consideration of earnings not pertaining to the year of claim.

An illustrative case is mentioned in the following paragraph:-

A certificate for duty credit of Rs. 12.64 crore under DFCE scheme for service providers was granted (10 October 2005) to M/s Essar Oil Ltd., Jamnagar by the RLA at Rajkot, on the basis of ten per cent of average foreign exchange earnings of the preceding three licensing years (2001-02, 2002-03 and 2003-04). Audit scrutiny revealed that the application for duty credit certificate was submitted on 22 December 2004. Therefore, the certificate should have been issued under SFIS, and duty credit restricted to ten per cent of foreign exchange earned (Rs. 20.60 crore) during preceding financial year (2003-04). The mistake resulted in grant of excess duty credit of Rs. 10.58 crore.

4.7.1.14 Incorrect computation of duty credit

As per paragraph 3.8 of the Exim Policy 2002-07, service providers who had average foreign exchange earning of over rupees ten lakh in the preceding three licensing years, were entitled to duty free imports equal to ten per cent of the average foreign exchange earning.

Similarly, as per paragraph 3.6.4.4 of the FTP 2004-09, service providers who earned foreign exchange of rupees ten lakh in the preceding or current financial year, are entitled to duty credit of ten per cent of foreign exchange earned in the preceding year. However, hotels/service providers in the tourism sector were entitled to duty credit at the rate of five per cent of the foreign exchange earned.

Scrutiny of the records of the licensing authorities at Delhi, Chennai and Trivandrum revealed grant of excess duty credit of Rs. 34.03 lakh in three certificates, where either the duty credit was granted at a higher percentage of export earnings or export earning itself was wrongly computed at incorrect exchange rates.

On this being pointed out, the licensing authority at Delhi and Trivandrum withdrew (February and April 2007) the credit of Rs. 29.39 lakh in two cases.

4.7.1.15 Non-imposition of late cut

As per paragraph 3.18 of the HBP, Volume-1, (2002-07), and paragraph 3.18 (b) of the FTP, 2004-09, the last date for filing application for the DFCE scheme for the service provider/SFIS is 31 December of the licensing year. The DGFT vide its circular no. 43 dated 30 December 2005, extended the date to 31 March 2006 for the licensing year 2005-06. Further, as per paragraph 9.3 of HBP, Volume-1, whenever application is received after the expiry of last date but within six months from last date, such application may be considered after imposition of late cut of ten per cent on the entitlement.

Scrutiny of the records of the licensing authority at Mumbai and Hyderabad revealed grant of excess duty credit of Rs. 33.91 lakh in 16 cases due to non-imposition of late cut on the entitlement, which needs to be recovered/withdrawn from the certificate holders.

C: Vishesh krishi upaj yojana (VKUY)

4.7.1.16 Duty credit scrips issued for port of registration other than the notified ports

In terms of paragraph 3.8.3 of the FTP, import from a port other than the port of export shall be allowed under 'telegraphic release advice (TRA)' facility as per the terms and conditions of the notification issued by the department of revenue. Thus, under the VKUY, import is permitted only through the port of export, except by issue of TRA.

Sea ports, airports, inland container depots (ICD) and land customs stations (LCS) for undertaking imports against VKUY scrip were notified through a notification dated 9 May 2005.

(i) Scrutiny of records of DGFT, Kolkata, revealed that 934 VKUY scrips were issued between 2 September 2005 and 31 March 2007 with a total duty credit of Rs. 43.76 crore mentioning the port of registration as either Hilli, Changrabandha or Gojhadanga (land customs stations), as the exports based on which these scrips were granted, were effected through these land customs stations. The issue of these scrips was incorrect as none of these ports were notified for undertaking import under VKUY.

(ii) Scrutiny of VKUY records of the RLA, Visakhapatnam, revealed that four scrips were issued to a 'merchant exporter' for Rs. 34.74 lakh on the FOB values of export of agricultural products made to Bangladesh with port of registration as 'Ghojadanga' LCS, and 'Changrabandha' LCS. Since, both the LCSs were not specified ports for the purpose of allowing imports, the duty

credit of Rs. 34.74 lakh allowed on the basis of the exports made through these non-notified ports was incorrect.

The department replied (March 2007) that the DGFT, New Delhi had clarified that the port of registration under VKUY is not restricted to ports specified in paragraph 4.40 of the FTP. The reply of the department is not tenable as no amendment to the notification has been issued by the Ministry of Finance, providing for issue of duty credit scrips for non-notified ports.

(iii) Similarly, 14 VKUY scrips were issued by the Joint DGFT, at Ahmedabad, Vadodara, Rajkot and Cochin for port of registration other than the port from where exports were effected. This resulted in incorrect issue of VKUY duty scrips totalling Rs. 1.34 crore.

4.7.1.17 Grant of duty credit on ineligible exports

As per paragraph 3.8.2 of the FTP 2004-09, exporters of fruits, vegetables, flowers, minor forest produce and their value added products are entitled to duty credit scrip equivalent to five per cent of the FOB value of exports for each licensing year commencing from 1 April 2004. Scrutiny of the records of the licensing authorities at Chennai, Madurai, Mumbai, Ahmedabad, Surat, Vadodara, Rajkot, Kochi and Bangalore revealed that in 137 scrips ineligible exports or items not covered under the scheme were considered for grant of scrip under the scheme. Duty credit involved was Rs. 10.82 crore.

A few illustrative cases are mentioned in the succeeding paragraphs:-

(i) As per DGFT public notice dated 27 April 2005, the export of commodities falling under chapter 12 of Import Trade Control (Harmonised System) {ITC (HS)} code were not eligible for the benefits under VKUY scheme. Accordingly, export of 'groundnut kernels HPS' classifiable under heading 1202 2010, were not eligible for availing of tax benefits under VKUY.

Audit scrutiny of VKUY scrips issued by the Joint DGFT, Chennai revealed that in 11 cases {411 Shipping Bills (SBs)}, 'groundnut kernels' were exported under heading 1202 2010 which was changed to 2008 1100 after a lapse of more than one year on the basis of 'no objection certificate (NOC)' issued by the AC, Customs (Export) for changing the heading of export of groundnut kernels'. Based on the NOC, VKUY scrip for Rs. 4.82 crore was granted to the exporters. Since 'groundnut kernels' were rightly classifiable under code 1202 2010 and were accordingly not eligible for VKUY benefits, the issue of VKUY scrip was incorrect in terms of the above public notice and therefore, the duty credit granted needs to be recovered.

(ii) As per section 149 of the Customs Act 1962, no amendment of bill of entry, shipping bill or bill of export should be allowed after the imported goods are cleared or export goods have been exported, except on the basis documentary evidence which was in existence at the time of clearance or export. Further, in terms of public notice dated 22 July 2002 no corrections in data (EDI bills) should be allowed after the issue of 'export promotion (EP) copy.

A VKUY scrip issued on 9 June 2006 by the Joint DGFT, Chennai, to M/s AVT Natural Products Ltd. for export of natural products of chapters 12, 13

and 19. In order to avail of the benefit of the VKUY scheme, the exporter requested the customs authority for amendment in the export documents which was accepted and a 'no objection certificate (NOC)' was issued to it on 20 September 2006. Based on the NOC, tariff heading of the exported product (chapter 12, 13 and 19) was changed to that of chapter 33. Audit scrutiny revealed that the VKUY scrip had been issued to the exporter even prior to the issue of 'NOC' by the department. The issue of VKUY scrip for Rs. 1.70 crore and amendments in export documents post export was irregular in terms of section 149 mentioned above and the scrip allowed needs to be recovered from the exporter.

(iii) In terms of the DGFT circular dated 15 February 2006, 'pepper and other items' covered under ITC (HS) heading 0904 exported between 1 September 2004 and 26 April 2005 were entitled to benefits under the VKUY.

Twenty one VKUY scrips were issued by the Joint DGFT, Chennai, taking into account export of 'chillies' exported between April 2004 and August 2005. As these exports were not effected between 1 September 2004 and 26 April 2005, they did not qualify as eligible exports. The inclusion of ineligible exports for credit entitlement resulted in incorrect allowance of duty credit of Rs. 1.05 crore under the VKUY scheme.

(iv) Export of 'niger seed' was included in the list of eligible items for benefit under VKUY with effect from 12 January 2006.

Scrutiny of VKUY scrips issued to M/s RSV Global, M/s Jabs International Ltd. and M/s Navjot International Ltd. revealed that these were issued for the export of niger seed prior to 12 January 2006. As the item was not eligible for VKUY benefits prior to 12 January 2006, issue of scrips for Rs. 1.70 crore was incorrect and needs to be recovered from the exporters.

4.7.1.18 Issue of VKUY scrip without obtaining valid 'registration-cum-membership certificate (RCMC)'

As per paragraph 2.44 of the FTP 2004-09, any person applying for (i) a licence/certificate/ permission to import/export or (ii) avail of any other benefit or concession under the policy shall furnish RCMC granted by the competent authority, unless specifically exempted under the policy. A status holder had the option to obtain RCMC from the Federation of Indian Exporters Organisation (FIEO). In addition RCMC could be obtained from any other export promotion council (EPC) if the product exported related to those EPCs. However, exporters of 'minor forest produce' (MFP) and their value added products shall obtain RCMC from 'Shellac Export Promotion Council' (SEPC) as per public notice dated 19 October 2005.

(i) During the scrutiny of VKUY scrips issued by the Joint DGFT, at Ahmedabad and Rajkot upto 31 December 2006, audit noticed that seven VKUY scrips were issued to five exporters who did not have valid RCMC on the date on which they had applied for VKUY benefits, as was required under the policy. This resulted in incorrect grant of duty credit of Rs. 1.45 crore.

(ii) Similarly, five VKUY scrips were issued to three exporters for export of minor forest produce by JDGFT, Vadodara without obtaining RCMC from SEPC, resulting in incorrect grant of duty credit of Rs. 9.69 lakh.

Joint DGFT, Vadodara, in reply to the audit observations stated (April 2007) that in future RCMC issued by SEPC will be insisted upon for claiming benefit of VKUY for minor forest produce.

4.7.1.19 Time barred claim

The last date for filing application to obtain VKUY scrip for the year 2004-05 was 31 March 2006. Thereafter applications could be filed upto 30 September 2006 for issue of scrip with a late cut of ten per cent on the credit entitlement. Any claim filed beyond the period of six months from the expiry of the last date of submission of application was not to be considered. Further, if an application had been submitted in time without the prescribed documents which were submitted after the time limit specified for such category of the application, then the initial application shall not be considered as submitted in time and shall be subjected to late cut or rejection (as per circular from DGFT dated 9 August 1999).

M/s Leila Impex Pvt. Ltd., exporter of 'herbal extracts products' under the RLA, Hyderabad, submitted an application for VKUY scrip for the year 2004-05 on 28 November 2005 without enclosing the prescribed documents. The application was rejected and communicated to the exporter on 10 February 2006 by the RLA. The exporter re-submitted his claim on 29 November 2006 after a period of nine months and a VKUY scrip for Rs. 1.43 crore was issued on 15 December 2006.

Since the exporter did not submit the documents as required under the policy within the time limit and the original SBs and other documents were submitted by him after the expiry of the time limit prescribed for even late cut on entitlement, the application was required to be rejected. The grant of duty credit of Rs. 1.43 crore was incorrect.

The RLA, Hyderabad replied that the circular dated 9 August 1999 applied only to DEPB licenses. The reply is not tenable in view of paragraph (2) of the circular, which clarifies that it is applicable to all schemes and not to the DEPB scheme alone.

4.7.1.20 Grant of excess duty credit in cases where other exemptions/remission had already been availed of

As per paragraph 3.8.2 of FTP 2004-09, the duty credit scrip under VKUY shall be granted only at a reduced rate of 3.5 per cent of the FOB value of exports in such cases where the exporter has availed of the benefit under chapter four (Duty exemptions/remission schemes) of the policy.

Audit scrutiny revealed that in 20 VKUY scrips issued by RLA at Mumbai, Rajkot, Ahmedabad and Vadodara to different importers, duty credit scrips were issued without restricting these at the reduced rate of 3.5 per cent of FOB value, despite the exporters having availed of the benefit under chapter four of the policy. This resulted in excess grant of duty credit of Rs. 51.74 lakh.

4.7.1.21 Incorrect allowance of duty credit for export of imported goods

Paragraph 2.35 of the FTP allows export of goods imported in the same or substantially same form as imported. However, as per paragraph 3.8.2.2 of the FTP, the exports of imported goods covered under paragraph 2.35 are not to be taken into account for determining the duty credit under VKUY.

Audit scrutiny of VKUY scrips issued by the JDGFT, Madurai revealed that six scrips for Rs. 33.76 lakh were issued to four exporters who had imported black matpeas, dun peas, lentils and exported yellow split peas, split lentils etc. Audit verified that the goods exported were substantially the same as were imported and the exports were covered under paragraph 2.35 of the FTP. Accordingly, these exports should not have been reckoned for VKUY duty credit scrips. The duty credit of Rs. 33.76 lakh incorrectly allowed was required to be withdrawn/recovered.

4.7.1.22 Excess duty credit scrips as ineligible exports considered

The objective of the scheme is to promote export of fruits, vegetables, flowers, minor forest produce and their value added products, by giving incentives to the exporters of such products. Exporters of such product are entitled to duty credit scrips, equivalent to five per cent of the FOB value of exports for each licensing year commencing from 1 April 2004.

Audit scrutiny of 27 VKUY scrips issued to nine exporters by the Joint DGFT, Chennai and Hyderabad, revealed that while working out the duty credit entitlement for the scrip for the year 2004-05, exports made during 2005-06 and 2006-07 were also taken into account. This resulted in grant of excess duty credit of Rs. 26.90 lakh.

4.7.2 Inappropriate use of certificates/scrips

A. Duty free credit entitlement (DFCE) scheme for status holders

4.7.2.1 End use of goods imported not verified

Certificates of installation and usage of the capital goods imported under the DFCE scheme are to be obtained from the jurisdictional central excise authorities and provided to the customs authorities after the duty credits were utilised (notification no. 53/2003-cus dated 1 April 2003) in the case of the registered manufacturing units. A certificate from the jurisdictional assistant/deputy commissioner of central excise or an independent chartered engineer in respect of units, which are not registered with the central excise department, is to be produced confirming installation and use of the capital goods in the importer's factory or premises, within six months from the date of import. Further, all goods imported under the scheme are meant for own use and not transferable or saleable.

Audit scrutiny of import records available with the commissionerate of customs, Kolkata (Port), revealed that five certificate holders imported nine consignments of different capital goods of assessable value of Rs. 25.68 crore between July 2005 and December 2006. But they did not furnish the requisite certificates of installation/use even after the expiry of the stipulated period of six months from the date of import. The duty exempted in these cases was Rs. 8.71 crore.

In the absence of these certificates indicating 'end-use', audit could not verify whether the imported goods under the scheme were used for purpose for which they were allowed and not diverted elsewhere.

The department needs to ascertain the end use, recover duty and penalty based on the investigation.

4.7.2.2 Incorrect payment of additional duty through duty credit certificates

In terms of the notification no. 19/2006-cus dated 1 March 2006, additional duty of customs at the rate of four per cent was leviable to countervail sales tax and value added tax (VAT). Further, in terms of the circular no. 20/2006-cus dated 21 July 2006, such duty had to be collected only by cash and could not be debited in the certificate.

Scrutiny of the records of import documents of customs commissionerates at Kolkata (Port), Chennai (Sea) and Chennai (ACC) revealed that additional duty amounting to Rs. 2.27 crore leviable under notification dated 1 March 2006 in 292 consignments under 59 DFCE certificates was debited in the certificates, which is against the provisions of the circular dated 21 July 2006.

An illustrative case is discussed in the following paragraph:-

Twenty-five consignments of 'yarn, carbon black feed stock, resin, capital goods etc.' were imported through the customs commissionerate, Kolkata (Port) by four DFCE certificate holders between May and July 2006. Additional duty of Rs. 80.03 lakh leviable under the notification dated 1 March 2006 was incorrectly debited to the certificates. This resulted in undue financial accommodation of Rs. 80.03 lakh given to the certificate holders and needs to be recovered.

B. DFCE scheme for service providers/SFIS

4.7.2.3 End–use of imported goods not verified

Installation and usage certificate of imported goods under the DFCE scheme were to be provided to the customs authorities after the duty credits were utilised (notification nos. 54/2003-cus dated 1 April 2003 and 92/2004-cus dated 10 September 2004). A certificate from the jurisdictional assistant/ deputy commissioner of central excise or an independent chartered engineer in respect of units which were not registered with the central excise department was to be produced confirming installation and use of the capital goods in the importer's factory or premises, within six months from the date of import. Further, all goods imported under the scheme were meant for own use and not transferable or saleable.

Audit scrutiny of the import particulars available with the commissionerate of customs, Kolkata (Port), revealed that 14 certificate holders imported 96 consignments of different capital goods of assessable value of Rs. 27.89 crore between June 2004 and December 2006. But the licencees did not furnish the requisite certificates of installation/use even after the expiry of the stipulated period of six months from the date of import. The duty exempted in these cases was Rs. 9.25 crore.

In the absence of these certificates indicating 'end-use', it was not clear how the department had verified whether the imported goods under the scheme were used for the purpose for which these were allowed and were not diverted

elsewhere. Since this condition is a prerequisite for granting the duty certificate, the department needs to ascertain the end use, recover duty and penalty based on the investigation.

4.7.2.4 Non-submission of details of imports

As per paragraph 3.18 of the HBP, Volume-1 (as on 1 April 2003), the service providers had to submit to the licensing authority a statement of import as per appendix 36B within one month of the expiry of the validity of the certificate. The time limit was further modified in the FTP 2004-09, according to which the statement was to be furnished within one month of the expiry of the validity of the certificate or completion of import, whichever was earlier.

Scrutiny of the records of the licensing authorities at Chennai, Mumbai, Hyderabad, Trivandrum, Ahmedabad and Rajkot revealed that 31 certificates, with a total duty credit of Rs. 7.97 crore, were issued to 26 service providers during the period June 2003 to January 2006. However, import details relating to these certificates were not submitted to the licensing authority even after two to three years of the expiry of the validity period of the certificates. In the absence of these details, audit could not verify the correctness of the use of these certificates.

4.7.2.5 Payment of duty through duty credit certificates with insufficient credit

As per notification nos. 54/2003-cus dated 1 April 2003 and 92/2004-cus dated 10 September 2004, duty leviable on the import of capital goods, including spares, office equipment and consumables can be paid by using DFCE/SFIS certificate (by debiting these) provided sufficient duty credit is available in the certificates.

Scrutiny of the records of the commissionerates at Kolkata (Port), Jamnagar and Chennai (Air) revealed that in four cases of import of goods, the applicable customs duty of Rs. 2.59 crore was paid by debiting the duty of Rs. 1.77 crore in the DFCE certificates and the balance Rs. 62.54 lakh was paid in cash in contravention of the provisions of the above notifications. As sufficient credit was not available in the certificates, the entire duty of Rs. 2.59 crore should have been paid by cash (PLA). The differential duty of Rs. 1.77 crore is to be recovered.

An illustrative case is discussed in the following paragraph:-

Gujarat Adani Port Ltd., Ahmedabad, a 'maritime port service provider', had imported one 'Tug boat' on 7 December 2004, through customs house, GAPL, Mundra under the DFCE Scheme. Duty was assessed at Rs. 1.04 crore. Audit scrutiny revealed that as the certificate dated 12 October 2004, issued by the RLA, Ahmedabad, had insufficient credit to cover the duties, the customs authority allowed partial debit of Rs. 92.67 lakh in the certificate and balance Rs. 11.47 lakh was paid in cash.

4.7.2.6 Import of inadmissible goods

As per paragraph 3.8 of the Exim Policy 2002-07 (as on 1 April 2003), duty free entitlement, under certificate issued under DFCE scheme for service provider, could be used for import of spares, office equipment and furniture,

professional equipment and consumables. Further, goods imported under the scheme should have nexus with the services rendered (DGFT circular no. 29 dated 9 March 2004). Similarly, capital goods including spares, office equipment, office furniture and consumables, related to the main line of business of the exporter can be imported under SFIS (paragraph 3.6.4.5 of the FTP 2004-09).

Scrutiny of the records of the commissionerates at Kolkata (Port), JNPT (Port) and Jamnagar revealed the in six cases there was import of inadmissible goods under the scheme such as synthetic machine, massage chairs and motor vehicles by using duty credit certificates. The duty involved in these inappropriate imports was Rs. 1.36 crore.

A few illustrative cases are discussed in the following paragraphs:-

(i) In terms of notification no. 43/2006-cus dated 5 May 2006, duty credit granted under SFIS is not available for import of vehicles.

Two consignments of 'Fantuzzi reach stacker with accessories', imported by M/s B. Ghose & Co. Pvt. Ltd., Kolkata, in June 2006 through the commissionerate of customs, Kolkata (Port). The goods were classified as 'Special purpose motor vehicles' under heading 87.05 of the Customs Tariff Act (CTA) 1975, and were cleared by debiting duty against SFIS certificate issued by RLA, Kolkata. Since utilisation of duty credit earned under SFIS was not permitted in case of import of vehicles, the action resulted in incorrect utilisation of credit of Rs. 1.06 crore.

The department replied (December 2006) that 'Reach stacker,' is a self propelled machine fitted with a diesel engine, tyres etc., main function of which is as a crane for lifting and stacking of containers, was erroneously classified under the heading 87.05 instead of the heading 84264100 as 'other self-propelled machinery on tyres'.

The reply is not tenable as explanatory note (9) of the heading 87.05 of the Harmonized Commodity Description and Coding System (HCDCS) includes 'Lorries fitted with stacking mechanisms'. Further, as per explanatory note (b) (2) 'machines mounted on automobile chassis or lorries, like, certain lifting or handling machines' are excluded from being classified under the chapter heading 84.26. Hence, the duty credit allowed to be used needs to be recovered.

(ii) As per notification no. 54/2003-cus dated 1 April 2003, capital goods and professional equipment, imported under the DFCE scheme for service provider/SFIS, are not to be sold or transferred. Thus, goods imported temporarily for re-export purpose are not eligible for duty free import under the above notification.

Gujarat Adani Port Ltd. (GAPL), Ahmedabad, imported seven consignments of capital goods/professional equipment through customs house, GAPL-Mundra and cleared the goods under two certificates issued by the RLA, Ahmedabad under the DFCE scheme for service providers. The goods were assessed at a concessional rate of duty under notification no. 27/2002-cus dated 1 March 2002, as machinery equipment and tools temporarily imported on re-export basis for execution of contract. Audit scrutiny revealed that the assessed duty was debited in DFCE certificates.

As the goods were assessed under notification dated 1 March 2002 meant for re-export, duty could not be debited in DFCE certificates in terms of notification dated 1 April 2003. This resulted in irregular grant of exemption of Rs. 25.03 lakh.

4.7.2.7 Irregular payment of additional duty

In terms of notification no. 19/2006-cus dated 1 March 2006, additional duty of customs at the rate of four per cent was leviable to countervail sales tax and value added tax (VAT). Further, in terms of circular no. 20/2006-cus dated 21 July 2006, such duty had to be collected only by cash and could not be debited in the duty credit certificate.

Scrutiny of the import documents of customs commissionerates at Kolkata (Port and Air) and Hyderabad-II revealed that additional duty amounting to Rs. 18.27 lakh leviable under the notification dated 1 March 2006 in 270 consignments was debited through 28 DFCE certificates, which was against the provision of the circular dated 21 July 2006.

C. Vishesh krishi upaj yojana (VKUY)

4.7.2.8 Inadmissible imports

As per paragraph 3.8.3 of the FTP 2004-09, VKUY scrips may be used for import of notified inputs or goods including capital goods.

Scrutiny of the records of the commissionerates at Kolkata (Port), ICD (Tughlakabad), Chennai (Sea), Kandla, Jamnagar and Delhi revealed that through 364 scrips, import of goods which were not notified, was effected. The duty credit of Rs. 22.53 crore was utilised through these imports, which was incorrect.

A few illustrative cases are mentioned in the succeeding paragraphs:-

(i) As per the scheme, a VKUY scrip can be used for import of agricultural products listed in chapters 1 to 24 of the ITC (HS) classification except items specified in Appendix 37B of HBP.

Scrutiny of records for imports made under VKUY scheme at custom houses, Kandla GAPL, Mundra and Delhi for the period upto 31 March 2007 revealed that goods falling under chapters other than chapters 1 to 24 were allowed to be cleared by debiting duties against 264 VKUY scrips, resulting in incorrect duty exemption of Rs. 18.20 crore.

(ii) As per public notice dated 4 January 2005 and appendix 37B of the HBP Volume-1, coconut, areca nut, oranges, lemon, fresh grapes, apple and pears and all other fruits with a duty of more than 30 per cent under chapter 8 of the ITC (HS), were not permitted for import under the VKUY Scheme.

'Fresh apples and pears' were imported through Chennai (Sea) customs during September 2005 to December 2006, utilising 86 VKUY scrips with a duty credit of Rs. 3.20 crore. As these were ineligible items, the duty debited in the VKUY scrips for Rs. 3.20 crore needs to be recovered.

(iii) In terms of the policy circular dated 8 December 2005, import of capital goods was not permitted under the VKUY scheme. The list specifying

capital goods allowed to be imported was finally notified on 5 October 2006 by the DGFT. Thus, import of any capital good was not permitted till 5 October 2006.

Twenty eight consignments of capital goods were imported and cleared between May 2006 and September 2006 against 13 VKUY scrips through Kolkata port. Duty forgone against these consignments worked out to Rs. 87.07 lakh.

Similarly**,** M/s Cosmos Builders and Promoters Ltd. imported six escalators during June 2006 with a duty effect of Rs. 24.64 lakh and the duty was debited against VKUY scrip registered at ICD, Tughlakabad. Since, escalators were capital goods and were imported prior to October 2006, the duty debited incorrectly against the VKUY scrip needs to be recovered.

4.7.2.9 Payment of duty through duty credit scrips with insufficient credit

Customs notification dated 9 May 2005 (as amended by notification nos. 77/2005 and 97/2005) exempts VKUY scrip holders from the payment of basic custom duty and additional customs duty, subject to the condition that exemption from duty shall not be admissible, if there is insufficient credit in the VKUY scrip for debiting the duties. Scrutiny of records of commissionerates at Visakhapatnam and Jamnagar revealed grant of exemption of duty through debit in 33 VKUY scrips even though sufficient credit was not available. This led to incorrect utilisation of duty credit of Rs. 2.74 crore which needs to be recovered.

An illustrative case is discussed in the succeeding paragraph:-

Test check of the BEs at custom house, GAPL, Mundra for imports made under the scheme revealed that M/s Adani Wilmar Ltd. had imported various goods between March and May 2006 under the scheme through eight BEs attracting total duty of Rs. 10.04 crore by utilising 14 VKUY scrips. Although the credit available in these scrips were not sufficient to cover the duties leviable, the custom department had allowed partial debit of Rs. 1.34 crore to the VKUY scrips and the balance duty of Rs. 8.70 crore was paid in cash/cheque.

On this being pointed out, the deputy commissioner of customs, GAPL, Mundra stated (December 2006) that there was no prohibition for a partial debit. The reply is not tenable in view of contents of the notification cited above.

4.8 Conclusions

The audit review of the three duty free credit entitlement schemes for (i) Status Holders, (ii) Service Providers and (iii) Vishesh Krishi Upaj Yojana (VKUY) has revealed system as well as compliance weaknesses relating to the issue of duty credit certificates/scrips and in ensuring their appropriate utilisation.

There was no mechanism to correlate declared export performance/foreign exchange earnings with other statutory records like annual accounts, foreign inward remittance certificate (FIRC), bank realisation certificate (BRC),

income tax (IT) returns, etc. This facilitated issue of excess duty credit certificate/scrips in a few cases.

The compliance issues noticed in audit related to (a) incorrect issue of duty credit certificates/scrips and (b) inappropriate utilisation of the certificates/scrips. The credit certificates/scrips were incorrectly issued mainly due to (i) non-achievement of prescribed incremental growth, (ii) certificates/scrips to importers/exporters who were not status holders or were not service providers or were not registered, (iii) incorrect computation of eligible export turnover/foreign exchange earning, (iv) inclusion of supplies from a status holder to another, (v) reckoning of exports against free shipping bills, (vi) consideration of export performances of closed companies for determining credit entitlement of a new company, (vii) incorrect computation, (viii) scrips being issued for un-notified ports, etc. The inappropriate use of duty credit certificates/scrips subsequent to these being issued related to (i) cases where end-use of the goods imported under the certificates was not verified, (ii) payment of additional duty incorrectly through the certificates, (iii) payment of duty through the credit certificates/scrips despite having insufficient credit, (iv) import of inadmissible goods, etc. The duty credit incorrectly granted/used in the deficiencies noticed in the test check by audit was Rs. 349.67 crore. The Government needs to recover the applicable duty foregone wherever these credits had already been utilised inappropriately, in addition to initiating appropriate penal actions.

4.9 Summary of recommendations

- *There is an urgent need to put in place control mechanisms to plug the loopholes/lapses pointed out in the cases discussed in the chapter. Further, the existing controls to verify data furnished by exporters to obtain duty free benefits should be strengthened.*
- *The Ministry of Commerce in coordination with the Ministry of Finance needs to strengthen the internal controls governing issue of duty credit certificates/scrips under DFCE/SFIS/VKUY as well as those relating to subsequent utilisation of these credit certificates/scrips, to ensure that the benefits derived by the importers/exporters are the intended ones and commensurate with the duty foregone.*
- *The Ministry may consider prescribing additional documents (like annual accounts, FIRC, BRC, IT returns, etc.) to be enclosed and verified before determining the duty credit entitlements under the existing or future similar schemes, where tax benefits are given based on export performance. This would mitigate the risk of obtaining ineligible benefits under the FTP/schemes.*
- *Extension of IEC code of a closed unit to a newly formed company constitutes a major risk, as it is likely that in a few cases export performance were purchased at a premium from others in order to avail the benefits under the DFCE scheme. The Government needs to address this risk while formulating similar schemes under the FTP.*

CHAPTER V
TARGET PLUS SCHEME (TPS)

Executive Summary

'Target Plus Scheme (TPS)' was introduced to 'accelerate growth in exports' by rewarding exporters who have achieved a quantum growth in exports. Duty credit certificates, as a percentage of the incremental export turnover achieved were issued to the deserving exporters/importers. A review of the scheme was conducted in audit, to evaluate whether internal control mechanism instituted in the department to ensure compliance with the provisions of the Act/Rules/Regulations/Scheme and policy for issue of these certificates and its subsequent utilisation for imports of goods, were adequate and effective.

The audit review has revealed system as well as compliance weaknesses relating to the issue of duty credit certificates and ensuring their appropriate utilisation. Broadly these relate to (i) grant of duty credit in excess of entitlement, (ii) duty credit certificates being issued despite negative growth in export, (iii) misuse of the scheme where exporters had probably purchased the export turn over of others to achieve higher incremental growth, (iv) duty credit certificates being issued to ineligible exporters, (v) duty credits were granted in cases where there was absence of nexus between imported and exported goods, (vi) issue of duty credits to newly formed companies based on the status and export performance of the closed firms and (vii) improper sale of imported goods, which was prohibited under the 'Foreign Trade Policy'.

The main cause of the irregularities noticed in audit is the complete reliance of the scheme on the declarations furnished by exporters and certified by the CAs for grant of TPS certificates. The non-correlation of these declarations with other statutory documents like annual accounts, BRCs and IT returns, was a risk area which was left unmitigated by the department. The Ministry may consider prescribing additional documents (like P&L A/c, IT returns, etc.) to be enclosed/verified before arriving at the trade benefits to be provided to the exporters under other existing or future similar schemes, where tax benefits are given based on export performance. This would mitigate the risk of obtaining of benefits fraudulently under the FTP schemes.

Specific recommendations designed to address the system deficiencies and mitigate the risk of similar irregularities in future, have been included in the report. The revenue implication of this review is Rs. 294.95 crore and this amount needs to be recovered/certificates withdrawn/amended.

5.1 Highlights

- **Regional licensing authorities had granted excess duty credit of Rs. 113.84 crore in 112 cases due to incorrect computation of incremental growth.**

(Paragraphs 5.6.1 and 5.7.1.2)

- **Forty-four duty credit certificates of Rs. 37.09 crore were issued to 11 exporters in spite of negative growth of export. Of this, duty credits of Rs. 7.02 crore were already utilised which needs to be recovered.**

(Paragraph 5.6.2)

- **In 21 cases, misuse of the scheme by 'probable buying of export turnover' was observed. Duty credit of Rs. 26.48 crore was involved in these cases.**

(Paragraph 5.6.3)

- **Irregular duty credit of Rs. 13.89 crore was granted in nine cases based on ineligible third party exports.**

(Paragraph 5.6.4)

- **Duty credit certificates of Rs. 77.59 crore were issued to non-status holders in violation of applicable provisions. These ineligible certificate holders had already utilised Rs. 38.39 crore which needs to be recovered with due penalty.**

(Paragraph 5.7.1.1)

- **In 24 cases, duty credit certificates of Rs. 8.92 crore were issued for manufacturer of products which hardly needed any imported raw material as inputs.**

(Paragraph 5.7.2.1)

5.2 Introduction

The Government of India introduced, through the Foreign Trade Policy (FTP) 2004-09, "Target Plus Scheme (TPS)" with effect from 1 September 2004, as a part of promotional measure for exports. The objective of the Target Plus Scheme was to 'accelerate growth in exports' by rewarding Star Export Houses[9] who have achieved a quantum growth in exports. The TPS allowed exporters duty credit based on incremental export turnover. All Star Export Houses (paragraphs 3.5.1 and 3.5.2 of FTP 2004-09) including Status Holders[10] (paragraph 3.7.2 of Exim Policy 2002-07) who have achieved a minimum export turnover in free foreign exchange of rupees ten crore or more in the previous licensing year were eligible for consideration for issue of duty credit certificates under the scheme. These certificates could then be utilised for duty free imports upto the prescribed duty credit in the certificates. The entitlement under this scheme was contingent on the percentage incremental growth in 'Free on Board (FOB)' value of exports in the current licensing year over the previous licensing year. According to the FTP 2004-09, for incremental growth over 20 per cent, 25 per cent and 100 per cent over the previous year exports, the duty credit available would be five per cent, ten per cent and fifteen per cent, respectively of the FOB value of incremental exports.

[9] Exporters with annual export turnover of Rs. 15 crore and above
[10] Exporters with annual export turnover of Rs. 45 crore and above

The certificate holder within one month of the last imports made under the certificate or within the expiry of one month of the certificate, which ever is earlier has to submit a statement of imports/utilisation made under the certificate to the jurisdictional 'Regional licensing authority (RLA)' with a copy to the jurisdictional central excise authority. For any violation of TPS, the Director General of Foreign Trade (DGFT) or the authorities empowered under the Act is required to initiate action under Foreign Trade (Development and Regulation) Act, 1992, which includes issue of 'show cause notice (SCN)', levy of penalty, suspension/cancellation of 'Importer Exporter Code, (IEC)', certificates etc. The applicable customs duty foregone is required to be recovered by the revenue department.

Estimated revenue foregone on the TPS for the year 2006-07 was Rs. 3,120 crore and revenue foregone during the years 2004-05 to 2006-07 was Rs. 4,136 crore.

The scheme was withdrawn with effect from 1 April 2006. However, the utilisation of the credits for imports would continue for the certificates which had been issued as these are valid for use upto two years after date of issue of certificate.

5.3 Audit objectives

Audit examined the implementation of the scheme with reference to the FTP 2004-09 and the procedure laid down in the Handbook of Procedures (HBP), Volume-1, 2004-09. The review was conducted to evaluate whether internal control mechanisms instituted to ensure compliance with the provisions of the Act/Rules/Regulations/Scheme and policy for issue of these certificates and its subsequent utilisation for imports of goods, were adequate and effective.

5.4 Scope of audit

Audit reviewed 3,107 certificates with duty credit of Rs. 3,471.17 crore. These were selected out of the population of 3,664 certificates (84 per cent of the total population) through which duty credit of Rs. 4,136.20 crore was granted by the licensing authorities at Delhi, Mumbai, Chennai and Kolkata upto 31 March 2007.

5.5 Acknowledgement

The Indian Audit and Accounts Department acknowledges the cooperation extended by the Ministry of Finance and the Ministry of Commerce and Industry in providing the necessary information and records for audit. The draft review was forwarded to the Ministries in November 2007 and an exit conference was conducted with the Ministry officials in December 2007. The conclusions and recommendations were agreed to be examined and referred to policy wing by the Ministries, wherever appropriate. While the written responses to the draft review from the Ministries are awaited, responses of the department, wherever received, have been incorporated appropriately.

AUDIT FINDINGS AND RECOMMENDATIONS

5.6 System issues

5.6.1 Incorrect computation of incremental growth

As per paragraph 3.7.3 of FTP 2004-09, the minimum incremental growth was required to be 20 per cent. Annexure 17D of HBP Volume-1 devised by DGFT incorporated various information relating to export turnover during the previous year and current year for computation of duty credit entitlement of the applicant.

Test check of the records of RLAs in Mumbai, Delhi, Chennai and Kolkata revealed incorrect grant of duty credit of Rs. 56.69 crore in 105 cases due to incorrect computation of incremental growth. Of this, duty credit of Rs. 32.90 crore has already been utilised in 32 cases.

A few of such cases are illustrated in the following paragraphs:-

(i) M/s Bharat Forge Ltd. was granted a TPS certificate by RLA Mumbai, on 20 October 2006 for Rs. 11.09 crore. Audit scrutiny revealed that while calculating the incremental growth, the department considered export against two shipping bills (nos. 3325925 and 3254156) for US$ 7,783.96 twice. Additionally, export of US$ 4,89,136.53 for 2005-06 was included as eligible export for 2004-05. Excluding these ineligible exports, the correct growth worked out to 18.38 per cent, which is below the required minimum of 20 per cent. This resulted in incorrect grant of duty credit of Rs. 11.09 crore, which is required to be recovered/withdrawn.

(ii) M/s Ikea Trading (India) Pvt. Ltd., a merchant exporter, was issued a TPS certificate for Rs. 8.50 crore by RLA Delhi, based on the declared FOB value of eligible exports for 2003-04 and 2004-05 as Rs. 898.16 crore and Rs. 1,068.06 crore, respectively with an incremental growth in exports of 21.59 per cent. However, the sales turnover as per the annual accounts for 2003-04 and 2004-05 was Rs. 966.91 crore and Rs. 1,218.57 crore, respectively. Audit scrutiny revealed that the firm was also issued 'Star Export House' certificate on 3 May 2005 based on an application on 10 January 2005. The firm in its application had mentioned its sales turnover as Rs. 969.67 crore for 2003-04, which was certified by the CA. Standard Chartered Bank had also certified that Rs. 969.67 crore was realised during 2003-04. In the light of the certificate of realisation of foreign exchange issued by the bank, the sales turnover of Rs. 898.16 crore as given in the application for TPS certificate could not be relied upon. If actual realisation of foreign exchange was taken into account, the incremental growth of the firm would fall below the minimum threshold limit of 20 per cent, required to avail of the benefits under the scheme. Failure of the department to correlate the different sets of data resulted in the issue of irregular certificate for Rs. 8.50 crore.

(iii) M/s Polyplax Company, Noida was granted a TPS certificate of Rs. 1.87 crore by RLA, Delhi. The company had declared FOB value of eligible exports as US$ 1,18,00,707 (Rs. 54.31 crore) and US$ 1,63,23,743. (Rs. 74.42 crore) for 2003-04 and 2004-05 respectively. Whereas as per the annual accounts, the FOB value of exports for 2003-04 and 2004-05 was

Rs. 62.56 crore and Rs. 73.15 crore respectively. Audit scrutiny revealed that the eligible export as per annual accounts was less than the figure declared for obtaining TPS certificate. Considering the export figures of annual accounts, the exporter was ineligible for any TPS certificate, as the incremental growth in export turnover fell below the prescribed limit of minimum incremental growth of 20 per cent. Thus, issue of certificate without verifying the shipping bills/bank realisation certificate (BRC) in this case resulted in irregular/incorrect issue of certificate with duty credit of Rs. 1.87 crore.

On the case being pointed out, the department stated (February 2007) that the TPS committee did not feel it necessary to call for the shipping bills/BRC in the instant case. The reply is not tenable as the accounts figures should be consistent with the figures adopted for the purpose of issue of TPS.

There is a need to verify whether the exporter had inflated his exports for obtaining of the TPS certificate. Prima-facie, it did, and the department therefore should take appropriate action including recovery.

(iv) In terms of Appendix 17D of HBP Volume-1, the duty credit under TPS had to be worked out by restricting the declared exports or exports effected (FOB value) to amounts realised actually as per BRC.

Audit scrutiny of nine certificates, issued by the RLA, Chennai between 10 January 2006 and 31 October 2006 to four exporters for Rs. 9.49 crore indicated that the duty credit entitlement had not been worked out by adopting the actual money realisation of export proceeds as per BRC. This resulted in excess granting/availing of duty credit of Rs. 98.53 lakh.

(v) Two TPS certificates for Rs. 23.81 lakh and Rs. 19.90 lakh were issued by the RLA, Chennai to M/s Karamal Garments Exports on 28 April 2006 and 13 November 2006 respectively. Profit and Loss (P&L) account revealed that the export turnover was Rs. 14.21 crore for 2003-04, which was certified by the CA as well. However, the department considered an export turnover of Rs. 12.21 crore as claimed by the exporter in his application for issue of TPS certificate. If the correct FOB value of export had been adopted, the incremental growth would have been 16.69 per cent only, making the exporter ineligible for issue of a TPS certificate. Thus, certificates with duty credit of Rs. 43.71 lakh issued to the exporter needs to be withdrawn/recovered.

In response to the audit observations, the RLA, Chennai replied (May 2007) that the P&L account was not the document prescribed to be submitted for issue of certificate. Further, the export turnover of P&L account might include third party exports and other ineligible exports. For the purpose of P&L account, the exporter might have taken exports for which invoice was raised during that period.

The reply of the department is not tenable. As per the CA's certificate for claiming deduction under section 80 HHC of the Income Tax Act, 1961, it was only the direct export made by the exporter and foreign exchange realised was Rs. 14.21 crore. Additionally, the Joint DGFT has the discretion to call for any additional documents required to ensure the correctness of the claims for issue of a certificate.

Similarly, in 58 other certificates issued by the RLA, Chennai and two by the RLA, Kolkata, the FOB value of exports relating to 2003-04 were understated and on that basis excess duty credit of Rs. 30.71 crore was allowed/availed of.

5.6.2 Duty credit allowed in spite of negative growth in export

As per the proviso to paragraph 3.7.2 of FTP and note 3 of Appendix 17D of HBP Volume-1, the FOB value of exports relating to 2004-05 should not be less than the FOB value of exports for 2003-04.

Audit scrutiny of 44 certificates involving duty credit of Rs. 37.09 crore issued to eleven exporters by the RLA, Chennai under TPS revealed that the export performance as per P&L account for 2004-05 was less than that of 2003-04. As there was a negative growth in exports in these cases, the exporters were not eligible for the benefit under TPS. The duty credit of Rs. 37.09 crore allowed was required to be withdrawn and credit availed of Rs. 7.02 crore (two cases) was required to be recovered.

The RLA, Chennai replied (May 2007) that the P&L account was not the document prescribed for submission alongwith the application for issue of TPS certificate. Further, the FOB value indicated in the P&L account might include third party exports and other ineligible exports. For the purpose of P&L account the exporter might have taken all the exports for which invoice was raised during that year.

The reply of the department is not tenable. As per the annual accounts, the foreign exchange realised was Rs. 89.81 crore for 2003-04 and Rs. 75.49 crore for 2004-05, based on which income tax (IT) deduction under section 80HHC of the Income Tax Act, 1961, was also claimed.

The main cause of the irregularities pointed out in paragraphs 5.6.1 and 5.6.2 is the complete reliance of the scheme on the declarations furnished by exporters and certified by the CAs for grant of TPS certificates. The non-correlation of these declarations with other statutory documents like annual accounts, BRCs and IT returns, was a risk area which was left unmitigated by the department.

Recommendation

- *The Ministry may consider prescribing additional documents (like P&L A/c, IT returns, etc.) to be enclosed/verified before arriving at the trade benefits to be provided to the exporters under other existing or future similar schemes, where tax benefits are given based on export performance. This would mitigate the risk of obtaining of benefits fraudulently under the FTP schemes.*

5.6.3 Misuse of the scheme by means of 'probable buying of turnover'

Misuse of the scheme by means of 'probable buying of turnover' of other exporting company to achieve higher incremental growth was noticed in 21 cases involving irregular duty credit of Rs. 26.48 crore.

A few illustrative cases are mentioned in the following paragraphs:-

5.6.3.1 As per paragraph 9.1 of HBP Volume-1, 'constitution' for the purpose of amendment of 'Importer-exporter code, (IEC)', would mean change in partners in a partnership firm, trustees of a trust, members of the board of society and directors of a private limited company and only in such cases the continuation of the IEC code is admissible to the firm. Additionally, as per note 2 of paragraph 3.7.3 of the FTP (2004-09), the export performance of one exporter is not transferable to another exporter.

Audit scrutiny of six certificates issued to M/s Sabare International Ltd. on 6 April 2006 involving duty credit of Rs. 7.74 crore revealed that the company 'Sabare International Ltd.' had come into existence only with effect from 9 October 2003 on closing of the business of the firm 'Sabare Garments' on 8 October 2003. The IEC code of Sabare Garments was extended to the newly formed company treating it as change in name and also the export turnover of the firm was taken into account of the company while giving star status and benefit under TPS.

The firm and company were legally separate entities. Extending the IEC code of the firm to a newly formed company, treating the event as only change in name, allotting the status of the earlier firm, and treating the export performance of the firm as that of the company was not in order. This resulted in issue of incorrect duty credit of Rs. 7.74 crore.

The RLA, Chennai replied (May 2007) that the IEC code had been properly updated with the change of constitution and necessary amendment made in the status holder's certificate by the concerned licensing authority.

The reply is not relevant as the audit observation relates to the incorrect extension of the IEC number of the closed firm to the newly formed company in contravention of paragraph 9.1 of the HBP Volume-1.

Similarly, in nine other certificates issued to six exporters, where duty credits for Rs. 14.41 crore were issued to newly formed companies based on the status and export performance of the closed firms, credits were required to be recovered.

5.6.3.2 Paragraph 9.61 of FTP (2004-09), requires the names of supporting manufacturers and the exporters to be endorsed in the export documents for these to be reckoned for entitlement of benefits under TPS. As per paragraph 3.2.5(iii) of HBP Volume-1, the names of the supporting manufacturers should appear in the shipping bill before these can be endorsed in the entitlement certificate issued under TPS. In addition, as per policy circular no. 9 dated 14 June 2005, for endorsing more than one exporter in the certificate, it is mandatory that documentary evidence in support of their claim should be produced to the committee approving the TPS claim.

Test check of the records of the RLA Chennai, revealed irregular duty credit of Rs. 4.33 crore in six cases due to endorsement of TPS benefits (credits) to those who were not supporting manufacturers. These cases are mentioned in the following paragraphs:-

(i) Two TPS certificates for Rs. 2.69 crore were issued to M/s UB Global Corporation Ltd. and the entire credit was endorsed to M/s UB International

Trading Ltd., M/s MC Dowell & Co. and M/s United Breweries Ltd., who were stated to be the supporting manufacturers. On verification, it was noticed that the shipping bills dated on or after 1 April 2004 did not contain the name of these supporting manufacturers. Hence, the endorsement in favour of the supporting manufacturers was not in order.

The department replied (May 2007) that the name of the supporting manufacturers was endorsed in the shipping bills. The reply is not tenable as audit has evidence to the contrary (names of the supporting manufacturers were not endorsed in shipping bills numbers 2019109 dated 7 March 2005 and 2816895 dated 11 June 2004).

(ii) M/s Om Vishkar was issued four duty credit certificates for Rs. 1.64 crore on 21 July 2006 with an endorsement of the entire FOB value of Rs. 28.14 crore in favour of three other companies, who were stated to be the supporting manufacturers. Audit scrutiny revealed that the names of these supporting manufacturers were not endorsed in any of the export documents viz. shipping bills, BRC etc. Hence, the endorsement in favour of the above manufacturers was not in order, and the duty credit was required to be withdrawn/recovered.

5.6.4 Grant of credit based on ineligible third party exports

In terms of paragraph 3.7.5 (g) of the FTP 2004-09, the export performance made by one exporter on behalf of another exporter was not to be taken into account for the calculation of export performance or for computation of entitlement under TPS. Further, as per paragraph 3.2.5 of the HBP, Volume-1, in case of third party exports, where goods have been procured from a manufacturer, the shipping bill should indicate the name of the exporter as well as the name of the supporting manufacturer, for these to be reckoned for entitlement under TPS. The export documents like export order, invoice, BRC should be in the name of the applicant only.

As per the DGFT circular no. 17 dated 15 July 2005, in case of supplies made by non-status holder to status holder, the former has to achieve at least 25 per cent incremental growth over its previous year's direct export turnover. As per note 2 of paragraph 3.7.3 of the FTP, the export performance was not to be transferred to or from any other exporter, to avail benefits under the TPS.

Test check of the records of the RLAs at Kolkata and Mumbai revealed irregular grant of duty credit of Rs. 13.89 crore in nine cases due to ineligible third party exports. A total duty credit of Rs. 12.38 crore has been utilised in eight of these cases, which needs to be recovered.

A few cases are illustrated in the following paragraphs:-

(i) Eight certificates with duty credit entitlement totalling Rs. 14.64 crore were issued by the licensing authority at Mumbai to three exporters (M/s Supreme Industries, M/s Euro Vista trading company Ltd. and M/s Kirlosker Brother Co. Ltd.). Audit scrutiny revealed that while granting the certificates, ineligible exports relating to the transfer of export performance from other exporters, supplies made by one status holder to another and supplies from a non-status holder to status holder were considered. The incremental growth in

these cases after excluding these would correctly work out to less than 25 per cent. This resulted in issue of inadmissible credit of Rs. 11.82 crore.

(ii) A duty credit certificate for Rs. 4.77 crore was issued to M/s JJ Exporters Ltd., Kolkata in April 2006 by the Joint DGFT, Kolkata based on its declared export of Rs. 65.10 crore made during 2004-05. The company had made exports worth Rs. 31.78 crore during 2003-04. On scrutiny of the statement of export made in 2004-05, it was observed that it had included third party exports worth Rs. 6.18 crore. Further, the invoice and the 'Statutory Declaration Form (SDF)' were not in the name of the applicant as required under the above provision. These exports were, therefore, ineligible for being considered as third party exports. Thus, the incremental growth in exports during 2004-05 would work out to 89.24 per cent which entitled the exporter to duty credit of ten per cent instead of 15 per cent, which was granted by the licensing authority. The excess grant of duty credit of Rs. 2.07 crore needs to be revised/recovered.

Recommendation

- *Consideration of third party exports for calculation of entitlement under TPS, constitutes a major risk, as it is likely that in a few cases export performance were purchased at a premium from others in order to avail the benefits under TPS. The Government needs to address this risk while formulating similar schemes under the FTP.*

5.7 Compliance issues

5.7.1 Incorrect issue of duty credit certificates

5.7.1.1 Incorrect issue of certificates to non-status holders

The objective of the scheme was to accelerate growth in exports by rewarding 'Star export houses including status holders'. The quantum of growth for the year 2004-05 (current year) was calculated based on exports made in the year 2003-04 (previous year). Thus, it was a pre-requisite that the applicant exporter should be status holder in the previous as well as in the current year.

Test check of records of RLAs at Kolkata and Mumbai revealed that 26 duty credit certificates (seven in Kolkata and 19 in Mumbai) under TPS were issued, even though the licencees were not 'Star export houses' during the previous (base) years 2003-04. Further, in a duty credit certificate issued by RLA, Chennai the applicant was not a status holder during the previous as well as current year (2004-05). The duty credit involved was Rs. 77.59 crore. Audit verified that Rs. 38.39 crore credit out of this has already been utilised in 13 cases.

Joint DGFT, Mumbai in reply to the observations relating to the 19 certificates issued by it, stated (April 2007) that the pre-requisite condition for grant of certificate was that the applicant should hold the status in the target year i.e. 2004-05 and the applicant was not required to be status holder in the base year 2003-04. The reply is not tenable as the applicant is required to be a 'status holder' in the base year as well as in the target year to be eligible under the scheme, in view of the specific eligibility criteria prescribed under paragraph

3.7.2 of the FTP. Replies from the licensing authorities at Chennai and Kolkata have not been received (September 2007).

5.7.1.2 Grant of excess duty credit

As per paragraph 3.7.3 (FTP 2004-09), the credit entitlement under this scheme was required to be five/ten/fifteen per cent of the incremental growth of 20-25/25-100/above 100 per cent respectively in FOB value of exports in the current licensing year over the previous licensing year. Audit scrutiny revealed that in seven certificates issued by 'Regional Licensing Authority, (RLA)' at Chennai and Mumbai, exports of the current year was incorrectly computed by adding the exports of base year in the current year exports, resulting in issue of certificates of excess value by adopting rates higher than what were admissible. This resulted in grant of excess duty credit amounting to Rs. 57.15 crore. The primary reason for these irregularities was incomplete examination of the export data furnished by the licence seekers.

A few cases are illustrated in the following paragraphs:-

(i) A scrutiny of certificate dated 27 September 2005 for Rs. 133.74 crore issued by RLA Chennai to M/s Hyundai Motor Ltd. revealed that the eligible export of Rs. 1,851.87 crore for the year 2004-05 was excessively computed by taking the export of Rs. 87.69 crore made during the year 2003-04 but realised in 2004-05. If this amount (Rs. 87.69 crore relating to the year 2003-04) was reduced from the eligible export turnover of 2004-05 and added to the eligible export turnover of 2003-04, the incremental growth would be only 80.12 per cent and the admissible rate of duty credit would be ten per cent as against 15 per cent, which was allowed. The incorrect computation of incremental growth resulted in excess grant of duty credit amounting to Rs. 55.28 crore, which needs to be recovered from the exporter as the certificate holder had utilised the entire credit.

The department replied (May 2007) that the export performance of the exporter was as per the provision based on the let export date[11]. The reply of the department is not tenable because even as per the chartered accountant's (CA) certificate, the export value recommended for reduction by audit from the year 2004-05 pertains to the year 2003-04.

(ii) Similarly, duty credit certificates for Rs. 3.21 crore were issued to three exporters (M/s Arvind A Traders, Karur, G Tex INC, Bangalore and Sri Balaji Traders, Rajapalayam) by RLA Chennai, taking into account the exports made during 2005-06 as part of export turnover of 2004-05. This was incorrect and resulted in excess allowance of duty credit of Rs. 1.67 crore. Of this, duty credit of Rs. 94 lakh has already been utilised in two of the three cases.

(iii) RLA Mumbai issued a TPS certificate for Rs. 39.31 lakh for 2004-05 to M/s A.V. Industries at the rate of ten per cent on the incremental growth achieved by the exporter. However, audit scrutiny revealed that the exporter had achieved a growth of 24.89 per cent only in 2004-05. As such, the exporter was entitled to duty credit at the rate of five per cent. The incorrect

[11] The date on which Customs Officer permits the clearance of goods for exports.

application of rate of duty credit resulted in excess grant of duty credit amounting to Rs. 19.65 lakh.

On the case being pointed out, the department intimated (April 2007) reduction in the duty credit by Rs. 19.65 lakh.

5.7.1.3 Certificates issued to ineligible exporters

As per paragraph 3.7.2 (FTP 2004-09), "all Star export houses which have achieved a minimum export turnover in free foreign exchange of rupees ten crore in previous licensing year" were eligible for consideration under the scheme.

In 14 cases under the RLA at Chennai, the export turnover for the previous year (2003-04) worked out to be less than rupees ten crore. However, certificates involving duty credit of Rs. 2.44 crore were issued incorrectly, as illustrated in the following paragraphs**:-**

(i) Joint DGFT, Chennai had issued ten duty credit certificates for Rs. 1.57 crore under TPS to M/s Star Agro Marine Exports Pvt. Ltd. The export turnover as per the copies of shipping bills for 2003-04 worked out to Rs. 5.03 crore. The duty credit of Rs. 1.57 crore allowed to the exporter is, therefore, required to be withdrawn/recovered.

(ii) Similarly, Joint DGFT, Chennai issued four certificates for Rs. 86.71 lakh on 7 October 2005 under TPS to M/s Pelican Rubber (P) Ltd. based on the export turnover for 2003-04. However, audit scrutiny revealed that eligible export for the year 2003-04 was only Rs. 5.78 crore. Thus, the exporter was not eligible for the duty credit under TPS. The duty credit of Rs. 86.71 lakh allowed is required to be withdrawn/recovered from the exporter.

5.7.1.4 Time barred claim

The last date for filing application to obtain TPS credit certificate for the incremental growth achieved in 2004-05 was 31 December 2005. This was extended until 31 March 2006. Thereafter applications could be filed upto 30 September 2006 for issue of certificates with a late cut of ten per cent on the credit entitlement. Any claim filed beyond the period of six months from the expiry of the last date of submission of application was not to be considered.

Test check of records of the RLA at Kolkata and Chennai revealed incorrect grant of duty credit of Rs. 37.69 lakh in two cases of ineligible time barred claim. Further verification revealed that a total duty credit of Rs. 20.56 lakh has already been utilised in these two cases.

The RLA Chennai, stated (May 2007) that as per note 8 of Appendix 17D, a single consolidated supplementary application could be filed within three months from the date of the last realisation and no late cut needed to be imposed on such supplementary claim. The reply of the department is not tenable because in the instant case the foreign exchange realisation in respect of four shipping bills were not eligible for export incentives, having been realised after 360 days (foreign exchange should be realised within 360 days for the exports to be reckoned) and for the remaining shipping bills, realisation

was made in November 2005 and the application was filed on 20 September 2006 which was neither within three months from the date of realisation nor was within six months from the last date of filing of application for TPS claims.

5.7.1.5 Non-imposition of late cut

(i) As per paragraph 9.4 of the HBP Volume-1, wherever any application for supplementary claim of TPS credit is received, within the stipulated time limit, such application would also be considered after imposing a cut at the rate of ten per cent on the entitlement.

Four certificates issued under TPS for 2004-05 by the RLA, Chennai revealed that duty credit totalling Rs. 2.19 crore was allowed under supplementary claim, without imposing ten per cent cut on the entitlement. This resulted in excess allowance of duty credit of Rs. 21.82 lakh.

(ii) Paragraph 9.3 of the HBP, Volume-1 provides that where the application was received after expiry of the time limit, but within six months from the last date, a late cut at ten per cent of the entitlement be imposed while issuing a certificate.

Scrutiny of five certificates issued by the RLA, Chennai and Kolkata revealed that though the applications were filed on the expiry of time limit, but within six months from the last date, late cut of ten per cent was not imposed. This resulted in the excess grant of duty credit of Rs. 21.77 lakh, which was recoverable from the certificate holders.

5.7.2 Incorrect/inappropriate utilisation of duty credit granted under TPS

Audit observed inappropriate use of 40 TPS certificates during audit of the records of the RLA at Chennai, Delhi, Kolkata and Mumbai involving duty credit of Rs. 14.98 crore issued by way of (i) absence of broad nexus between exported and imported product, (ii) inadmissible imports and (iii) irregular sale of imported goods. These cases are discussed in the following paragraphs:-

5.7.2.1 Inadmissible imports against certificates

As per sub-paragraph II of 3.2.5 of the HBP, Volume-1 (2004-09), goods imported under the scheme should have a broad nexus with the products exported. Further as per paragraph 3.7.6 of FTP (2004-09), agricultural products of Chapter 1 to 24 of the Import Trade Control (Harmonised System) {ITC (HS)}, except as may be notified from time to time, shall not be permissible for imports under this scheme.

In 24 cases relating to the RLAs at Kolkata and Mumbai, duty credit certificates of Rs. 8.92 crore were granted for manufacture of products, which hardly needed any imported raw material. Thus, the certificate holders were provided with the means to import items without having broad nexus with the export products and the scope to sell such imported items at a premium. Duty credit of Rs. 1.43 crore has been utilised in 14 of these cases.

In another case of the RLA at Chennai (ACC), absence of broad nexus between imported and exported product resulted in irregular utilisation of duty credit of Rs. 12 lakh. In yet another case at Delhi, irregular import of agricultural goods of Chapter 8 involving duty credit utilisation of Rs. 18 lakh was noticed.

5.7.2.2 Irregular sale of imported goods

In terms of paragraph 3.7.6 of the FTP 2004-09, the duty credit granted under the TPS may be used for import of goods for their own use or their supporting manufacturer as declared in the application for TPS. Further, sub-paragraph III of 3.2.5 of the HBP, Volume-1, provides that the licensing authority at the time of issue of the certificate should endorse the name of the associate manufacturer/supporting manufacturer/job worker. Accordingly, notification no. 32/2005-cus dated 8 April 2005 stipulated that where the goods are imported by a merchant exporter having supporting manufacturer(s) whose name and address are specified in the certificate, the same goods may be utilised by the said supporting manufacturer(s). The notification also provided that the certificate and the goods imported against it should not be transferred or sold.

M/s Ellenbarrie Exim Ltd., Kolkata, a merchant exporter, imported 3,778 MT of 'crude palm oil and crude degummed soyabean oil' between May and July 2006 against TPS certificates. As per the records at the customs commissionerate, Kolkata (Port), the goods were transferred to a job worker M/s Paceman Sales Promotion Pvt. Ltd. Chanditala, Hoogly, who had the facility for manufacturing vanaspati/refining oil. Audit scrutiny revealed that the goods were refined and finally sold to the job worker, which is violative of the above customs notification. This resulted in irregular utilisation of duty credit of Rs. 5.76 crore which needs to be recovered. Suitable penal action may also be initiated against the certificate holder.

5.7.3 Ineffective monitoring after the issue of certificates

Installation and usage certificate of imported goods under TPS were to be provided to the customs authorities after the duty credits were utilised (notification nos. 32/2005-cus dated 8 April 2005 and 73/2006-cus dated 10 July 2006 read with paragraph 3.7.6 of the FTP 2004-09). A certificate from the jurisdictional assistant/deputy Commissioner of central excise or an independent chartered engineer in respect of units which are not registered with the central excise department, was to be produced confirming installation and use of the capital goods in the importer's factory or premises, within six months from the date of import. Further, all goods imported under the scheme were meant for own use and not transferable or saleable.

Audit scrutiny of import particulars available with the commissionerate of customs, Kolkata (Port), revealed that five certificate holders imported 244 items of different capital goods of assessable value of Rs. 22.44 crore between May 2006 and October 2006. But the licencees did not furnish the requisite certificates of installation/use even after the expiry of stipulated period of six months from the date of import. The duty exempted in these cases was Rs. 7.83 crore.

In the absence of these certificates indicating 'end-use', audit could not verify whether the imported goods under the TPS were used for purpose for which they were allowed and not diverted elsewhere.

The department needs to ascertain the end use, recover duty and penalty based on the investigation.

5.8 Conclusions

The audit review has revealed system as well as compliance weaknesses relating to issue of duty credit certificates and ensuring their appropriate utilisation. Broadly these relate to (i) grant of duty credit in excess of entitlement, (ii) duty credit certificates being issued despite negative growth in export, (iii) misuse of the scheme where exporters had probably purchased the export turn over of others to achieve higher incremental growth, (iv) duty credit certificates being issued to ineligible exporters, (v) duty credits were granted in cases where there was absence of nexus between imported and exported goods, (vi) issue of duty credits to newly formed companies based on the status and export performance of the closed firms and (vii) improper sale of imported goods, which was prohibited under the 'Foreign Trade Policy'.

Audit noticed irregularities in 283 TPS certificates, which was nine per cent of the sample selected for the review. The duty credit incorrectly granted/used in these cases was Rs. 294.95 crore, and the Government needs to recover applicable duty foregone wherever these credits had already been utilised inappropriately, in addition to initiating appropriate penal actions.

Recommendation

- *Since credits under the scheme are still available although the scheme has now been discontinued, there is an urgent need to put in place control mechanisms to plug the loopholes/lapses pointed out in the cases discussed in the report. Further, the existing controls to verify data furnished by exporters to obtain duty free benefits should be strengthened.*

5.9 Summary of recommendations

- *The Ministry may consider prescribing additional documents (like P&L A/c, IT returns, etc.) to be enclosed/verified before arriving at the trade benefits to be provided to the exporters under other existing or future similar schemes, where tax benefits are given based on export performance. This would mitigate the risk of obtaining of benefits fraudulently under the FTP schemes.*
- *Consideration of third party exports for calculation of entitlement under TPS, constitutes a major risk, as it is likely that in a few cases export performance were purchased at a premium from others in order to avail the benefits under TPS. The Government needs to address this risk while formulating similar schemes under the FTP.*
- *Since credits under the scheme are still available although the scheme has now been discontinued, there is an urgent need to put in place control mechanisms to plug the loopholes/lapses pointed out in the cases discussed in the report. Further, the existing controls to verify data furnished by exporters to obtain duty free benefits should be strengthened.*

CHAPTER VI
SPECIAL ECONOMIC ZONES (SEZs)

Executive Summary

A review of the SEZ scheme was conducted in audit with the limited objective of verifying that the units in the SEZ had complied with the applicable Customs Act, Rules, notifications etc. and had functioned appropriately under the provisions of Exim Policy and the procedures prescribed as per the 'Handbook of Procedures (HBP), Volume-1'. The adequacy and effectiveness of the internal controls to ensure compliance with the applicable Act/Rules/procedures were also examined.

The review brings out system as well as compliance weaknesses relating to policy and procedures governing the management and functioning of SEZ units in ensuring that these functioned as intended. While the revenue implication of this audit review is Rs. 246.72 crore, an additional Rs. 1724.67 crore was foregone or could not be recovered in the absence of enabling provisions.

There was no restriction on 'deemed exports' being reckoned as exports enabling the units to attain positive net foreign exchange earning (NFE) predominantly through deemed exports rather than actual exports. As a result, 22 SEZ units had achieved the required positive NFE, notwithstanding the fact that the actual export earnings were only 28 per cent and the remaining 72 per cent came from domestic sales. The Government may consider restricting reckoning of deemed exports for the purpose of calculating NFE by an appropriate scale.

The units under domestic tariff area (DTA) were put under disadvantageous position as no provision had been made to recover duty foregone on inputs procured by the SEZ units and used in the manufacture of products which were cleared at 'nil' rate of duty in DTA. The Government needs to address this disparity to ensure a level playing field for the units in the DTA as well as in the SEZ.

The SEZ scheme relies mainly on self-certification and does not require the 'quarterly/annual performance reports (QPRs/APRs)' to be supported by other statutory documents like annual accounts, customs records, income tax (IT) returns, bank realisation certificates (BRC) etc. This facilitated a few units to provide incorrect/inconsistent data in their APRs/QPRs. The NFEs derived on the basis of this inconsistent data cannot be relied upon. The Government needs to address this concern.

Few other issues noticed in audit related to (i) non-achievement of positive NFE, (ii) violation of the conditions of LOP, (iii) short levy of duty on DTA sales, (iv) non-recovery of applicable lease rent, (v) excess payment of drawback/interest, (vi) goods removed for inter-unit transfer/job work not accounted for, (vii) short levy of duty from de-bonded units, and (viii) non-levy of service tax on services rendered in the DTA, and (ix) non-constitution of the 'unit approval committee' in four zones.

Specific recommendations designed to address the system deficiencies and mitigate the risk of similar irregularities in future, have been included in the report.

6.1 Highlights

- **SEZ units had been achieving the prescribed (positive) NFE mainly through domestic sales defeating one of the sub-objectives of the scheme, which was to augment exports. Customs duty to the extent of Rs. 1,043 crore was forgone on imports by these units.**

(Paragraph 6.6.1)

- **Duty of Rs. 681.38 crore was foregone on the inputs used in the manufacture of mobile phones cleared into the DTA at 'nil' rate of duty. This duty could not be recovered, in the absence of provisions to pay back the duty foregone on inputs utilised for manufacture of such goods when cleared at 'nil' duty into the DTA.**

(Paragraph 6.6.2)

- **Duty of Rs. 106.71 crore alongwith interest of Rs. 46.17 crore was recoverable from 24 SEZ units which had failed to achieve positive NFE.**

(Paragraph 6.7.1)

- **Forty one units in the SEZs had violated the conditions of the applicable 'Letter of Permission (LOP)'. Accordingly, duty totalling Rs. 74.90 crore was recoverable from these units.**

(Paragraph 6.7.2)

- **Duty of Rs. 8.03 crore was short levied on DTA sales relating to 21 SEZ units.**

(Paragraph 6.7.3)

6.2 Introduction

The 'Special Economic Zones' (SEZs) policy was announced in April 2000. This policy intended to make the SEZs an engine for economic growth supported by quality infrastructure complemented by an attractive fiscal package, both at the centre and the state level, with the minimum possible regulations. SEZs functioned from 1 November 2000 to 9 February 2006 under the provisions of the 'Foreign Trade Policy' (FTP) and fiscal incentives were made effective through the provisions of the relevant statutes.

The SEZ Act, 2005, supported by the SEZ Rules, came into effect from 10 February 2006, providing for simplification of procedures and for single window clearance on matters relating to Central as well as State Governments. The main objectives of the SEZ Act/policy were (i) generation of additional economic activity, (ii) promotion of exports of goods and services, (iii) promotion of investment from domestic and foreign sources, (iv) creation of employment opportunities and (v) development of infrastructure facilities.

A single window SEZ approval mechanism has been provided through a 19 member inter-ministerial 'Board of Approval (BOA)'. The applications duly recommended by the respective State Governments/UT Administration are considered by the BOA.

The functioning of the SEZs is governed by a three tier administrative set up. The BOA is the apex body and is headed by the Secretary, Department of Commerce. The 'Approval Committee' at the zone level deals with approval of units in the SEZs and other related issues. Each zone is headed by a 'Development Commissioner (DC)', who is the ex-officio chairperson of the 'Approval Committee'.

Once an SEZ has been approved by the BOA and the Central Government has notified the area of the SEZ, units are allowed to be set up in the SEZ. All the proposals for setting up of the units in the SEZ are approved at the zonal level by the 'Approval Committee' consisting of DC, customs/central excise authorities and representatives of the State Government. All post approval clearances including grant of importer-exporter code number, change in the name of the company or implementing agency, broad banding diversification, etc. are given at the zone level by the DC. The performance of the SEZ units is to be periodically monitored by the 'Approval Committee' and the units are liable for penal action under the provisions of the Foreign Trade (Development and Regulation) Act, 1992, in case of violation of the conditions of the approval.

The incentives and facilities offered to the SEZ units include (i) duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units, (ii) 100 per cent income tax exemption on export income for SEZ units under section 10AA of the Income Tax Act for first five years, 50 per cent for next five years thereafter and 50 per cent of the ploughed back export profit for next five years, (iii) exemption from minimum alternate tax under section 115JB of the Income Tax Act, (iv) external commercial borrowing by SEZ units upto US $ 500 million in a year without any maturity restriction through recognised banking channels, (v) exemption from central sales tax, (vi) exemption from service tax, (vii) single window clearance for central and state level approvals and (viii) exemption from state sales tax and other levies as extended by the respective State Governments.

All the import/export operations of the SEZ units are on self-certification basis. The units in the zones are required to be a net foreign exchange (NFE) earner, calculated cumulatively for a period of five years from the commencement of production. These units have to execute a legal undertaking with the development commissioner to achieve positive NFE. Periodical monitoring on the functioning and performance of the units in the SEZ should be carried out by the unit approval committee. Further, monitoring of SEZ units is also to be done by the jurisdictional customs/central excise authorities through participation in such a committee. The performance of the units was to be monitored quarterly, based on the reports received in prescribed formats. Based on such review, the DC should inform/suggest to the Department of Commerce and the Central Board of Excise and Customs (CBEC), corrective measures to enable the defaulting units to fulfil their obligations as per the SEZ scheme. For any violation of the

scheme, the Director General of Foreign Trade (DGFT) or the authorities empowered under the Act were required to initiate action under the Foreign Trade (Development and Regulation) Act, 1992, which included issue of show cause notice (SCN), levy of penalty, suspension/cancellation of the importer-exporter code (IEC), licences etc. The applicable customs duty foregone is required to be recovered by the revenue department.

SEZ is a specifically delineated duty free enclave and is a deemed foreign territory for the purpose of trade operations, duties and tariffs. Accordingly, goods and services from domestic tariff area (DTA) to SEZ are to be treated as exports and goods coming from SEZ into DTA are to be treated as imports. An SEZ unit could opt out (de-bonding) of the SEZ scheme with the approval of the DC and on payment of the applicable customs/excise duties on the imported and indigenous capital goods, raw materials etc. and finished goods in stock.

There were 154 SEZs in private and joint sectors which had been notified after the SEZ Act came into force, in addition to the 19 SEZs that had existed prior to the enactment of the Act.

Duty foregone by the Government on the SEZ scheme during the period 2000-01 to 2005-06 was Rs. 8,842 crore. The budget estimates of the duty foregone for the year 2006-07 was Rs. 2,146 crore.

6.3 Audit objectives

The review was conducted with the limited objective of verifying that the units in the SEZs had complied with the applicable Customs Act, Rules, notification etc. and had functioned appropriately under the provisions of the Exim Policy and the procedures prescribed as per the 'Handbook of Procedures (HBP) Volume-1'. The adequacy and effectiveness of the internal controls to ensure compliance with the applicable Act/Rules/procedures were also examined.

6.4 Scope of audit

Two thousand and sixty one units were approved during 2000-01 to 2005-06 in nine SEZs, under the jurisdiction of seven (Mumbai, Gandhidham, Chennai, Cochin, Vishakhapatnam, Noida and Kolkata) out of eight DCs. Of these, 1,019 units were functional, 120 units had de-bonded and 922 were either closed or were non-functional as on 31 March 2006. The demands outstanding against the units that were closed and de-bonded were Rs. 57.10 crore, in these nine zones. Audit reviewed (between July 2006 and May 2007) the performance of 370 functional units and 180 units that had de-bonded or were closed.

6.5 Acknowledgement

The Indian Audit and Accounts Department acknowledges the cooperation extended by the Ministry of Finance and the Ministry of Commerce and Industry in providing the necessary information and records for audit. The draft review was forwarded to the Ministries in December 2007 and an exit

conference was conducted with the Ministry officials in December 2007. The conclusions and recommendations were agreed to be examined and referred to policy wing by the Ministries, wherever appropriate. While the written responses to the draft review from the Ministries are awaited, responses of the department, wherever received, have been incorporated appropriately.

AUDIT FINDINGS AND RECOMMENDATIONS

6.6 System issues

6.6.1 Achievement of NFE was mostly through deemed exports

One of the main objectives of the scheme was augmentation of exports. Additionally, as per paragraph 7.4 of the Exim Policy 2002-07 (as on 1 April 2003) and the FTP (2004-2009), an SEZ unit had to achieve a positive NFE. For determination of NFE, DTA sales/supplies effected (i) in terms of chapter 8 of the policy (deemed exports), (ii) to other SEZ units, 100 per cent EOUs etc. were also to be reckoned and added to the FOB value of actual physical export.

However, the policy does not prescribe any percentage of foreign exchange that should be earned by an SEZ unit through actual physical export and that which could be earned through deemed exports in DTA, to be a positive NFE compliant.

In the absence of such a specification, audit observed that 22 SEZ units had been achieving the prescribed (positive) NFE mainly though domestic sales and this defeats one of the sub-objectives of the scheme, which was to augment exports. While an overall export of Rs. 7,149.23 crore was made by these 22 units, the actual export content was only Rs. 1,999.27 crore (28 per cent) and the remaining Rs. 5,149.96 crore (72 per cent) related to DTA earnings. The range of the domestic earnings as a percentage of total export earning in these units was 59 to 100. Customs duty of Rs. 1,043.29 crore was foregone on import of goods by these units.

Recommendation

- *One of the objectives of any export promotion scheme is to augment exports and boost foreign exchange earning. The Ministry may consider restricting reckoning of deemed exports by an appropriate scale for the purpose of calculating NFE.*

6.6.2 Absence of provision to collect duty foregone on inputs used in exempt products cleared in DTA

After satisfying certain conditions an EOU, which imports inputs, raw materials duty free, could clear its final products into DTA after paying the applicable BCD and CVD as if the final products were imported. However, in cases where both the BCD and the CVD were 'nil' on certain products, the EOU would not pay any duty on clearance of the final products in DTA. A unit in the DTA producing/clearing same final product would also clear these goods at 'nil' rate of duty, but would have suffered duty on inputs used in the manufacture of these products (as cenvat credit too is not available when final

products are exempt from duty). This had put the DTA units under a comparative disadvantage. To remove this anomaly, the EOUs were required to pay back the duty foregone on inputs utilised for manufacture of such goods cleared into DTA with effect from 1 September 2004**. (**Paragraph 6.8 (j) of the FTP 2004-09).

However, such protection to units in DTA was not provided under the SEZ policy/Act. SEZ units can sell its goods, including by-products, and services in DTA on payment of applicable duty including at 'nil' rate with no requirement to pay back the duty foregone on inputs used in the clearance of products (at nil rate of duty) into the DTA.

Audit scrutiny of records of Nokia India Pvt. Ltd., a unit in Madras SEZ, revealed that the unit cleared mobile phones with a value of Rs. 4,855.69 crore in 2005-06 and 2006-07 in DTA at 'nil' rate of duty. Duty of Rs. 681.38 crore (Rs. 86.76 crore in 2005-06 and Rs. 594.62 crore in 2006-07) foregone on the inputs used in the manufacture of these mobile phones could not be recovered in the absence of enabling provisions. Additionally, this policy had put SEZ units at a distinctly advantageous position compared with similar units in the DTA or even other EOUs.

Recommendation

- *The Government may consider introducing a provision to collect the duty foregone on inputs used by SEZ units in manufacturing final products cleared at 'nil' rate into the DTA to provide a level playing field for the indigenous industry.*

6.6.3 Absence of mechanism to verify data in QPR/APR [12]

As per the Exim Policy/Foreign Trade Policy, every unit in a SEZ has to maintain proper accounts, and submit QPR/APR in prescribed format to the DC duly certified by a chartered accountant (CA). This data is important being the basis for verifying whether the units have indeed achieved the required positive NFE and also as a monitoring mechanism to ensure that the units are functioning as intended under the applicable policy and rules.

However, the SEZ scheme relies mainly on self-certification and does not require the QPRs/APRs to be supported by other statutory documents like annual accounts, customs records, income tax (IT) returns, bank realisation certificates (BRC) etc. This facilitated a few units to provide incorrect/inconsistent data in their QPRs/APRs. The NFEs derived on the basis of this inconsistent data cannot be relied upon.

Audit correlated data furnished by the units in their annual performance reports with data available in the annual accounts, customs records, IT returns, BRC, etc. and observed that 16 units had under reported the CIF value of imports, (ii) 25 units had inflated the FOB value of exports, (iii) three units had both under reported imports and inflated exports, and (iv) six units of Cochin SEZ had shown less foreign exchange outflow, in their APRs.

[12] QPR/APR: Quarterly Performance Report/Annual Performance Report

A few illustrative cases are discussed in the succeeding paragraphs:-

(i) M/s Crysind Electronics Pvt. Ltd., a unit in Cochin SEZ, was authorised to manufacture and export electronic devices. The unit showed in its APRs export of Rs. 81.01 crore and import of Rs. 79.13 crore during 2001-02 to 2005-06. However, audit scrutiny of its annual accounts revealed that the unit had exported goods worth Rs. 55.62 crore and imported goods for Rs. 77.25 crore during the above period. Accordingly, the unit had actually not achieved positive NFE (short by Rs. 21.73 crore) for which proportional duty foregone was recoverable in addition to initiation of penal actions under the FT (D&R) Act, 1992.

(ii) M/s Electronic Controls and Discharge System Pvt. Ltd., a unit in Cochin SEZ, was granted LOP for manufacture and export of electronic controls and ignitors. The unit was supplied raw material by M/s Venture Lighting Europe Ltd. with the condition that finished products would be returned to the supplier or to the consignee, as directed in the consignment order. The unit was only paid processing fee for this job work carried out by it and the same was shown as income in the balance sheet and IT return. The BRC was also for the value shown as processing charges. During the period from 2001-02 to 2005-06, the unit had shown exports of Rs. 105.94 crore in the APR (being the value of both the goods supplied to it plus the processing charges paid for the job work done), whereas the actual export was of the services (job work) of value Rs. 50.39 crore (i.e. amount received towards processing charges).

(iii) M/s Gemini International Pvt. Ltd. and two other SEZ units in Vishakhapatnam SEZ, submitted APRs duly certified by the CA to the effect that there were no arrears in foreign exchange realisation. However, the annual accounts certified by the same CA indicated that sale proceeds of Rs. 37.82 crore was pending realisation for periods ranging between one and four years.

Recommendation

- *The Ministry may consider prescribing additional documents like annual accounts, IT returns, BRC etc. to be enclosed with the APRs and require these to be verified to determine if the SEZ units had actually achieved the prescribed positive NFE and, in case of default, take appropriate action as prescribed including recovering duty.*

6.7 Compliance issues

6.7.1 Non-achievement of positive NFE

As per paragraph 7.12.1 of the HBP Volume-1, 2004-09, an SEZ unit was required to achieve positive NFE, which is calculated cumulatively for a period of five years from the commencement of production as per the formula "NFE = A-B". Where, 'A' is the FOB value of exports by the SEZ unit and 'B' is the sum total of the CIF value of all imported inputs, value of all payments made in foreign exchange by way of commission, royalty etc.

Scrutiny of records of 24 units of Falta, Cochin, Madras, Kandla and Vishakhapatnam SEZs revealed that these units failed to achieve the required positive NFE. Accordingly, a duty of Rs. 106.71 crore (determined in proportion of the shortfall in achieving positive NFE) with interest of Rs. 46.17 crore was recoverable from these units.

A few illustrative cases are discussed in the following paragraphs:-

(i) M/s Plastolene Polymers Pvt. Ltd., a unit in Falta SEZ, was granted an LOP for manufacture and export of plastic granules/sweeping granules/bags for a period of five years. The unit started its commercial production on 1 March 2000 and completed five years of operation on 28 February 2005.

Audit scrutiny revealed that during this period, the unit imported raw material, mainly plastic scrap, worth Rs. 79.93 crore and earned foreign exchange of only Rs. 6.69 crore by selling the manufactured goods in DTA. The DC permitted (May 2004) broad-banding of dissimilar items such as readymade garment, jewellery etc. which was, however, rejected (June 2004) by the Department of Commerce. Though the broad-banding was cancelled, export turnover of these broad banded items was included in calculating the NFE achieved. If the export value of the broad banded items were not taken into account then the unit's NFE achievement was negative by Rs. 73.24 crore. Proportionate duty of Rs. 37.75 crore alongwith interest of Rs. 20.74 crore was, therefore, recoverable for the failure to achieve positive NFE.

(ii) As per paragraph 9.40 of the HBP, Volume-1 (1997-2002), 20 per cent of the value of capital goods imported was to be amortised every year for the purpose of calculation of NFE. With effect from 1 April 2003, capital goods were to be amortised at ten per cent.

M/s M.B. Innotech (India) Ltd., a unit of Falta SEZ (FSEZ) (converted from an EPZ unit), was granted a LOP dated 20 October 1997 for the manufacture of polystyrene cups, containers and packaging materials. The unit started its commercial production on 15 October 1999 and completed five years of operations on 14 October 2004.

Audit scrutiny revealed that during these five years, the unit effected exports and imports of Rs. 9.98 crore and Rs. 31.49 crore respectively, out of which import of capital goods alone was to the extent of Rs. 24.83 crore. After considering the amortisation of capital goods, the NFE worked out to minus Rs. 20.97 crore. Accordingly, proportionate duty of Rs. 11.16 crore alongwith interest of Rs. 10.84 crore was recoverable from the unit. Further, audit observed that the DC had not reviewed the performance of this unit during the five-year period and the unit also did not submit any performance reports substantiating the foreign exchange earning.

On the matter being pointed out, a show cause notice was issued (29 May 2006) to the unit by the DC, FSEZ which was followed (5 October 2006) by a demand notice, by the customs department. Further progress in the case has not been received (November 2007).

6.7.2 Units functioned in SEZ in violation of the conditions of LOP

In terms of the Exim Policy/FTP, the LOP issued to an SEZ unit is valid for five years from the date of commencement of production and is treated as a licence for all purposes. On completion of five years' period, the LOP may be renewed by the DC for a further period of five years. Further, each LOP should have separate earmarked premises and has to specify the items of manufacture/service activity and capacity, etc. In case of any change in approved activity, the DC has to issue an amended LOP. An SEZ unit has to fulfil the terms and conditions of the LOP failing which the unit is liable for penal actions under the FT (D&R), Act, 1992.

Scrutiny of records of Falta, Madras, Vishakhapatnam, SEEPZ, Kandla and Surat SEZs revealed that 41 units had violated the conditions of the approved LOPs while carrying out their business. These included (i) carrying out trading activity though the LOP was for manufacture, (ii) manufacturing in a premises not mentioned in the LOP, (iii) excess trading than what was permitted in the LOP, (iv) operating without a valid LOP, (v) clearing all goods in DTA despite the facts that these were required to be exported to the general currency area (GCA) countries etc. Penal action should have been initiated by the DC under the FT (D&R) Act, 1992. Additionally, customs duty of Rs. 74.90 crore was also recoverable from these units.

A few illustrative cases are discussed in the succeeding paragraphs:-

(i) M/s Diastar Jewellery Pvt. Ltd., a unit of SEEPZ SEZ, was issued an LOP for manufacture of plain & studded jewellery at plot no. 58, SEEPZ SEZ.

Audit scrutiny revealed that the operations of the unit were carried out from two different premises (plot no. 5 and 58) located in the SEZ. Imports and exports were carried out under a single LOP and the units were also not filing separate APRs. Carrying out manufacturing activity in a premises, other than that permitted in the LOP was not in order. Accordingly, the duty forgone of Rs. 18.84 crore on the imports is recoverable.

(ii) M/s Patni Computers Systems Ltd., a unit of SEEPZ SEZ, converted from EPZ unit, was issued a LOP for development of computer software. The LOP expired in March 2003 after periodical renewals. The unit had not applied for renewal thereafter and was functioning within the SEZ without a valid LOP. The unit had imported capital goods of Rs. 9.41 crore during 2003-04 to 2005-06, on which duty of Rs. 3.34 crore was foregone, which needs to be recovered, as the unit had no valid LOP for these imports.

6.7.3 Short levy of duty on DTA sales

In terms of the paragraph 7.8 (a) of the Exim Policy (2002-07), an SEZ unit can sell goods including by-products, in DTA, in accordance with the import policy in force, on payment of applicable duty. Assessable value for such DTA sale is determined under section 14 of the Customs Act.

Audit scrutiny of the records of 21 units of Falta, Cochin, SEEPZ, Manikanchan and Madras SEZs revealed short levy of duty of Rs. 8.03 crore due to undervaluation of goods sold in the DTA.

A few illustrative cases are discussed in the following paragraphs:-

(i) M/s Alps Exports Pvt Ltd., a unit in Falta SEZ, had imported 90,840 square metre of polyester fabric, classifiable under customs tariff heading (CTH) 5407.61, for an assessable value of Rs. 21.22 lakh and cleared the goods 'as such' in DTA in October 2003 on payment of duty of Rs. 17.47 lakh.

Audit scrutiny revealed that the basic customs duty applicable to the goods under CTH 5407.61 was 25 per cent advalorem or Rs. 150 per square metre, whichever was higher. However, the customs department while calculating the duty applied incorrectly the advalorem rate, instead of Rs. 150 per square metre resulting in a short levy of duty of Rs. 1.18 crore.

(ii) M/s Deodhar Electro Design Pvt. Ltd., a unit of SEEPZ SEZ, was allowed to sell goods of assessable value of Rs. 2.54 crore in the DTA.

Audit scrutiny revealed that the assessable value of the goods did not include cost of freight, insurance and landing charges, which were to be included in the assessable value in terms of the applicable provisions of the Act. This resulted in undervaluation of goods by Rs. 56.27 lakh and consequent short levy of duty of Rs. 23.27 lakh.

6.7.4 Lease rent not recovered

In terms of the paragraph 7.20.1 of the HBP, Volume-1, 2004-09, a unit set up in a SEZ established by the Government is required to make payment of lease rent as per specified rates.

Scrutiny of records of 109 units in Cochin, Noida, Kandla and Vishakhapatnam SEZs revealed that recovery of lease rent totalling Rs. 5.49 crore was outstanding for periods upto five years. This amount alongwith interest is recoverable from these units.

6.7.5 Irregular/excess payment of drawback/interest

Supply from the DTA to an SEZ unit is treated as a 'deemed export' and for such deemed export, the DTA supplier is entitled to the drawback or the DEPB credit. However, on the submission of a disclaimer from the DTA supplier, the SEZ unit can avail this drawback.

Audit scrutiny of records of 11 units in Falta, Cochin and Madras SEZs revealed irregularities like (i) drawback being paid to SEZ units without the disclaimer certificates of the DTA units, (ii) drawback being paid on goods procured from DTA for manufacture of products, which were not covered under the LOP issued and (iii) payment of interest on drawback at higher rates. Total drawback amount including interest involved in these cases was Rs. 2.26 crore.

An illustrative case is discussed in the succeeding paragraph:-

As per the section 75A of the Customs Act, 1962, if the drawback is not paid by the department within one month from the date of filing of the claim, then interest is payable at the prescribed rates.

M/s Jupiter Impex and R.S. Enterprise, two DTA units had supplied goods to SEZ units in Falta SEZ and had claimed (August 2001 to September 2003) drawback. However, there was inordinate delay in finalising the claims and the drawback payments were effected between July 2003 to March 2004. The DTA units were, accordingly, paid total interest of Rs. 4.28 crore. While the delay in processing the claims by the department resulted in payment of interest of Rs. 4.28 crore, audit observed that this interest liability itself was determined at incorrect rates resulting in excess sanction of interest by Rs. 42.19 lakh. The excess interest paid is recoverable.

6.7.6 Goods removed for inter-unit transfer/job work not accounted for

In terms of the paragraphs 12 (iv) and 21 (iii) of the SEZ (Customs Procedures) Regulations, 2003, when goods are transferred from one SEZ unit to another SEZ unit or 100 per cent EOU, the supplying unit has to submit the re-warehousing certificate to the proper officer within 45 days from the date of clearance, failing which the proper officer should initiate action for recovery of duty from the receiving unit through the jurisdictional officer of the receiving unit.

Further, when goods are sent for job work, such goods are required to be returned to the unit within a period of 90 days from date of removal. Any failure on the part of the unit to get back the goods within the prescribed time attracts recovery of the applicable customs duty.

Audit scrutiny of the records of 14 units in Falta and Vishakhapatnam SEZs revealed that the re-warehousing certificates for 99 consignments of goods of a total value of Rs. 3.76 crore, which were cleared (during May 2004 to March 2006) for transfer to other SEZ units (outside the zone) and 100 per cent EOUs, were not received. In the absence of any evidence that these goods were used for the intended purpose, the applicable customs duty of Rs. 1.38 crore was recoverable from these units.

Additionally, six units in Falta SEZ, Vishakhapatnam SEZ and Noida SEZ, had sent goods of total assessable value of Rs. 31 lakh for job work during 2002-03 to 2005-06. However, these goods were not brought back in the units within the prescribed time. Therefore, Rs. 9.96 lakh was recoverable as duty from these six units.

6.7.7 Short levy of duty from de-bonded units

In terms of the paragraph 7.13 (a) of the Exim Policy 2002-07 (as on 1 April 2003), an SEZ unit can opt out of the scheme with the approval of the DC. Such exit from the scheme is subject to the payment of applicable customs and central excise duties on the imported and indigenous capital goods, raw material and finished goods lying in stock.

Audit scrutiny of records of two de-bonded units in Cochin and Vishakhapatnam SEZs revealed short levy of duty of Rs. 84.87 lakh and interest of Rs. 11.36 lakh upon these units exiting the SEZ scheme.

An illustrative case is discussed in the following paragraph:-

M/s C.D. Services India Pvt. Ltd., an SEZ unit in Cochin SEZ, was granted (August 2003) a LOP for trading in cigarettes, watches etc. The unit was allowed de-bonding in June 2005, after achieving positive NFE.

Audit scrutiny revealed that the unit had imported 66,472 cases of cigarettes and 87,481 pieces of watches during its operational period. The unit had exported 66,108 cases of cigarettes and 85,177 pieces of watches, including the deemed exports. Hence, there was a balance of 364 cases of cigarettes and 2,304 pieces of watches lying with the unit, for which customs duty of Rs. 79.63 lakh and interest of Rs. 11.36 lakh was recoverable from the unit.

6.7.8 Non-levy of service tax on services rendered in the DTA

In terms of the paragraph 7.8 of the Exim Policy (2002-07), an SEZ unit can render services in DTA on payment of the applicable duty. As per the Finance Act, 1994, amended from time to time, service tax is levied on the value of taxable services rendered.

Audit scrutiny of the records of six units in Madras and Cochin SEZs revealed that service tax of Rs. 72.47 lakh was not paid on services valuing Rs. 7.22 crore rendered (during 2003-04 to 2005-06) in the DTA. The concerned services related to manpower services, technical testing and analysis services etc., which were taxable.

6.7.9 Unit approval committees were not constituted

In terms of the paragraph 7.14.1 of the HBP, Volume-1 (2004-09), the performance of SEZ units was to be monitored by the unit approval committee as per the guidelines given in the appendix-14-IG of the HBP. The committee was to be chaired by the DC and should have other members including those from the revenue department (central excise/customs). The performance of the SEZ units was to be monitored quarterly on the basis of reports received from the units on the prescribed formats. Based on the review, the DC was to prepare a report for the information of the Department of Commerce and CBEC and suggest corrective measures to enable the defaulting units to fulfil their obligations as per the SEZ Scheme/customs notifications. Further, circular no. 33/2004-cus dated 12 May 2004 stipulates that the monitoring of SEZ units is also to be done by the jurisdictional customs authority through participation in such a committee.

Scrutiny of the records of the DCs at Noida, SEEPZ, Surat and Vishakhapatnam SEZs revealed that no such committee had been constituted in these zones.

Recommendation

- *An effective and functioning unit approval committee is a key control, which could ensure that the units in SEZ operate as per the established law and achieve the intended goals. The committee is also required to suggest corrective action so that the units achieve the goals. The Government should expeditiously constitute the unit approval committees*

in all zones which would also mitigate the risk of lapses similar to the ones pointed out through this report.

6.8 Conclusions

The review has revealed system as well as compliance weaknesses relating to policy and procedures governing the management and functioning of SEZ units in ensuring that these functioned as intended. While the revenue implication of this audit review is Rs. 246.72 crore, an additional Rs. 1724.67 crore was foregone or could not be recovered in the absence of enabling provisions.

There was no restriction on 'deemed exports' being reckoned as exports enabling the units to attain positive net foreign exchange earning (NFE) predominantly through deemed exports rather than actual exports. As a result, 22 SEZ units had achieved the required positive NFE, notwithstanding the fact that the actual export earnings were only 28 per cent and the remaining 72 per cent came from domestic sales.

The units under domestic tariff area (DTA) were put under disadvantageous position as no provision had been made to recover duty foregone on inputs procured by the SEZ units and used in the manufacture of products which were cleared at 'nil' rate of duty in DTA.

The SEZ scheme relies mainly on self-certification and does not require the QPRs/APRs to be supported by other statutory documents like annual accounts, customs records, income tax (IT) returns, bank realisation certificates (BRC) etc. This facilitated a few units to provide incorrect/inconsistent data in their APRs/QPRs. The NFEs derived on the basis of this inconsistent data cannot be relied upon.

Few other issues noticed in audit related to (i) non-achievement of positive NFE, (ii) violation of the conditions of LOP, (iii) short levy of duty on DTA sales, (iv) non-recovery of applicable lease rent, (v) excess payment of drawback/interest, (vi) goods removed for inter-unit transfer/job work not accounted for, (vii) short levy of duty from de-bonded units, and (viii) non-levy of service tax on services rendered in the DTA and (ix) non-constitution of the 'unit approval committee' in four zones.

6.9 Summary of recommendations

- *One of the objectives of any export promotion scheme is to augment exports and boost foreign exchange earning. The Ministry may consider restricting reckoning of deemed exports by an appropriate scale for the purpose of calculating NFE.*
- *The Government may consider introducing a provision to collect the duty foregone on inputs used by SEZ units in manufacturing final products cleared at 'nil' rate into the DTA to provide a level playing field for the indigenous industry.*
- *The Ministry may consider prescribing additional documents like annual accounts, IT returns, BRC etc. to be enclosed with the APRs and require*

these to be verified to determine if the SEZ units had actually achieved the prescribed positive NFE and, in case of default, take appropriate action as prescribed including recovering duty.

- *An effective and functioning unit approval committee is a key control, which could ensure that the units in SEZ operate as per the established law and achieve the intended goals. The committee is also required to suggest corrective action so that the units achieve the goals. The Government should expeditiously constitute the unit approval committees in all zones which would also mitigate the risk of lapses similar to the ones pointed out through this report.*

New Delhi **(JAYANTI PRASAD)**
Dated : **Principal Director (Indirect Taxes)**

Countersigned

New Delhi **(VIJAYENDRA N. KAUL)**
Dated : **Comptroller and Auditor General of India**