CHAPTER IV: MINISTRY OF COMMERCE AND INDUSTRY

STCL Limited

4.1 Iron Ore Business Segment

Introduction

Spices Trading Corporation Limited, a wholly owned subsidiary of State Trading Corporation of India Limited, whose core business was trading in whole range of spices, amended (July 2004) the objects clause in its Memorandum of Association to include trading in iron ore and other metal scrap including third country exports and the erstwhile Spices Trading Corporation Limited was renamed as STCL Limited. Turnover of iron ore trade of STCL Limited (Company) ranged from ₹ 2.62 crore (0.61 *per cent)* of the turnover of the Company in 2004-05 to ₹ 22.55 crore (20.96 *per cent)* in 2009-10.

Trading in iron ore is carried out by the Company by procuring iron ore from different sources through Business Associates (BA) and bringing the ore to the nominated port plots under the custody of the Company. The Company nominates an inspection agency for analysis of the ore as per the requirement of the contract. Cost and freight (C&F) agent holds stock on behalf of the Company. The Company by availing of packing credit loan from its bankers, funds the procurement of ore as per the investment pattern agreed with BAs. Payment is made through internet Real Time Gross Settlement (RTGS) transfer against the stock at the mine head or FOR basis and thereafter progressively through FOB expenses as and when incurred.

Scope of Audit

Activities involved in the trade of iron ore carried out by the Company during the period 2007-08 to 2009-10 covering 47 shipments involving sales turnover of ₹ 367.29 crore and transactions relating to four BAs *viz.* Future Resources India Private Limited (FRIPL), SS Exports, Trimurthi Exports and Devi Minerals Resources Private Limited (DMRPL) were covered in this thematic audit with special emphasis on BAs in respect of whom stocks of iron ore were not disposed off and the Company was yet to recover its dues.

Year-wise turnover of the Company *vis-à-vis* turnover from iron ore trading for the last three years ended 2009-10 was as follows:

Year	Total Turnover (₹ in crore)	Turnover in iron ore trade (₹ in crore)	Percentage of iron ore trade to total turnover	No of shipments
2007-08	2,440.91	265.41	10.87	33
2008-09	2,170.43	80.11	3.69	11
2009-10	107.46	22.55	20.96	3

The decline in turnover in iron ore trading was due to fall in iron ore price from 2008-09.

Audit Objectives

The objectives of audit were to examine whether:

- BAs were selected in a transparent manner based on adequate risk analysis;
- Agreements entered into with the BAs safeguarded the financial interests of the Company and the trading assets retained by the Company; and
- Trading transactions were supported by adequate internal control procedures.

Audit criteria

The criteria adopted for judging the trading activity were as follows:

- Policies and Guidelines issued by the Board of Directors and the Management of the Company;
- Procedure for selection of BAs and agreements with them; and
- Industry best practice for trading in back to back contracts.

Audit Methodology

Audit methodology involved examination of agreements with the BAs, documents relating to shipments effected through BAs and discussions with the Management in reviewing the documents relating to trading in iron ore segment.

Audit findings

A review of the trading activity in iron ore revealed the following:

4.1.1 Feasibility study of the new business

In the Revised Market Plan for 2004-05, approved (July 2004) by the Board of Directors (BOD), the Company proposed to undertake export of iron ore considering the then market trend and potential of sourcing in Karnataka State in view of the geographical advantages as per the modalities framed. The BOD directed the Management to seek guidance from the Holding Company before diversifying into new product line. Despite the directives of the Board, the Company neither sought guidance from the Holding Company before diversifying into new product line nor conducted any market survey/SWOT[♦] analysis/ risk analysis.

The Management admitted (December 2010) that neither any guidance of the holding Company was sought nor risk analysis conducted before venturing into new business.

4.1.2 Selection of Business Associates

The Company had not floated tenders calling for Expression of Interest (EOI) from the prospective Business Associates (BAs).

The Management while admitting (December 2010) that the Company never followed the practice of floating tenders for EOI from the prospective BAs, stated that the Company continued iron ore trade with the existing BAs considering their past performance, credibility *etc.*, who were responsible for identifying the overseas buyers and suppliers of

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[♦] ***Strength, Weakness, Opportunities and Threat***

iron ore as per the terms of back-to-back contract since the entire transactions were carried out at their risk and cost.

Audit observed that 44 of the 47 shipments traded during the period were carried out by three BAs. Of the three, two BAs (Devi Minerals Resources (P) Limited and S. S. Exports) were dealing in trading of agricultural commodities and the third BA (Trimurthi Exports) was a new Company for whom financial credentials, risk analysis and relevant past experience in iron ore trading was not on record. As iron ore trade was a new line of business, not calling for open tenders deprived the Company of choice of BAs. The system of selection of BAs was neither competitive nor transparent. The Company should have ensured relevant past experience of even the existing BAs to justify their capability to handle the iron ore trading.

4.1.3 Modalities of trading arrangement

4.1.3.1 The Company had not framed any guidelines for conducting iron ore trading. The annual Business Plan approved by the Board in 2004-05 included two options, viz. (i) the Company would identify the prospective sellers/ mine owners for sourcing of iron ore in India as well as overseas and (ii) the Company would enter into overseas contract through nominated BA who will be the sole performer for sourcing as well as fulfilling the export obligations as per contract and terms of letter of credit (LC). Though the Company could have better control over the business by selecting competent BAs, it carried out the transactions through BAs who were neither the mine owners nor the ultimate buyers of the ore.

The Management admitted (December 2010) that as per Business Plan, the Company proposed to identify the source of supply (Sellers/Mine owners). Subsequently, considering the business practice in iron ore trade, responsibility for identifying the source of supply under the back-to-back contract was assigned to the BAs since the transactions were carried out at their risk and cost.

However, the fact remained that the change in the trading arrangement was not brought to the notice of the Board for its approval**.**

4.1.3.2 The modalities for trading in iron ore stipulated (2004) that the suppliers should submit performance bond at 2 *per cent* of FOR/FOB value. This clause was deleted from the subsequent market plans exposing the Company's investments to market risks as no additional security other than the stock brought in by the BAs existed. The reason for this change was not placed on record.

The Management stated (December 2010) that the clause was amended to be in line with the market practice prevalent in iron ore trade, since the sourcing of material had been entrusted to the BAs at their risk and cost on back-to-back contract terms.

Reply of the Management was not tenable as by deleting the clause the Company exposed itself to market risk as it held no other security other than stock.

4.1.3.3 The Delegation of Power (DOP) approved (January 2006) by BOD provided for non-fund based back-to-back contracts. The Managing Committee comprising the Managing Director (MD) could enter into contracts up to ₹ 20 crore only beyond which the proposals were to be approved either by one Director or the Chairman/BOD. DOP was silent about the maximum extent to which the MD could commit the Company by entering into such contracts within his delegated powers.

Audit observed that in three cases, payments for ₹ 9.30 crore were released with the approval of the Finance Manager who was not competent to authorise the payments.

4.1.4 Deviation from the approved investment pattern in the business

As per the Market Plan and also the agreements, the Company's investment pattern was approved at 80-90 *per cent* of FOR cost and progressively for other expenses. The investment pattern of 80 *per cent* by STCL and 20 *per cent* by the BAs was revised by the BOD (May 2007) in the Marketing Plan for 2007-08, to either 80 *per cent* by STCL and 20 *per cent* by the BAs or 90 *per cent* by STCL and 10 *per cent* by the BAs.

Audit observed that on many occasions the Company had advanced funds in excess of sale proceeds resulting in excess funding. Further, non-reconciliation of advances released resulted in retention of surplus advance by the BAs. Failure of internal controls to keep a track of payments resulted in excess payment of ₹ 11 crore to BAs in respect of five cases wherein funding was made in excess of 80 *per cent.*

Management admitted (December 2010) that the Company advanced only to the extent of 80 *per cent* against each proposal against which BA brought in quantities less than proposed and made shipments to that extent and that the realisation had been adjusted by STCL towards the advances. As a result, the advances recoverable were more than the stocks available against the investments made by STCL. Management further stated (December 2010) that though justifications were not recorded in the file, the investment ratio was changed to suit the market conditions prevalent at that point of time depending upon the merit of the case.

Reply of Management was not tenable as change in investment pattern from 80 to 90 *per cent* involved outflow of Company's funds and, justification should have been kept on record taking approval of competent authority considering fluctuations in the iron ore prices and additional exposure involved.

4.1.4.1 The Company extended undue benefit to M/s. Trimurthi Exports by giving a running advance of ₹ 24 crore (in 17 shipments) which resulted in 100 *per cent* financing of their activities through the funds of the Company.

The Management stated (December 2010) that agreement with Trimurthi Exports was based on running advance of ₹ 12 crore which was increased to ₹ 24 crore based on the pledge of 1.5 lakh Metric Tonne (MT) of iron ore cargo at Litho Ferro Mines valued at ₹ 1,200 *per* Dry Metric Tonne (DMT).

Reply was not acceptable as providing running advance to BA was in deviation of the Marketing Plan approved by the BOD and acceptance of iron ore pledged valuing only ₹ 18 crore as against the running advance of ₹ 24 crore was not financially prudent.

4.1.4.2 The Company despite being aware of the inability of a BA (FRIPL) in fulfilling the export obligation (May 2008) and resultant accumulation of stock of ore at the Krishnapatnam port, entered into an agreement (July 2008) with another BA *viz.* S.S. Exports and the overseas buyer *viz.* Elgenburg Limited (August 2008) for facilitating export of 40,000 MTs of iron ore. Based on the request of the BA and without ensuring the deployment of BA's share of contribution, the Company released advance of ₹ 6.68 crore between July 2008 and September 2008 for procurement of iron ore accepting bank guarantee in lieu of the BA's contribution to the extent of 20 *per cent* and, thus, extended finance for 100 *per cent* value of the material. The shipment was to be completed within

45 days. However, the BA did not execute the shipment till December 2008. The Company asked (December 2008) the BA to either complete the shipment or settle the amount outstanding (including interest) and informed that the existing bank guarantee of ₹ 8 crore available with the Company would be invoked, if the issue was not resolved. Audit observed that the Company waited for 14 months before requesting (March 2010) the Bank to invoke the BG. S.S Exports obtained (April 2010) a court injunction order restraining STCL from invoking the BG.

The Management while admitting the observation stated (December 2010) that as per the records available, the BA was given extensions for performance up to March 2010 i.e. to the validity of the BG. The BG was invoked during March 2010 without giving any further extensions against which the BA took an injunction**.** When STCL tried to vacate the injunction through High Court, the BA requested for arbitration proceedings as per the arbitration clause of the contract, which was under progress.

The Company could have avoided fresh exposure to the extent of ₹ 6.68 crore made with SS Exports as it could have utilised the existing unsold stocks lying at Krishnapatnam port brought by M/s FRIPL.

4.1.5 Failure to enter into Tripartite Agreement

4.1.5.1 As per the modalities of trade, the Company was to enter into agreement for sale with the overseas buyer on a back-to-back agreement with the BA for procurement of the required quantity of ore simultaneously. However, while in respect of one contract with FRIPL (for which no agreement was signed with BA also) for export of ore at Krishnapatnam port, the advances against procurement of ore was not backed by any back-to-back sale contract, in another two contracts with SS Exports (May 07 and July 08) the agreement with the overseas buyer was executed subsequently in July 2007 and August 2008 respectively and not at the time of entering into the said contracts.

Management while admitting (December 2010) the observation on SS Exports stated that the proposal during August 2007 for contract with overseas buyer was on record. As regards ore brought by FRIPL it was treated as stock advance pending finalisation of overseas contract.

However, the fact remained that no back-to-back contract was available at the time of entering into agreement with BA in respect of the above contracts.

4.1.5.2 The Company invested (April 2008) ₹ 12.45 crore being 80 *per cent* of the value of 40,360 MTs of iron ore stocked at Vishakapatnam port and proposed to be exported by the BA (FRIPL). However, due to litigations with the group company *viz*., Future Metals Private Limited, (FMPL), FRIPL did not fulfill the contractual obligations inspite of repeated notices for shipment. The stock remained unsold and the Company's efforts to sell the same were not fruitful as the BA initiated legal proceedings and the matter was pending for adjudication.

Further, the Company without entering into any contract either with the BA (FRIPL) or identifying the overseas buyer, also invested ₹ 16.80 crore being 90 *per cent* of the value of 52,000 MTs of iron ore procured at Krishnapatnam port which was proposed to be exported by the BA. The BA failed to identify the overseas buyer resulting in accumulation of the stock at the port. The Company sold (December 2009) the iron ore stock lying at Krishnapatnam port through tenders to Shiva Shankar Minerals Limited,

Hyderabad for ₹ 13.37 crore resulting in non-realisation of ₹ 4.26 crore (inclusive of ECGC premium charges recoverable from the BA) on the sale of the ore.

The Management admitted (December 2010) that 52,000 MTs of iron ore brought by FRIPL to Krishnapatnam port was treated as stock advance pending finalisation of the overseas contract. In view of the litigations with the group company, Future Metals Private Limited (FMPL)[♣], the contracts could not be fulfilled. The unrealised balance money of ₹ 4.26 crore in respect of stocks sold at Krishnapatnam Port was recoverable from FRIPL as of December 2010. As regards, 40,360 MTs of iron ore stocks held at Vishakapatnam port, FRIPL had initiated legal proceedings and the matter was pending (December 2010) for adjudication.

4.1.6 System of Procurement - Determination of purchase price

Purchase price paid to the BA was computed keeping the agreed sale price as the base and deducting therefrom the Company's profit margin, handling charges, transportation charges, interest and other expenses.

Audit observed that the purchase price did not reflect the prevailing market price leading to absence of correlation of the actual price of ore procured with the amount advanced to the BA. Further, no safeguard clauses were incorporated in the agreements to protect the Company's interest on account of fluctuations in the price of ore.

The Management stated (December 2010) that the Company had realised the sale price and the same was considered for arriving at the purchase price at the time of giving advance except in a few cases wherein the sale had taken place after considerable time gap due to delay in convergence of stocks, which resulted in differential sale price realised by Company. However, the Company had realised its investment, interest on investment and margin in all the cases.

Reply was not relevant as the Company was not aware of the prices of iron ore from where it was sourced, and the procurement price derived was not representative of the prevailing market price.

4.1.7 Profit margin

4.1.7.1 The profit margin of STCL which was originally fixed in 2004-05 at 1.5 *per cent* of free on board (FOB) / C&F at the named port of destination (CFR) value stood revised to US$ 0.75 *per* DMT to US$ 1.50 *per* DMT or at the rate of 1.5 *per cent* to 2.5 *per cent* of the FOB/C&F value in Business Plan 2007-08 and to US$ 1 to US$ 2 *per* DMT during 2008-09. Audit observed that, no record of discussions as to the basis / adequacy of the margin charged by the Company was available. The margin of profit foregone in respect of 16 shipments where the Company had changed its margin at US$ 1/1.5 instead of 1.5 *per cent* of the contract, was ₹ 0.43 crore whereas in respect of 20 shipments the margin of profit increased by ₹ 2.15 crore.

The Management stated (December 2010) that though initially it was envisaged that the margin of profit would be collected at 1.50 *per cent* on FOB value as followed in other commodities, it was changed to USD 1 to 2 *per* DMT as per prevailing market practice

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[♣] ***Failure to devise internal controls in entering into and executing contracts with the same and another Business Associate leading to a loss of ₹ 1167.48 crore was reported vide in CAG para 4.3.1 of Audit Report No. 9 of 2009-10 (Commercial)***

and as followed by other PSUs related to iron ore trade and that the above practice had not resulted in any loss to the Company.

Reply was not acceptable as the factors considered for profit margin were not on record. In order to maximise the trading profit/margin the Company should have considered the nature of the product, market practice, competition, expected turnover and risk involved.

4.1.8 Lack of inventory control

4.1.8.1 The Company did not maintain any stock register to monitor the receipt/issue of ore from its storage points despite the fact that the stock of ore was being received and stored at the ports on behalf of the Company. The Company did not also have the system to physically verify the stocks at the ports before releasing payments. In the absence of the same, it relied solely on the certification of ore as indicated by the BAs / C&F agents. On being pointed out by Audit, the Company during 2009-10 reversed stocks valued at ₹ 95.79 crore certified as available as on 31 March 2009 as 'purchase returns' as these stocks were not available at the designated ports.

The Management stated (December 2010) that the stock details were obtained from the BAs or C&F agents since Company was giving advance to the BAs for investing in iron ore stocks. The Company booked the stocks of iron ore as inventory in the books only during 2008-09 and found that in some cases the BAs had not invested for the stocks or stocks invested had been already sold out without depositing the sale proceeds with the Company. The balance purchase was reversed as purchase return in the books during the year 2009-10.

Reply was not tenable as by relying on the certification done by C&F agents, the Company was unaware of the fact whether the BAs had not invested for the stocks for which advances were released or that the stocks had been sold without routing the sale proceeds through the Company. Further, the entire stock of iron ore valuing ₹ 95.79.crore including ₹ 29.50 crore provided in the accounts for the year 2008-09 was reversed as purchase returns in the books during the year 2009-10 as per the provisional accounts submitted to Audit.

4.1.8.2 Apart from the stocks reversed by the Company during 2009-10, the Statutory Auditors had conducted (April 2010) physical verification of iron ore stock and pointed out non-availability of iron ore stock of 25,214 MTs at various ports valuing ₹ 7.37 crore (based on sale price of ₹ 2,924 *per* MT realised during 2009-10).

The Management stated (December 2010) that the total closing stock has been reversed and accounted for as secured or unsecured advances recoverable from the BAs.

However, the fact remained that the Company was unaware of the unavailability of stocks valued at ₹ 95.79 crore till the same was pointed out by Audit. Further, the Company did not get its accounts for 2009-10 approved by the BOD till date (December 2010) due to which the actual quantity and value of closing stock remained unascertainable and amount remained unrealised so far (December 2010) from the BAs.

4.1.8.3 The Company did not have any records for two shipments (Doric Pride and Rishkesh) which had taken place as per the reports of the C&F agent of the Company through Devi Minerals during December 2008 and January 2009.

The Management stated (December 2010) that in respect of shipment through Doric Pride, as the Company could not make further investment towards port charges, customs duty *etc.*, BA diverted the shipment to other trader with a condition that the cargo so released would be replaced. Further, it was stated that in respect of shipment through Rishikesh, the details of movement of stock and shipment was not intimated by BA /C&F agent.

Reply was not tenable as the undertaking from BA regarding replacement of cargo for the shipment through Doric Pride was not on record.

4.1.9 Poor Financial Control

As a safeguard against breach of contractual obligations by the BAs, the agreements provided that BAs should furnish Corporate/ Personal Guarantee together with post dated cheques to the Company.

Audit observed that the reasons for accepting cheques as security without verifying the financial credentials of the BAs were not on record. As of March 2010, a sum of ₹ 36.58 crore was outstanding against Devi Mineral Resources (P) Limited, (DMRPL). Despite holding 11 cheques (including 6 blank cheques) for ₹ 33.65 crore issued by DMRL, the Company deposited only two cheques for ₹ 1.24 crore which were however, dishonored and returned (February 2010) by the banks. The bank slips giving the reasons for return of the cheques by the banks and for not presenting the other cheques by the Company were also not on record.

The Management stated (December 2010) that the cheques held as security against the investment were not presented in view of the shipment effected during May 2010 and the party had come forward for discussions to reduce its dues. As regards 2 cheques for ₹ 0.62 crore each, though initially dishonoured, subsequently one cheque of ₹ 0.62 crore was cleared. DMRL paid ₹ 0.32 crore and issued fresh cheque for the balance amount of ₹ 0.30 crore, which was also dishonoured by the Bank and returned during October 2010. Legal proceedings had been initiated for the same.

Reply was not tenable as even though the BA had come forward for discussion to reduce its dues, the Company should have deposited the cheques on due dates for realisation of the outstanding dues..

The Ministry, while forwarding (December 2010) the reply of the Management to Audit, did not offer any comments on the ground that issues related to commercial activities of the Company.

Conclusion

- The Company accepted to act as facilitator for iron ore trade with BAs without ensuring their financial credentials and without insisting on back-to-back contracts to safeguard its interests.
- Investment pattern was modified to benefit the BAs and the release of money by Company to the BA (3 cases) for procurement of ore was not linked to establishing of the tripartite agreement with the overseas buyers. The Company's action of venturing into trading in iron ore without such a contract exposed itself to the risk of non-fulfillment of the contracts.

- Consequent to fall in iron ore prices from 2008-09 and in the absence of financial and contractual safeguards, the advance of ₹ 54.37 crore paid by the Company to three BAs (FRIPL, SS Exports and Devi Minerals) became unrecoverable as on March 2010 due to the BAs failing to fulfill their export obligations.
- The Company failed to exercise basic inventory control and was unaware of the physical unavailability of stocks valued at ₹ 95.79 crore. Instead it relied entirely on the stock details furnished by the BAs and C&F agents which proved to be misleading.

Recommendations

- ***The Company should formulate guidelines in consultation with the holding company keeping in view the best industry practice before venturing into any new product line to safeguard its interests:***
- ***The Company should conduct a SWOT analysis/market survey and frame guidelines /procedures for selection of BAs in a competitive and transparent manner after calling for expression of interest through open advertisement.***
- ***The Company should carry out an analysis of financial capabilities of the BAs for risk assessment through an independent risk analyst.***
- ***Release of advances for procurement should be linked to the tripartite agreement with the overseas buyer.***
- ***The Company should establish a system of linking its financial exposure to the prevailing price of ore so as to be in a position to seek/obtain additional securities whenever required.***
- ***The Company should have a system of physical control over the receipt of stocks and sale thereof and also physically verify the stocks before releasing any payments to the BAs.***
- ***The agreements with the BAs should be in accordance with the guidelines approved by the BOD and vetted by a legal authority.***
- ***The Company should carryout the transactions with the BAs strictly in accordance with the provisions of the agreements with them and take immediate remedial measures in case of default/non-fulfillment of contract terms by the BAs.***