True Copy of the Extracts of the final report of the CAG for the year ended 31st March 2015 (Commercial) – Transaction Audit observations on Malabar Cements Ltd

Malabar Cements Limited

Failure of the Company to accept dry fly ash supplied by a contractor led to stoppage of supply, subsequent encashment of bank guarantee and consequent loss of Rs. 14.49 crore.

The Company is engaged in the manufacture and sale of ordinary portland / portland pozzolana cement (PC / PPC). Dry fly ash (pozzolanic material) is one of the major raw materials in the manufacture of PPC which can be used (15to 35 *per cent*) in lieu of costlier clinker. In order to ensure regular supply of dry fly ash, the Company entered into (November 2004) a contract with ARK Wood & Metals (P) Ltd. (ARK) Coimbatore for a period of nine years (November 2004 to November 2013). The terms of the contract provided that ARK would supply to the Company an average 600 MTs of dry fly ash daily (15000 MT per month) at Rs.130[32] per MT. The base rate of Rs.130 per MT was subject to annual increase. In addition maintenance cost, electricity charges, water charges and taxes and duties which at that time were nil were reimbursable by the Company. The fly ash was to be supplied from the silo allotted by Tamil Nadu Electricity Board (TNEB) at their Tuticorin Thermal Power Station (TTPS).

As per the provisions of the contract, ARK was to deposit Rs. 5 lakh (Demand Draft / Bank Guarantee) as security deposit against non-performance of the contract / premature termination of the contract while the Company reserved the right to premature termination of the contract on payment of compensation of ` 50 lakh to ARK, to be secured by a Bank Guarantee. Accordingly, the Company furnished (December 2004) a bank guarantee for ` 50 lakh and ARK furnished a bank guarantee for Rs. 5 lakh. The contract, however, did not contain damages clause which could safeguard its financial interest against non-supply of dry fly ash by ARK.

The relationship between the Company and the contractor became strained since August 2006, due to reduction in off take, delay in making payments and withholding of electricity charges (Rs. 11.27 lakh) payable as per the terms of contract. The Company also expressed its reservations to ARK for non-furnishing the split up details of the quantities of dry fly ash lifted by them from TTPS and the electricity required. On the other hand, due to low off take of fly ash by the Company, TNEB reduced (December 2007) the allotment by 50 *per cent*. This caused erratic supply initially and ultimately resulted in non-supply (September 2008) by ARK. However, ARK encashed (September 2008) the bank guarantee of Rs.50 lakh furnished by the Company attributing delay in release of payment, lower off take and non-payment of power charges. The Bank debited (December 2008) an amount of Rs. 52.45 lakh to the account of the Company Rs. 50 lakh towards bank guarantee plus Rs. 2.45 lakh towards interest). The Company's complaint (February 2009) before the Banking Ombudsman against the action of the Bank in admitting invocation of bank guarantee by ARK was turned down (March 2009) by the Ombudsman on finding that the action of the Bank was in order. In the absence of supply of dry fly ash by ARK, the Company was forced to source dry fly ash from other suppliers which was inadequate to meet its requirements resulting in a loss of Rs. 14.13 crore[33] (April 2007- May 2010) due to use of costlier clinker in lieu of fly ash.

We noticed that the Company, failed to accept the quantity offered by the supplier in full since September 2006 and delayed payment to the contractor, which resulted in stoppage of supply by the contractor and subsequent encashment of bank guarantee containing compensation clause favourable to the contractor, resulting in a loss of Rs. 36.18 lakh[34]. Consequent to the stoppage of supply of fly ash, the Company had to source the material from other sources, which was inadequate to meet its requirements and resulted in loss of Rs. 14.13 crore (April 2007-May 2010) due to use of costlier clinker in lieu of dry fly ash. In the absence of provisions in the agreement to recover damages for non-supply of dry fly ash, chances of recovery of loss from the contractor were also remote.

Management replied (March / June 2010) that the Company was immensely benefited by the regular supply of dry fly ash so that the Company had to agree for a disproportionate amount of bank guarantee towards performance of the contract. The reply does not hold good as the bank guarantee included disproportionate compensation clause proved disadvantageous to the Company and the cost of alternate clinker used in absence of supply of fly ash was high leading to huge loss to the Company. Further the Company could not safeguard its financial interest for non-supply of fly ash by ARK.

The matter was reported to Government (May 2010); its reply is awaited (October 2010).

---

[29] Processing fee at the rate of 0.25 *per cent* of loan amount subject to a maximum of Rs. 10000/- was collected against micro credit.
[30] Worked out for the period April 2004 to March 2009.
[31] Calculated @ 13 *per cent* for the period 2004-05 to 2008-09.
[32] Service charges (Rs. 60 per MT) + Silo operation and maintenance cost (` 25 per MT) and investment cost and other incidentals (Rs. 45 per MT).
[33] Worked out based on the difference between variable cost of clinker and landed cost of dry fly ash. Loss accepted by the company i.e Rs. .61 crore (2007-08), Rs. 4.57 crore (2008-09), at Rs. 600 per MT calculated on the total requirement – quantity received from other sources during 2009-10 and 2010-11 (upto May 2010).