State Pharmaceuticals Manufacturing Corporation of Sri Lanka - 2012

1 Financial Statements

1.1 Qualified Opinion

In my opinion, except for the effects of the matters described in paragraph 1.2 of this report, the financial statements give a true and fair view of the financial position of the State Pharmaceuticals Manufacturing Corporation of Sri Lanka as at 31 December 2012 and its financial performance and cash flows for the year then ended in accordance with the Sri Lanka Accounting Standards.

1.2 Comments on Financial Statements

1.2.1 Accounting Policies

Absorption of Overhead Cost

Absorption of 90 per cent out of overheadcostssuch as taxes and rates, electricity, water bills, insurance, maintenance of equipment, general maintenance, maintenance of buildings and depreciation as production cost and the remaining 10 per cent as administrative expenditure is the policy of the corporation.

Following observations are made.

(a) Even though approximately 70 per cent out of the buildings of the corporation had been utilized for manufacturing unit, an amount of Rs. 27,995,061 equivalent to 90 per cent of depreciation of buildings amounting to Rs. 31,105,624 had been absorbed into the production cost. As such, depreciation of approximately Rs. 6,221,124 had been overstated in the production cost.

(b) Even though a total depreciation of Rs. 3,089,303 consisting of 32 per cent of depreciation of furniture and fittings,11 per cent of depreciation of equipment and 12 per cent of depreciation of computer and accessories should be absorbed into the production cost, an amount of Rs. 21,866,469 equivalent to 90 per cent of depreciation of furniture and fittings, equipment and computers and accessories had been absorbed into the production cost. As such, a total of Rs. 18,777,166 of depreciation of furniture and fittings, equipment and computers and accessories had been overstated in the production cost.

1.2.2 Lack of Evidence for Audit

Confirmation in respect of Rs. 52,837,397 payable to 72 institutes out of Rs. 55,159,247 payable to 86 private institutes under trade and other payables had not been received.

1.2.3 Non-compliance with Laws, Rules, Regulations and Management Decisions

Following Instances of non-compliance were observed.

ence to Laws, Rules, Regulations etc..	Non-compliance
(a) Letter No.DMS/E4/10/4/090/2 dated 09 March 2009 of the Department of Management Services addressed to the Secretary to the Ministry of Health.	
(i) Paragraph No.02 – 01	Instead of paying transport allowancesto every executive and non-executive employee based on distance travelled, a monthly fixed transport allowance amounting to Rs. 4,700 and Rs.3,000 had been paid to themrespectively.
(ii) Paragraph No.02-01(1)	Transport allowances too had been paid to the employees who had been provided with group transport facilities and live close to the vehicle running route by the Corporation.
(iii) Paragraph 02-02	Eventhough maximumproduction incentive of Rs.9,600,000 can be paid at Rs.4,000 per month,

	an amount of Rs,19,300,515 had been paid at Rs. 12,000 per month to the entire staff of 200since 01 July 2011 without approval of the Department of Management Services. As such, production incentive paid in excess amounted to Rs. 9,700,515 approximately.
(b) Public Enterprises Department Circulars	
(i) Circular No. PED 13 dated 18 March 1998	As a result of chargingloan interest by reducing interest rate onemployee loan from 07 per cent to 4.2 per cent without the approval of the Department of Public Enterprises, the loan interest income under recovered was approximately Rs. 1,110,450.
(ii) Circular No. PED 12 dated 02 June 2003	
Paragraph No. 6.5.2	Even though the Annual Report should be tabled in Parliament within 150 days of closure of the year of accounts, annual report of the year 2011 had not been tabled in Parliament even by 31 March 2013.
Paragraph No. 6.5	Even though draft annual report should be presented to the Auditor General within 60 days of closure of the financial year, the draft annual report for the year under review had not been presented to the Auditor General.
(iii) Circular No. PED 57 dated 11 February 2011	Even though approval of the Minister of Finance and Planning should be obtained for making grants and sponsorship exceeding Rs. 100,000

	provided to a non-governmental institute or non-government development projects, grants and sponsorship grants of Rs. 2,398,512 had been paid in 09 instances, contrary is that provision.
(iv) Circular No. PED 58(2) dated 15 September 2011	Even though an additional payment could not be paidtothe Private Secretary to the Chairmanfor serving also as Secretary to the Board of Directors, additional allowances of Rs.25,000 had been paid at each instance Rs.2,500 in the year under review and Rs. 15,000 in the year 2011.
(c) Public Finance Circular No. GF/PE/6 dated 31 January 2000	PAYE tax amounting to Rs. 724,474 payable by officers relevant to the year under review, had been paid by the Corporation.
(d) Letter dated 19 February 1990 relevant to legal affairs of government institutions issued by the Secretary to the Ministry of Policy Planning and Implementation	A sum of Rs.130,000 had been paidby the Corporation during the year under review for obtaining legal advice from external lawyers without obtaining the prior approval of the Attorney General.

2 **Financial Review**

2:1 **Financial Results**

According to the financial statements presented, the operation of the Corporation for the year ended 31 December 2012 had resulted in a pre-tax net profit of Rs.117,136,719 as compared with the pre-tax-net profit of Rs.241,118,693 for the preceding year thus showing a decrease of Rs.123,981,974. Further, before taking into account the non-operating income of Rs.34,251,670 comprising the interest income received on

Treasury bills amounting to Rs.31,843,823 a net profit of Rs.82,885,049 had been earned by the Corporation in the year under review. The net profit before taking into account the non-operating income of Rs.24,961,712 in the preceding year amounted to Rs.216,156,981. Accordingly, the net profit before taking into account the non-operating incomecompared with the preceding year indicates a decrease of Rs. 133,271,932 or 62 per cent. Increase of production cost and considerable increase of selling and distribution expenditure in the year under review had resulted in this decrease in the financial result.

2:2 Analytical Financial Review

Performance of assets management in the year under review had been analyzed and given below.

(a) Profit Ratio

		Year	
		2012	2011
Gross profit ratio	Percentage	13.7	21.0
Net profit ratio	Percentage	7.0	15.7

Following observationis made.

A decrease ingross profit and net profit ratios had been indicated in the year under review as compared with the gross profit and net profit ratios in the preceding year.

(b)Liquidity Ratio

	Year	
	2012	2011
Current ratio	15.2	13.6
Quick Acid ratio	6.8	7.2

Following observationis made.

It is observed that excess working capital had not been effectively utilized in the existence of very high liquidity ratios over standard ratios.

(c)Operating Ratio

Operating Ratio	Year 2012	Year 2011
Stock turnover ratio	10	32.2
Stock turnover period - days	37	11
Debtor turnover	5.2	7.9
Debtor turnover period - days	70	46
Creditor turnover	15.3	20.1
Creditor turnover period - days	24	18

Following observations are made.

(i) Deterioration of stock turnover ratio in the year under review was 22.2 per cent as compared with the preceding year and stock turnover period had been increased by 26 days. Accordingly, stocks had not been maintained with a proper management.

(ii) Deterioration of debtor turnover ratio in the year under review was 2.7 per cent as compared with the preceding year and debt collection period had been increased by 24 days. Accordingly, recovery of debts had not been maintained with a proper management.

(iii) Deterioration of creditor turnover ratio in the year under review was 4.8 per cent as compared with the preceding year and period of settling loanshad been increased by 06 days. Accordingly, settling of loans had not been maintained with a proper management.

3 Operational Review

3.1 Performance

(a) Manufacturing Activities

Comparative information in respect of types of drugs manufactured by the Corporation during the year under review and 04 preceding years is given below.

Year	**No. of types of Drugs Manufactured**	**Production**
		Million units
2008	39	1032.6
2009	38	1195.2
2010	38	1614.1
2011	37	1796.4
2012	40	1920.2

Following observations are made.

(i) Growth rate of unitsof drugs manufactured in the year 2011 was 11.3 per cent and since it was 7 per cent in the year under review, the growth rate had decreased to 4.3 per cent as compared with the preceding year.

(ii) As compared with the total production of 37 types of drugs of 1,796.4million in the year 2011 with the year under review, the production of the said 37 types of drugs was 1755.1 million. As such, production in the year under review had decreased by 41.3 million units relevant to the drugs produced in the preceding year.

(iii) In the year 2011, 37 types of drugs had been manufactured and number of types of drugs had been increased up to 40 in the year under review. However, out of them 02 types of drugs were thosewhich were out of production in the preceding year and only one type was a new production. An amount of 1.5 million units of the new drug had been manufactured in the year under review. Further, initial research activities thereonhad been commenced in the year 2006 and it had taken 06 years to introduce it to the market.

(iv) Out of 40 types of drugs manufactured in the year under review, contribution for the total production of 05 types of drugs was only 0.4 per cent and out of the total production of 1057.05 million units or 54.99 per cent had been dependent on 07 types of drugs.

(v) The number of types of drugs which were in testing level during the period from 2005 to April 2013 was 10 and it had taken 02 to 07 years for the said testing purposes. Inadequacy of laboratory facilities, lack of trainee staff and opportunity to undergo a proper training had mainly affected these delays.

(d) Use of Machinery in the Production of Drugs

Eleven machines had been used by the Corporation for purposes of manufacturing drugs in the year under review and the machine No. G.K.F 800 had not been used in production during the months of March, May, August and December in the year under review. Only 02 types of drugs namely Indometacin Cap BP 25 mg and Chloramphenicol Cap BP 250 mg had been manufactured by the said machine in the year under review and the Corporation had failed to supply 7.78 million units and 11.18 million units of the said drugs respectively at the end of the year.

(c) **Marketing and Pricing**

Information on marketing activities relating to tablets and capsules in the year underreview andthe preceding year is given below.

Market Segment	Sale of Drugs		Value of Sales	
	2012	2011	2012	2011
	MnUnits	Mn Units.	Rs.Mn.	Rs.Mn.
State Pharmaceutical Corporation	492.4	546.7	412.4	424.0
Director General of Health Services	1,203.9	1,244.3	1,000.7	1,006.8
Exports	3.8	-	1.4	-
Other	-	1.4	-	0.8
	1,700.1	1,792.4	1,414.5	1,431.6

The following observations are made.

(i) The number of unitsof drugs and value of marketing sold to the State Pharmaceutical Corporation and Director General of Health Services by the Corporation during the year under review was 99.8 per cent of the total sales.However, as compared with the preceding year, the number of units of drugs sold to the State Pharmaceutical Corporation and Director General of Health Services had decreased by 9.9 per cent and 3.2 per cent respectively. As a whole, compared with the preceding year, total value of sales had decreased by 1.1 per cent and its financial value was Rs. 17.1 million.

(ii) During the year under review, 3.8 million units of Diethlcarbamazine tab 50 mg had been manufactured and exported for Rs. 1.4 million.

(iii)When considering the sale of drugs, 53 per cent of the total units of sales had been dependent on 06 types of drugs.

(iv)Out of the types of drugs ordered bythe Director General of Health Services and the State Pharmaceutical Corporation, 389.4 and 193.61 million units had remained respectively for supplying at the end of the year under review. In the year 2011, 100.5 million units of 07 types of drugs and 62.9 million units of 06 types of drugs that should be supplied to the Director General of Health Services in second and third quarterly in the year 2012 had been included in the said remaining drugs.

(v) Prices of drugs are determined by adding 12 per cent profit margin on the standard production cost when selling drugs to the Director General of Health Services. However, without identifying the component of costs included total standard production cost, standard cost had been calculated by including components of costs irrelevant to it. For an example, cost of damages and unused materials had been made use of in calculating standard cost.

(vi) Even though price should be determined by adding 12 per cent profit margin to the total standard cost, the profit margin of certain types of drugs had been in a range from 13 per cent to 20 per cent. The profit calculated in the year under review was inaccurate as a result of failure in using approved profit margin when determining price.

3.2 **Management Inefficiencies**

Following observations are made.

(a) Six items of raw materials valued at a cost of Rs. 8,137,215 purchased for production of drugs had not been used for production. Details given below.

Item	**Quantity**	**Value /Rs.**
E/H Gelatin capsules	35.56 million- units	5,656,285
Malaic Acid BP 2010	84 kg	115,572
Sodium starch Glycalate BP 2010	2000 kg	771,080
Aspirin	1100 kg	1,017,053
Ferric oxide Red	8.84 kg	17,939
Bisacodyl BP	55.5 kg	559,286

		8,137,215

As a result of raw materials of E/H Gelatin capsule at a cost of Rs. 5,656,285being rejected by machines, inaccuracies in formulaof raw materials of Aspirin and Bisacodyl BP at a cost of Rs. 1,576,339, not in compliance with specifications, change in colour and expiry of raw materials at a cost of Rs. 904,591, the said raw materials had not been used in production, out of 06 types of raw materials as describedin the above table purchased for production of drugs.

Even though in compliance with specifications, the Chairman has informed that steps are being taken to recover the cost from the supplier in respect of damaged Sodium Starch Glycolate as a result of being rejected by machines, damaged by absorption of water vapour and air due to issue of Malaic Acid BP 2010 in small quantity for production of tablets, continuous developed processes in Aspirin and Bisacodyl BP prescription are in progress and expiry of Feric Oxide Red.

(b) Purchase of Tablet Production Machine

Tendershad been called on 29 March 2011 to purchase of a tablet production machine and the supplier who submitted third minimum bid including the value added tax of Rs. 91,026,700 had been selected by the procurement committee of the Ministry. An amount of Rs. 23,337,876 as advances had been paid to the local agent of the supplier on 16 July 2012.

Following observations are made.

(i) Even though according to the agreement, the machine should have been supplied in November 2012, the period of contract had been extended by the procurement committee of the Ministry up to 30 May 2013 at the request of the contractor. As the supplier failed to supply the machine even at this date, the advance amounting to Rs. 23,337,876 although been recovered from the performance bond on 23 April 2013, an amount of Rs. 23,337,876 equal to this advance had been paid to the supplier as advance. However, this machine had not been supplied by the supplier even on 15 October 2013.

(ii) Accordingly, action had not been taken even up to 15 October 2013 to recover approximately Rs. 2.28 million of interest relevant to Rs. 23.34 million from 16 July 2012 on which the advance was paid up to 23 April 2013 on which it was recovered.

(c) Instead of deemed dividend of Rs.20, 445,145 payable on profit after tax amounting to Rs. 81,780,582 in the year under review by the Corporation, an amount of Rs. 20,000,000 had been paid as deemed dividend. As a result of paying deemed dividend less by an amount of Rs. 445,145 by the Corporation, there is a risk of recovering deemed dividend taxretained on deemed dividend paid less to the Department of Inland Revenue.

3.3 **Transactions of Contentious Nature**

Following observations are made.

(a) According to the decision of the Board of Directors No. BP/18/13 dated 22 February 2013, a total amount of Rs. 1,110,450 consisting of damaged packing materials at a cost of Rs. 938,056 and damaged raw materials at a cost of Rs. 172,394 had been written off against the profit in the year under review.

(b) Even though the State Pharmaceutical Corporation and the Director General of the Health Services are the main purchasers of drugs manufactured by the Corporation, the Corporation had incurred Rs. 11,111,731 as Sales Promotion Expenditure. Out of the said amount Rs. 5, 969,053 had been incurred as radio and paper advertisements. Even though Rs. 4,875,379 had been incurred as Sales Promotion Expenditure over the expenditure of year 2011, when comparing the sales of the year under review with that of the preceding year, it had decreased by Rs. 17,108,468. As such, the cost incurred as Sales Promotion Expenditure had not been effectively used.

3.4 **Weaknesses in Contract Administration**

3.4.1 **Construction of Building for Packing of Products and Storing Facilities**

Contract of construction had been awarded to the contractor who had submitted a minimum bid of Rs. 72,152,252 excluding VAT by Open Tender in the year 2009.

Following observations are made.

(a) Even though according to the agreement of the contract, construction work was scheduled to be completed on 08 August 2010, constructions had not been completed and handedover to the corporation even by 15 October 2013 and action had not been taken to recover the liquidated damagesof Rs. 8,081,052 thereon.

(b) After selecting the contractor by following the procurement procedure, the contract had been awarded on the value added to the contract bid of Rs.2, 061,000 by agreeing to pay a participatory fee of06 per cent calculated on the contract bid.Despite the agreement to pay a consultant fee of 06 per cent to the State Engineering Corporation as engineering consultant, reasons caused for payment of participatory fee of 06 per cent to the contractor had not been disclosed.

3.4.2 Construction of Office Building and two Storeyed Building for Stores and Office

The procurement procedure had not been followed to select a contractor for the construction of the above two buildings. These contracts had been awarded to the same contractor mentioned above on engineering estimates including Rs. 40,249,323 and Rs. 8,650,538 of VAT respectively prepared by the Contract Consultant Company.
Following observations are made.

(a) Even though according to the agreement of the contract, the office building should be completed and handed over on 06 September 2010, it had not been so done even by 15 October 2013 and action had not been taken to recover the liquidated damages of Rs. 4,024,932 thereon.

(b) Even though according to the agreement of the contract, the two storied building for stores and office should be completed and handed over on 20 January 2012, it had not been so done even by 15 October 2013 and action had not been taken to recover the liquidated damages of Rs. 865,053 thereon.

(c) The contractor had been paid a total of Rs. 9,625,744 (on account) of 05 bills before certifying of bills. However, according to the contract files submitted, it had been certified by the contract consultant firm antedating on the date of the said payments.

4. Accountability and Good Governance

4.1 Corporate Plan

Eventhough the objective of the corporate plan prepared for the period from 2012 to 2016 had been the promotion of sales of drugs by an amount between 10 per cent – 15 per cent annually, the sale of drugs had decreased by 1.1 per cent in the year under review over the preceding year. Further, operating results for a period of 03 ensuing years had not been included in the corporate plan.

4.2 **Action Plan**

Periods which the activities to be completedincluded in the action plan prepared for theyear underreview had not been mentioned.

4.3 **Budgetary Control**

The budget relevant for the year 2012 approved by the Board of Directors had been revised in the month of September in the year under review.

As variances were observed ranging from 46 per cent to 1040 of actual expenditure relating to six heads of budgeted expenditure and 10 per cent to 3017 per cent of assets thus, the budget had not been use of as an effective instrument of financial control.

5. **Systems and Controls**

Weaknessesobserved in systems and controls during the course of audit were brought to the notice of the Chairman of the Corporation from time to time. Special attention is needed in respect of the following areas of control.

(a) Property, Plant and Equipment
(b) Pricing of Drugs
(c) Production Activities
(d) Tax
(e) Budget
(f) Constructions
(g) Receivables
(h) Corporate Plan
(i) Noncompliance with Laws, Rules and Regulations
(j) Human Resources Management