

Performance of the
Furniture Manufacturing
Plant at Kaldemulla State
Timber Corporation -
2010



**Performance and
Environment
Audit Unit**

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**Auditor General's
Department**



01. Executive Summary

The State Timber Corporation was established in April 1968, under the State Industrial Corporations Act, No.49 of 1957. Its vision is to be the nation's leader in providing most trusted and best quality timber and timber based products. In order to achieve corporate goals and objectives, the STC is well equipped with country- wide operation network which consists of 13 saw mills, 4 timber treatment plants, 3 furniture manufacturing factories and 32 sales depots.

STC owns to three furniture manufacturing plants namely Kaldemulla, Ampara and Bussa, Kaldemulla Furniture Manufacturing Plant (KFMP) commenced its production process in the year 1981 and started producing household furniture items from the year 2000. However, from the inception the KFMP had been operating as a loss making unit. Therefore, KFMP was selected as a pilot project of the performance audit.

The main objectives of the audit were to assess whether; the operations of KFMP are conducted in efficient, effective, economical manner to maintain commercial and financial viable position in the future and that the activities of the KFMP are conducted to ensure that there is no unfavorable impact to the environment.

Audit was planned and conducted during the period July 2010 to October 2010. The audit include collection of documentary evidence, field work, physical verifications and observations.

The summary of significant audit findings includes selling prices of key furniture items below the current market prices, standard cost of furniture items not being accurate and not been revised for a long period non-operation of the plant at the optimum sales mix, non-existence of marketing strategy and a plan, showroom not being attractive to the customers, absence of a proper recruitment plan for KFMP, inadequate training for staff, lack of coordination and monitoring over the operations, wastage of materials, idle labour and machine hours, lack of coordination between factory, seasoning plant and the saw mill when preparing the supply lists, use of valuable and usable pieces of sawn timber as firewood, uneconomical procurement of raw materials, lack of proper quality inspection and assurance, manufacture furniture items from the factories without a demand, non-maintenance of proper stock records, ineffective usage of land and buildings, environmentally harmful manufacturing process, lack of management information in a timely manner and non-compliance with the corporate governance guidelines by the STC.

Audit recommendations include among the others the introduction of an accurate pricing mechanism to consider competitive market prices and standard cost structure, introducing a sales system and automate the pricing, and invoicing procedures to eliminate the manual procedures, identify the most profitable product mix within the available resources, appropriate marketing mechanism and necessary infrastructure inside the showroom to make the locations more appealing to the customers, provide formal training for showroom staff and factory workers, introduction of a Management Information System (MIS) for monitoring and strategic decision making, factory to have a proper production plan to fully utilize the available resources, key managers should be involved with planning and monitoring of the activities, introduction of 5S system to improve infrastructure and minimizing the wastage, introduction of an incentive scheme, compliance with the procurement guidelines, existing recruitment procedure should strictly apply to recruit skilled and experienced workers, introduction of quality control functions, Board of Directors should take steps to comply with the corporate governance guideline, floors of the timber treatment area, treated timber storage area and the creosote barrels storage area should be well cemented in order to prevent pollution of ground water, dispose waste material (saw dust) according to the regulations, facilitate adequate ventilation and light inside the factory and safety gears to the workers, timber requirement of the factory should be planned properly, saw, seasoning and cut timber according to the plan to be efficient and effective in the production process, need to introduce a proper system to maintain the stock ledger at the seasoning plant, introduction of proper system to sort timber before them being used as fire wood for the boiler.

02. Introduction

2.1 Background

The State Timber Corporation (STC) was constituted in April 1968, under the State Industrial Corporations, Act No.49 of 1957. It is mandated by the Act of Parliament to be the state institution responsible for harvesting forest resources and conversion of them into material forms required by the timber and furniture industry and people of Sri Lanka. It operates under the Ministry of Environment.

The STC is responsible for the development of the operations of the timber industry, in keeping with the modern industrial trends to maximize utilization of the increasingly scarce resource of timber and enhance productivity of those involved in the operations and others engaged in the industry.

The “vision” of the STC is to be the nation’s leader in providing most trusted and best quality timber and timber based product while the “mission” is to produce timber and timber based products to the customers through the knowledge, skills gained over the time and to contribute to the national and environmental demands of Sri Lanka.

In order to achieve corporate goals and objectives, the STC is well equipped with countrywide operation network which consists of 13 saw mills, 4 timber treatment plants, 3 furniture manufacturing factories, 13 regional offices, 32 sales depots and 2 agency depots.

Structure of Kaldemulla Complex

The main operations of Kaldemulla complex include sale of logs, conversion of timber into sawn timber, sale of sawn timber, production and sale of finished products, impregnation, preservation and seasoning of timber.

Evaluation of history and current situation at the KFMP

KFMP commenced its production process with 4 machines in the year 1981. Subsequently in 1986, the plant was further expanded to produce office furniture using 30 machines transferred from the Forest Department. Prior to year 2000, STC has been purchasing and selling household furniture items from the outside contractors. STC started producing household furniture items from the year 2000.

Currently, 60 employees are engaged in the furniture factory and 5 employees are engaged at the Ratmalana showroom. In addition, carpenters, painters and cane workers are hired on contract basis as and when required.

2.2 Authority for the Audit

The provisions of the Constitution of the Democratic Socialist Republic of Sri Lanka, provide the Auditor General to carry out much more than the financial audit and covers performance audits which aim at assessing the economy, efficiency, effectiveness and environmental aspects of transactions, programs and activities of the public sector institutions. The aim is to improve public sector administration and accountability.

Accordingly, the performance audit of Furniture Manufacturing Plant at Kaldemulla was carried out under the Auditor General’s Constitutional duties.

2.3 Purpose and the reasons for the selection

KFMP had been established for the fulfillment of the needs of the furniture requirement of the public sector institutions and the general public as a separate unit under the STC. However, from the inception the KFMP had not been operating in commercially and financially viable manner. The losses incurred from the year 2007 had been remarkably high as compared with the previous years.

Summary of financial statements for the years 2007, 2008 and 2009 are given below;

	Year ended 31 March 2009 LKR Mn	Year ended 31 March 2008 LKR Mn	Year ended 31 March 2007 LKR Mn
Sales	21.7	22.9	22.8
Less: Cost of sales	(25.3)	(8.6)	(23.8)
Gross profit/(loss)	(3.6)	14.3	(1.0)
Administrative costs	(25.4)	(25.3)	(20.0)
Other costs	-	-	-
Net loss	(29.0)	(11.0)	(21.0)

2.4 Scope of the Audit

Performance audit was conducted under my direction in accordance with the provisions in Article 154 of the Constitution of Democratic Socialist Republic of Sri Lanka, and included such tests as we considered necessary. We obtained an understanding of the KFMP's operations and internal control systems (to the extent necessary as a basis to determine their impact on the achievement of stated objectives), the risks related to achievement of the identified objectives and conclude on the findings and recommendations of our performance audit.

- 1 We expected to obtain such appropriate audit evidence as we considered sufficient to enable us to draw reasonable conclusions therefrom. The nature and extent of our procedures could vary according to our assessment of the risk and related activities which prevent KFMP achieving the objectives. Our procedures also included examination (that may relate to financial audit / investigative audit), of evidence supporting the findings and recommendations.
- 2 Our work was planned in advance and incorporated into an audit plan. This had varied on the basis of our findings during the course of the performance audit. Accordingly, we had to modify our audit scope and propose matters of special emphasis, as the circumstances dictated.
- 3 Our performance audit covered only the identified objectives relating to KFMP and had involved audit of financial statements of either the furniture manufacturing plant or STC.

2.5 Audit Approach, Objectives and Criteria

The approach to the audit was as follows:

- Observing the operations of sawmill, seasoning plant, factory and showroom;
- Gathering and analyzing data from various independent sources and compare them with the KFMP; and
- Reviewing other relevant documentation and interviewing the relevant personnel.

The main objectives of the audit were to assess whether;

- The operations of KFMP are conducted in efficient, effective and economical manner to maintain commercial and financial viable position in the future.
- The activities of the KFMP are conducted to ensure that there is no unfavorable impact to the environment.

Audit Criteria

The following are the criteria upon which the audit findings and recommendations will be based:

1. Selling price at which KFMP would make profits in respect of selected furniture items with highest contribution to profit
2. Volume at which the factory makes profits in respect of selected furniture items with highest contribution to profit
3. Utilization of main resources attributable to the selected furniture items line with predetermined standards of KFMP and independently obtained standards
4. Stock residence period of selected furniture items against the expected residence period
5. The guidelines of good governance practices issued by the Department of Public Enterprises and implementation by factory management
6. Guidelines/norms set by the Central Environmental Authority for disposal of saw dust and scarps and KFMP practices for disposal

2.6 Limitations, rare departures and remediation

In panning this audit, it was attempted to minimize limitations. However, there are some limitations that are beyond scope of this audit. This audit was limited for only four months period and the staff had to engage with their normal duties during this period as well. Certain information required by the Audit Team was not readily available with the staff of the KFMP. Sometimes this meant waiting for days because of their busy schedule. Therefore, audit team had to start another work until such information was made available. Another major limitation is that even though the actual resources utilized in the production process cannot be identified directly, in the absence of MIS, the Audit Team had to calculate the actual timber and labour and machine hours utilized in the production process. The Audit Team had to spend time exceeding the time scheduled to carry-out the verification of stocks at the seasoning plant due to absence of the timber stock records.

The detailed scope of work including scope, objectives and audit criteria used as bases for measurement of performance is given in the Appendix A to this report.

Part - I

3 Audit Observations and Recommendations

3.1 Policy on price fixing is not sufficient to maintain the financial viability

Observation

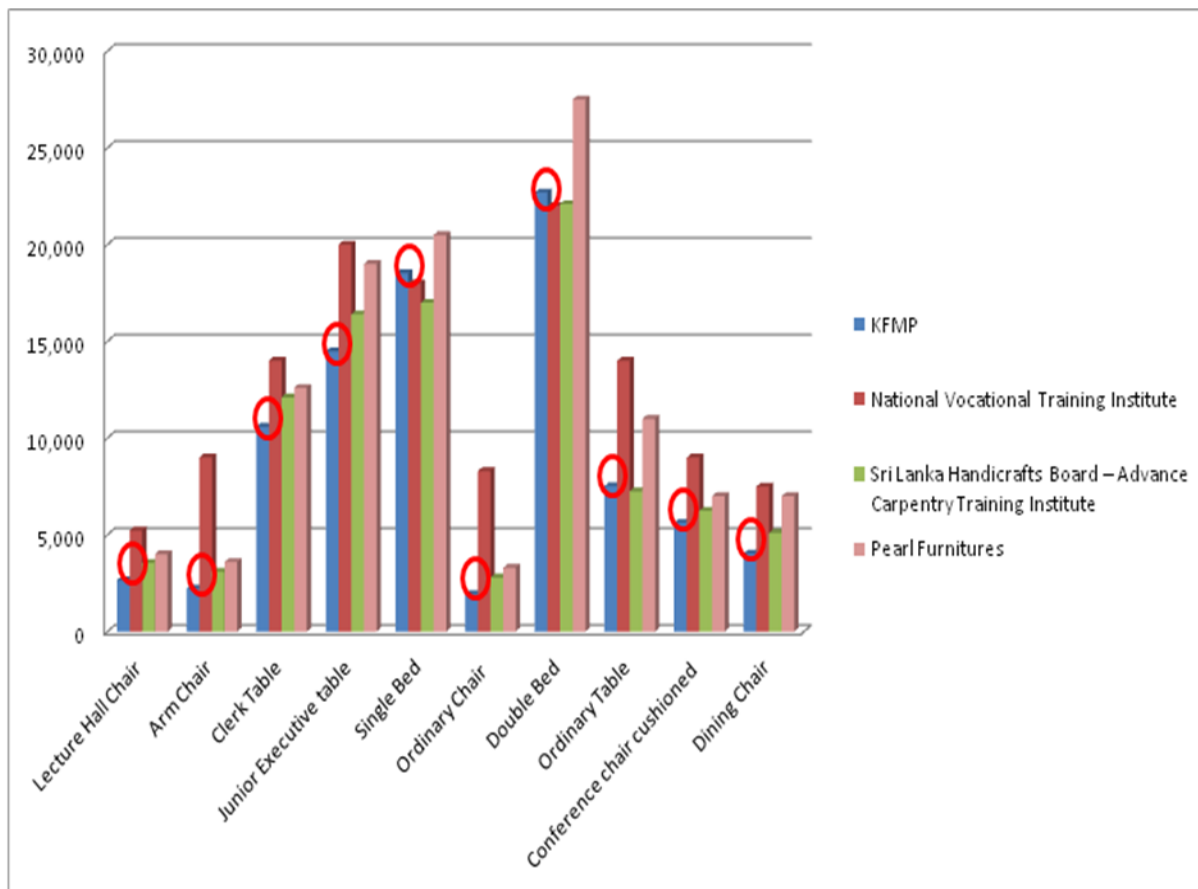
We obtained selling prices for the selected items from two Government institutions and a private institution and noted that there are differences between competitor selling prices and KFMP selling prices;

- 1 Government Institution 1 (GI-1)
- 2 Government Institution 2 (GI-2)
- 3 Private Institutions (PI)

Please refer following table and graph for the selling prices of selected items.

	Furniture Item	KFMP (LKR)	GI-1 (LKR)	GI-2 (LKR)	PI (LKR)
1	Lecture Hall Chair – Grandis	2,653	5,222	3,550	4,000
2	Armchair – Grandis	2,228	9,000	3,100	3,600
3	Clerk Table – Grandis	10,591	14,000	12,100	12,600
4	Junior Executive Table – Grandis	14,479	20,000	16,400	19,000
5	Single Bed –Teak	18,525	18,000	17,000	20,500
6	Ordinary Chair – Grandis	1,944	8,300	2,800	3,300
7	Double Bed – Teak	22,700	22,000	22,100	27,500
8	Ordinary Table – Grandis	7,527	14,000	7,250	11,000
9	Conference chair cushioned – Teak	5,617	9,000	6,250	7,000
10	Dining Chair – Teak	4,038	7,500	5,100	7,000

Comparison of KFMP selling prices with competitor prices



According to the above table and graph, prices of all the items of KFMP are lower than the other institutions.

It is pertinent to note that the KFMP's competitive position has not been improved although the selling prices are less than its competitors.

Implication

Failure to set prices which are in-line with the market and the current cost structure result in the KFMP incurring losses as selling prices are not enough to cover the cost of the production and other relevant costs.

Recommendation

A realistic pricing mechanism should be introduced by considering both competitive market prices and KFMP cost structure.

STC Response

Once the cost of production is worked out in the Kaldemulla factory it is sent to the Pricing Committee (PC) in Head Office and the final prices are fixed by the PC taking into account the cost of production and the market trend. Later STC introduced the ERP system to centralize costing process.

3.2 Standard cost structure is not maintained with actual expenditure pattern

Observations

KFMP still uses a standard costing system developed by a private consulting firm in 1992. For instance, following overhead absorption rates which were determined through the consultancy report was not enough to meet break-even point;

- Factory overheads at LKR 3.37 per dm³
- Cutting and planning at LKR 3.53 per dm³
- Machine cost at LKR 2.50 per dm³

In addition, cost of seasoning charges for 1dm³ (LKR 4.10) had not been revised for the last five years.

Although the KFMP sets selling prices using the standard costing system which was developed 18 years ago, we observed instances where actual selling prices at which some of the furniture items were sold are significantly below the standard selling prices as illustrated in the table below.

As observed in preceding point (3.1), it is important to note that the current selling prices of the KFMP are far below the market competitor prices.

Furniture Item		Selling price according to standard cost sheets (LKR)	Actual selling price (LKR)	Difference (LKR)
1	Lecture Hall Chair – Grandis	3,242	2,653	589
2	Armchair – Grandis	3,045	2,228	817
3	Clerk Table – Grandis	11,394	10,591	803
4	Junior Executive Table – Grandis	18,865	14,479	4,386
5	Single Bed – Teak	18,823	18,525	298
6	Ordinary Chair – Grandis	2,762	1,944	818
7	Double Bed – Teak	28,450	22,700	5,750
8	Ordinary Table – Grandis	6,756	7,527	(771)
9	Conference chair cushioned – Teak	4,553	5,617	(1,064)
10	Dining Chair – Teak	4,629	4,038	591

Except items 8 and 9 all other items are sold at a price less than their standard selling prices.

Implication

KFMP uses the standard cost for each item of furniture as guidance in determining the selling price. As result of not revising the standard costs for a long period and also selling furniture at prices which are not even in-line with the standard selling price, KFMP sells its furniture at a loss.

Recommendations

- Standard costing structure should be revised in-line with the current market prices and set furniture selling prices by considering the current cost structure and competitive market prices
- KFMP should also consider introducing a sales system and automate the pricing, and invoicing procedures which will eliminate the manual procedures (which KFMP currently following) and increase efficiency

STC Response

Previously STC performed its furniture costing based on Cooper's system. Now STC has introduced the ERP system for costing.

3.3 Volume of Furniture items and that required to be sold to make KFMP break-even point

Observation

In order to determine the point at which the KFMP will reach break-even (no profit, no loss), the calculation below was performed for 10 selected furniture items.

These volumes are calculated based on the assumption that only one item is produced at one time.

	Lecture hall chair	Armchair	Clerk table	Junior executive table	Single bed	Ordinary chair	Double bed	Ordinary table	Conference chair-cushioned	Dinning chair
Selling price per unit	2,653	2,228	10,591	14,479	18,525	1,944	22,700	7,527	5,617	4,038
Less:										
Variable cost per unit	(1,775)	(1,557)	(6,465)	(11,404)	(14,913)	(1,197)	(23,496)	(8,135)	(2,033)	(2,685)
Contribution per unit	878	671	4,126	3,075	3,612	747	(796)	(608)	3,584	1,353
Volume	6,772	8,860	1,441	1,934	1,646	7,962	*	*	1,659	4,395
Fixed cost	(5,945,957)	(5,945,957)	(5,945,957)	(5,945,957)	(5,945,957)	(5,945,957)			(5,945,957)	(5,945,957)
Breakeven	0	0	0	0	0	0			0	0

* We were unable to calculate the break-even volumes for the double bed and ordinary table since selling prices of those items are lower than the variable costs.

When the actual volume of sales for year 2009 is compared with the break-even volumes, it was noted that actual volumes are well below the break-even volumes thus resulting KFMP incurring substantial losses.

The table below illustrates the comparison between break-even volume and actual volume for year 2009.

Item	Volume that should be produced to break-even	Actual production volume (2009)	Difference
	Units	Units	Units
Lecture Hall Chair	6,772	2,227	4,545
Armchair	8,860	967	7,893
Clerk Table	1,441	152	1,289
Junior Executive table	1,934	98	1,836
Single Bed	1,646	26	1,620
Ordinary Chair	7,962	203	7,759
Double Bed	7,469	16	7,453
Ordinary Table	9,782	34	9,748
Conference chair cushioned	1,659	44	1,615
Dining Chair	4,395	54	4,341

Implication

Failure to select an appropriate mix of furniture items that will generate positive contribution and not producing above the break-even volumes, the KFMP had been incurring losses over the years.

Recommendation

KFMP should identify the most profitable product mix that provide the positive contribution to the business within the available resource limitations (labour, machines, etc.) and also the market demand for the selected sales mix.

STC Response

STC annually prepare the production plan for all complexes including Kaldemulla. For preparation of this plan we take into account and give priority for the production of fast moving house hold and office furniture and thereafter to other mix items of furniture. The break-even volume suggested in the report is unrealistic given the limits of our resources and the market trends. STC will strive to reduce the suggested break-even volume by reducing the fixed and other variable costs to make it profitable.

Part - II

3.4 Location and physical infrastructure at the showroom were not up to the acceptable standards.

Observations

We observed that the the showroom has not been located appropriately to attract customers since the appearance of the showroom is obstructed by fences and trees.

Given below are some of the photographs of specific observations made in relation to the showroom.

- The appearance of the show room is not attractive to the customers and front side of the building is covered by a fence and trees which obstruct visibility of the showroom to the potential customers travelling on the Galle road;



- An attractive and prominent name board or a cutout has not been displayed in front of the showroom;



- Interior arrangements such as ventilation, lighting and display of furniture were not in a satisfactory level. Furniture are scattered all over the showroom and not displayed in a manner to attract the attention of potential customers.



3.5 Restricted operating hours of the showroom

- The showroom operate from 8.00 a.m.to 4.30 p.m. during the weekdays and Saturday from 8.00 a.m. to 1.00 p.m.

The restricted operating hours of the showroom hinders its ability to attract more customers as many customers prefer to shop late in the weekdays and especially during weekends.

Implication

Poor location, visibility and infrastructure (lighting, ventilation, etc.) available at the showroom adversely affect the competitiveness of the KFMP in the highly organized furniture trade.

Recommendations

- KFMP should introduce appropriate marketing strategies and necessary infrastructure of the showroom to make the locations more attractive to the customers
- Operating hours of the showroom should be extended as most customers prefer to shop at leisure after office hours and over the weekends.
- Study the display strategies of competitors with a view to improving the display of furniture in the KFMP showroom.
- The photographs below illustrate furniture showrooms properly arranged, illuminated in sharp contrast to the haphazard display resorted by the KFMP.



STC Response

STC has allocated funds in 2013 budget to build a new state-of-the art showroom and to upgrade the existing showroom including the surrounding environment. The photos of the products and showrooms printed do not depict the correct circumstances, amateur's photographs.

As suggested STC will explore the possibility to extent the showroom open hours.

3.6 Proper Marketing Plan had not been established by the KFMP

Observation

Marketing activities relating to the KFMP are performed by the Marketing Division of STC. However, we noted that either Marketing Division of STC or KFMP do not have a marketing plan. Instead of an action plan developed by the Marketing Division of STC which addresses KFMP separately is being used.

Implication

Well written, comprehensive marketing plan is the focal point of the business because it describes how the KFMP plans to attract and retain customers and it provides guidance as to how the KFMP should conduct its activities to improve its sales.

The following are some of the advantages which the KFMP could gain by having a marketing plan of its own.

A properly structured marketing plan;

- identifies needs and wants of consumers;
- determines demand for product;
- assists in designing products catering to the fastidious customer demand;
- outlines measures for generating cash for daily operation, to repay debts and to generate a profit;
- identifies competitors and analyzes the products and their competitive advantages;
- identifies new product areas;
- identifies new and/or potential customers; and
- allows for test to see if strategies are producing the desired results.

Unavailability of a marketing plan will prevent the KFMP from reaping the benefits accruing from the above advantages.

Recommendation

KFMP and Marketing Division of STC should develop a comprehensive marketing plan exclusively for the KFMP and should conduct its marketing activities in accordance with the developed plan.

STC Response

Marketing activities relating to the Kaldemulla Complex are performed by the marketing division of STC. As suggested STC will develop a comprehensive marketing plan exclusively for implementation by KFMP.

3.7 Promotion Campaigns and Advertising methods

Observations

- We observed that STC had introduced a furniture package called “Prasada Abimani” to the STC employees and the other Government sector employees in April 2010. The STC had spent about LKR 468,270 on the promotions and advertising relating to the campaign. The sales under the package during the period 06 April 2010 to 14 August 2010 amounted Rs.1,548,430.
- It was further observed that furniture items not included in the “Prasada Abimani” package amounting to LKR 505,551 had been sold under this package by allowing a special discount of 10 percent.

Implications

- Incurring expenditure on advertisements which does not commensurate with the projected sales under the package will lead to losses
- By selling furniture items which were not included in the “Prasada Abimani” package with discounts will lead the KFMP loss of revenue

Recommendation

Economize on the advertising expenses in keeping with the projected sales and prevent deviation from management decisions relating to the composition of packages when they are offered to the customers.

STC Response

Since 2010 we have commenced several advertising and promotion campaigns.

- Prasada Abimani Package – a promotion to sell furniture up to a limit of Rs.200,000/= on easy payment scheme to STC and Government Sector employees.
- For the 1st time the Corporation’s furniture were exhibited in an exhibition in Maldives and attracted several customers, and sold all the exhibited items, and obtained orders for supply of furniture.
- On the request of several customers now accept the electronic credit cards for purchase of loose furniture. We expect to increase the market by this means.
- Advertisements and promotional activities do not bear rewards immediately, its takes some time to bear fruit.

3.8 Training Requirement of Showroom Staff

Observation

The KFMP has deployed 6 officers on customer relations and sales activities of the showroom at Ratmalana. However none of the officers had been given any training on customer relations, sales, marketing and other activities relating to running of a business.

Training in customer relations and persuasive sales strategies, etc. is an essential feature of a successful business and if that is lacking, it will adversely affect the performance of the showroom.

The staff deployed in the showroom should be given a training in customer relation, persuasive sales strategies and showroom management.

Implication

Lack of formal training to customer fronting staff may lead to low quality service and poor customer relations which could ultimately affect the performance of the showroom.

Recommendation

All staff who are engaged in the showroom should be given formal training.

STC Response

STC aims to promote and enhance the role and status of employees engaged in wood work. For this purpose we have a training division to train apprentices and skilled workers. STC allocates funds every year to implement the training programme. In 2011 STC recruited/assigned a highly qualified Furniture Designer for the Kaldemulla complex who will look after the arrangements and training in the Showrooms

3.9 System to identify the Actual Resources Utilization

Observation

We observed that KFMP does not have a proper system in place to capture management information in a timely manner. As a result, actual cost information in respect of timber, labour, machine and other direct and indirect cost of the furniture items produced by the factory are not being properly captured and monitored.

Implication

In the absence of a Management Information Systems (MIS), it will not be possible for the management to monitor and control operations of KFMP in a timely manner. Monitoring the operations and taking decisions based on the information generated from manual calculation / informal channels could lead to ineffective and inefficient decision making and control of the business.

Recommendation

Management Information System (MIS) geared to generate accurate and timely information should be introduced for monitoring and strategic decision making in relation to the performance of KFMP.

STC Response

STC Management introduced an Information system to monitor resource utilization, production and financial progress. STC is now testing the ERP computer system which will monitor resource utilization, production and order completion online.

3.10 Comparison of Actual Resources utilized with the Standard Resources

Observations

Even though the actual resources utilized in the production process cannot be identified directly, in the absence of MIS, we have calculated actual timber, labour and machine hours utilized in the production process for the months of May, June and July 2010 and compared with the standard resources utilized by the KFMP.

Timber

We have assumed actual timber utilized is equal to the standard timber required and timber received from seasoning plant to the factory had been fully utilized.

Month	May (dm ³)	June (dm ³)	July (dm ³)
Manufacturing of components (A)	1,871	5,483	2,444
Manufacturing of finished goods (B)	9,531	16,232	35,538
Total production (C=A+B)	11,402	21,715	37,983
Total production +10 percent wastage (D=C*1.1)	12,542	23,887	41,781
Seasoned timber issued to factory (E)	15,157	30,188	61,094
Wastage of seasoned timber (F=E-D)	2,615	6,301	19,313
Wastage of seasoned timber as a percentage of E	21	26	46

We considered normal loss of the furniture factory as 10 percent of the total production.

It was noted that the wastage of seasoned timber during the months of May 2010, June 2010 and July 2010 were 21 percent, 26 percent and 46 percent respectively. We consider this as too high for a manufacturing process.

Reasons for the above wastage:

- Lack of coordination between factory, seasoning plant and the saw mill in the preparation of the supply lists
- Bulk issue of timber from seasoning plant to the factory over the requirements
- Total quantity of timber received at the factory from seasoning plant had been considered as fully utilized for the production process irrespective of whether they were fully utilized or not. The cost of such unutilized timber in a month is included in the total manufacturing cost of that month. However, the excess quantity of timber unutilized has been stored in the factory or outside the factory and open to the elements in the latter case.
- Lack of proper stacking system at the factory
- Inadequate monitoring and supervision of the factory had resulted in the following unsatisfactory features we physically observed during our visit
 - Usable timber was found in the timber stocks marked for disposal
 - Half finished components, improperly assembled parts were kept in the factory without being used

Implications

- Consumption not accurate because of the improper production plan and consumption which capture leftover which should brought to inventory (RM)
- Lack of effective information system hinders timely and up to date decisions. (decisions made being inaccurate, inappropriate and outdated)
- Due to lack of infrastructure, high amount of wastage and instances where the quality of timber deteriorate due to bad storage.
- Lack of monitoring will result in lack of direction and deviate from the mission and objectives of the factory

Recommendations

- Factory should have a proper production plan where the key managers (head of showroom, head of saw mill, head of seasoning plant and head of factory) should be involved in the planning process
- STC should introduce a Management Information System (MIS) to capture information
- Proper monitoring of the activities
- Introduction of 5S system to improve infrastructure and minimizing the wastage

Labour

Observations

Due to the unavailability of information / MIS, our observations were limited to labour of the cutting and machine sections.

We have computed the actual labour in respect of selected items by using the following formula.

$$\text{Actual labour hours for a selected item} = \left[\frac{\text{Total actual labour hours for the relevant month}}{\text{The total actual timber utilized (cubic decimeters) in that month}} \right] \times \text{Number of cubic decimeters of timber attributable to a particular item}$$

	Furniture Item	Actual labour hours per unit (Cutting, machine and assembling sections)		
		May 2010	June 2010	July 2010
1	Lecture Hall Chair	7.88	5.33	3.14
2	Armchair	6.89	4.67	2.75
3	Clerk Table	30.15	20.41	12.03
4	Junior Executive table	45.92	31.09	18.32
5	Single Bed	44.79	30.33	17.87
6	Ordinary Chair	5.58	3.78	2.23
7	Double Bed	71.4	48.34	28.48
8	Ordinary Table	37.94	25.69	15.14
9	Conference Chair	4.56	3.08	1.82
10	Dining Chair	6.43	4.35	2.57

Actual labour hours utilized for selected items in July 2010 had decreased significantly as compared to May 2010 and June 2010. But we were unable to identify any reason for such high decrease in the labour hours per unit due to the unavailability of information.

We were unable to compare the actual labour hours per unit with the standard labour hours per unit due to the lack of information on the standard labour hours required.

Labor utilization

The actual labour hours available in the cutting and machine sections of the KFMP from May 2010 to July 2010 are as follows.

Section	May	June	July
Cutting	1,311	1,551	1,603
Machine	1,727	2,043	2,369
Labour hours available	3,038	3,594	3,972
Idle labour(cutting and machine only)	1,331	1,897	2432
Idle labour as a percentage	44%	53%	61%

Actual labour hours in July 2010 had increased by 20 percent when compared to June 2010 and actual labour in June 2010 had increased by 15 percent when compared to May 2010. The total production in July 2010 increased by 64% when compared to June 2010 had the total production in June had increased by 90 percent when compared to May.

Main reason for such idle labour hours could be attributed to the absence of proper production plan.

Implications

- Idle labour had resulted in an additional cost to the furniture item
- Available labour is more than necessary compared with the labour requirements of the factory
- Motivation level will be reduced
- Adverse influence of the idle labour on the other labour
- Increase of per unit additional cost
- Idle labour will result labour unrest and trade union actions

Recommendations

- Proper production planning system which include job cards should be introduced for each item produced
- Introduction of a bonus / incentive scheme based on the performance of the workers
- Performance of the workers should be monitored monthly and prompt feedback should be provided and action should be taken on staff who are not performing up to the standard
- Production process should be planned in such a way to fully utilize the available labour
- Required skills should be identified and necessary training should be introduced

Machinery

Observations

We have computed the actual machine hours in respect of selected items by using the following formula.

$$\text{Actual machine hours for a selected item} = \left[\frac{\text{Total actual machine hours for the relevant month}}{\text{The total actual units of timber utilized (cubic decimeters) in that month}} \right] \times \text{Number of cubic decimeters of timber attributable to a particular item}$$

	Furniture Item	Actual machine hours per unit (Cutting and machine sections)		
		May 2010	June 2010	July 2010
1	Lecture Hall Chair	2.09	1.01	0.49
2	Armchair	1.83	0.88	0.43
3	Clerk Table	7.99	3.85	1.89
4	Junior Executive Table	12.16	5.87	2.88
5	Single Bed	11.86	5.72	2.81
6	Ordinary Chair	1.48	0.71	0.35
7	Double Bed	18.91	9.12	4.48
8	Ordinary Table	10.05	4.85	2.38
9	Conference Chair cushioned	1.48	0.71	0.35
10	Dining Chair	1.7	0.82	0.4

Actual machine hours per unit for the selected items had decreased significantly from May 2010 to July 2010. But we were unable to identify any reason for such high decrease in the machine hours per unit due to the unavailability of information.

We were unable to compare the actual machine hours per unit with the standard machine hours per unit due to lack of information on the standard machine hours required.

Machine utilization

Month	Maximum machine hours available (A)	Actual machine hours utilized (B)	Idle machine hours (A-B)
May	3,480	1,185	2,295
June	4,060	1,089	2,971
July	4,263	875	3,388

In July 2010, actual machine hours had decreased by 20 percent when compared to June 2010 and actual machine hours in June 2010 had decreased by 8 percent compared to May 2010. The total production in July 2010 had increased by 64 percent compared to June 2010 and the total production in June 2010 had increased by 90 percent compared to May 2010.

The utilization of 06 of the machines had been less than 15 hours per machine during the first half of the year 2010.

Most of the machines had not been utilized up to their maximum capacity although they are in good working condition.

The reasons for idle machine hours

- Lack of a production plan
- Lack of competent machine operators

Implications

- Idle machine hours will lead to increase the cost of production and efficiency impairment and decrease resource utilization
- Impairment of machines due to idling (depreciation of machinery without accruing any benefit)

Recommendation

Proper production planning system should be introduced for the optimum utilization of machines effectively and efficiently.

STC Response

- Material wastage, idle labour and idle machine hours are inevitable in any Department/Organization or Corporation worksite. However this is minimal in STC due to various control measures adopted by the Management.
- STC Management introduced an Information system to monitor resource utilization, production and financial progress. STC is now testing the ERP computer system which will monitor resource utilization, production and order completion online.
- The costing system introduced to production divisions will identify the resource utilization viz. labour, materials, machinery, the variable as well as direct costs and will help the Management to effectively monitor the cost and utilization of resources for production processs and will enhance productivity and profitability.
- STC will take steps to examine and take corrective action to rectify the deficiencies indicated in the report regarding wastage of timber, and introduce the 5S system as recomended.
- However we do not agree with your contention of idle machine hours due to machines not been operated to their maximum capacity. The machines will be operated as and when required depending on the available resources.
- As regarding the location and physical infrastructure of the whole complex STC has already taken action to relocate the facilities in Kaldemulla complex according to just-in-time system which will assist to enhance productivity and profitability.

Part - III

3.11 Assess Compliance with the Guidelines on Procurement Procedure

Observations

The KFMP should comply with the Procurement Guidelines and the Procurement Manual of the Government. We observed the following deficiencies in relation to the procurement procedures.

- In the case of polishing materials, quotations had not been called for as specified in the Procurement Manual. The KFMP had continued to purchase polishing materials over and over again up to March 2010 on the basis of approval given by the AGM (Kaldemulla) on 21 July 2008 based on 3 quotations.
- Interviews conducted with the painters of the KFMP revealed that the materials supplied did not conform to standard quality.

After mid March 2010, the procurement of polishing materials had been taken over by the Head Office on behalf of the KFMP

- In the case of hardware items, 5 open quotations had been called from suppliers operating in the locality of the KFMP. In most instances, quotations had been obtained from the suppliers informally by an employee of the factory. This procedure continued up to the date of audit.
- We noted instances where purchases had been made by splitting the total value to avoid authorization limit of the Rs.25,000 being exceeded.
- With regard to the purchases made through the head office during the year 2010, it was observed that an overpayment of LKR 324,000 had been made due to the selection of quotations other than the lowest. It was further observed that samples had not been checked before making purchases for the year 2010

Implications

- Non-compliance with the specified procurement procedures will lead to transactions which are not economical to the KFMP
- Failure to maintain standard quality of finished products
- Excess payments made to the suppliers when high quality products can be purchased at lower prices.
- Health conditions of the workers could be affected by procurement of materials not conforming to standards.

Recommendations

- Strict compliance with the Procurement Guidelines and Procurement Manual by the Management.
- Arrangements should be made to check the quality of materials purchased.

STC Response

STC Management has given instructions to strictly comply and follow Procurement Guidelines when procuring goods and services. The Management will note the observations reported in Clause 3.11 and take follow up action.

3.12 Absence of Recruitment Policy

Observations

We noted that there is no approved recruitment policy for STC. Absence of such policy had led to enroll excessive unskilled labor deployed without considering labour requirements of the KFMP. As a result, we further noted the following;

- Certain employees hired as carpenters had been engaged in other functions such as assistant machine operators and timber selectors;
- Even though about 16 carpenters are employed, only 4 are engaged in the carpentry work;
- A Factory Manager had not been appointed and the duties of the Factory Manager had been entrusted to the costing officer who does not possess the skills to manage a factory;
- No Quality Assurance Officer is employed at the factory. Therefore, no quality control process is being practiced by the KFMP;
- Most of the workers had not been given sufficient training. Eighteen workers had been trained for three months and four had been trained for three days. Further we noted that some workers are entrusted with work for which they have not been given proper training.

Implications

- As a result of ad hoc recruitment practices (due to lack of policy) unskilled employees have been recruited by the management. Non-existence of a training, development, structure and training need analysis process had also contributed to the inefficiencies of the factory. This has resulted in inefficiencies in all sections (reduction in the productivity and producing low quality products)
- Unavailability of a Quality Assurance Officer and quality control process had led to the production of inferior quality furniture

Fifty dining chairs sold to Police Headquarters on 12 August 2010 returned on 13 August 2010 due to inferior quality can be cited as an example.

Recommendations

- Introduction of a recruitment policy, approved cadre and a Scheme of Recruitment should need urgent attention.
- Factory cadre should be reviewed on regular basis and recruitment should be made in line with the approved cadre
- Training need should be assessed on regular basis and all workers should be provided on the job and classroom training where necessary
- Quality assurance function should be established by employing a qualified Quality Assurance officer who has experience in quality assurance in relation to furniture manufacturing

STC Response

3.13 Ownership and Utilization of Land and Buildings

Observation

The ownership of the land and building at Kaldemulla was vested to the STC by the Gazette Notification No.14879 dated 7 November 1969. However the land and buildings at Kaldemulla are stated at historical cost and they have neither been revalued nor reflected at the market value in the books of account of STC.

Total area of the land is 3.26 hectares of which a larger part is not utilized effectively. Although adequate space is available, management has not taken any steps to build stacking sheds to store the seasoned timber which have been stored outside the seasoning plant without any shelter. (The seasoned timber are being exposed to elements and therefore the quality of the timber deteriorates).

The pictures below show instances where season timbers are being stacked exposed to elements.



We further observed that finished product of furniture have been stored in areas which are not suitable to store finished products (dust and pollutants are commonly presents where the finished products are stored). Discussion with the factory workers revealed that these finished products have to be re-polished in most instances when they are sold.

Implications

- Value of Land and buildings of the KFMP are understated in the books of account of STC
- Storing in areas which are not conducive to seasoned timber and finished products could lead to quality deterioration and financial losses (auctioned at prices which are disadvantageous to the KFMP)
- Ineffective use of land and buildings could deprive the KFMP from the opportunity of utilizing the land for the profitable ventures (such as expansion of manufacturing plant, new ventures to sell seasoned timber to the outside customers)

Recommendations

- Take immediate actions to survey and revalue the land and buildings and adjust the books of account to reflect current market value
- Assess the required storage facilities and take action to construct additional storage facilities
- Assess the alternative use of available land and buildings to generate alternative sources of income to the KFMP

STC Response

Under the just-in-time relocation of facilities in complex area, and the construction of new showroom ineffective usage of land and buildings will be rectified.

3.14 Non-compliance with Guidelines of Good Governance Practices issued by the Department of Public Enterprises

Observations

Reference Public Enterprise Observations
Circular No.PED 12 of 02 June
2003

Section: 3.2
 Composition of the Board Board of Directors consists of 7 members, comprising the Chairman, Working Director, Conservator General of Forest, Treasury representative and three other Board Members.

Sections 3.6(a)

Ensure that Board policies are executed in the same spirits as it was framed and in the best interest of the institution and the public at large There was no evidence that the Board of Directors had reviewed the requirements of the guidelines as against the procedures in place at the KFMP and the actual procedures implemented so as to assure satisfactory compliance with the guidelines

Section (b)

Monitor the activities of management by means of management information reports and evaluate performance, to ensure that the enterprises on track in its operations.

Section (c)

If results do not match desired expectations, take remedial actions without delay to ensure that those are achieved
 Section 4..2.2

The Board should periodically review its corporate plan, budget and performance to ensure that actual performance is in line with the plan and take timely remedial action, if wide discrepancies are observed and wherever necessary revised the plans/budget. Monthly meetings had not been conducted on regular basis during the year 2009 and 2010.Threfore, Board had not taken timely remedial actions to avoid discrepancies.

In addition we observed that the KFMP doesn't prepare annual budgets and measure its performance against the budget regularly.

The financial statement furnished for audit in the previous years had disclosed an overall negative position of all the showrooms maintained by the corporation.

However, on our request the factory management prepared the following financial information to isolate the financial performance of the Kaldemulla Complex.

It is imperative that monitoring should be done at frequent intervals so as to hold Senior managers responsible for their assigned functions and also ensure that transparencies achieved.

Yea	Loss LKR Mn	Sales LKR	Productio LKR Mn	Administrativ LKR Mn
2007	21	22,8	23.8	20.00
2008	11	22.9	8.6	25.30
2009	29	21.7	25.3	25.40

The Unit had incurred countable losses due to the insufficient sales volums, increase of cost of production and increase of administrative costs compared with those of the previous years.

Section 5.1.2

Action Plan clearly identifying the responsibilities of managers with goals and targets to be achieved during the plan period

Even though the Corporate Plan is in existence, we observed that some of the key proposals contained in the plan had not been carried out by the management as shown below:

- To increase production and competitiveness of furniture and other wood based products;
 - Appoint a Committee to prepare project proposal, repair and expansion of factory buildings, electrification and procurement, install machines, train the skilled and unskilled employees. Recruit a Quality Assurance Officer and 2 Quality Assurance Assistants and a Production Manager to the KFMP.
- To improve operation efficiency of furniture show rooms;
 - It is suggested to construct show rooms at Moratuwa ; and
 - carry out a feasibility study.
- To develop strategic partnership with furniture association and 10 private producers in next 5 years.

The Annual Action Plan for the year 2008, 2009 and 2010 had been prepared, indicating only the objectives relating to production and sales of timber whilst attention had not been paid to the other objectives such as production and marketing of furniture setout in the Corporate Plan.

Implication

- Non compliance with the circular and other governance requirements issued by the Department of Public Enterprises.
- KFMP had failed to achieve its goals and objectives due to the failure to follow the Corporate Plan.
- In the absence of stipulated targeted in the Corporate Plan prepared for the period 2008-2012 and absence of Annual Action Plan was not possible to evaluate the actual performance.

Recommendation

The Board of Directors should take early steps to comply with the corporate governance guidelines specified in the Public Enterprises Circular No. PED 12 of 2 June 2003.

STC Response

Part - IV

3.15 Environmental Impact

Observations

- In terms of Section 18, Part C of the Notification published in the Gazette Extraordinary No 1533/16 dated 25 January 2008 published under the National Environmental Act No. 47 of 1980, a license is required to carry on the operations of a sawmill having a milling capacity of not less than 50 cubic meters per day.

However, we observed that STC had not obtained this license to Kaldemulla sawmill as required by the Notification published in the Gazette Extraordinary.

- In accordance with Section 23 A of Part IV A-(Environmental Protection) of National Environmental (Amendment) Act No 56 of 1988 and National Environmental (Amendment) Act No. 53 of 2000, discharge, emission or deposits of waste into the environment are prohibited. Further, in terms of Section 64, Part A of the notification in the Gazette Extraordinary No 1533/16 dated 25 January 2008 a license is required for industries involved in chemical treatment and preservation of wood excluding boron treatment.

According to the letter issued by the CEA dated 03 September 2010, the Manager of the KFMP had submitted an application for the renewal of the license to the Western Province - CEA on 13 September 2010. KFMP had not received any response from the CEA regarding the renewal of the license as at the date of concluding the audit field work, on 30 September 2010. Although the application for renewal of the license should be submitted to CEA 3 months prior to the date of expiration, the KFMP had not complied with that requirement.

- License obtained for the period 18 August 2010 to 17 August 2011 in terms of Section 64 of regulations in Part A of the Notification in the Gazette Extraordinary No 1533/16 dated 25 January 2008, the following additional terms and conditions had been specified
 - The storm water drain should be separated from the timber treatment area in order to stop any overflow or contamination by creosote / furnace oil. However we observed instances where creosote / furnace oil are stored and used negligently in the premises. As depicted in the photograph below creosote barrels are stored in an open area exposed to elements.



Since these are dangerous chemicals materials, proper precautions should be taken in storing the barrels of creosote to avoid any accident and spillages into the soil causing contamination.

- The floors of timber treatment area and the treated timber storage area should be well cemented with provision to collect any spillage or accidental discharge in order to prevent pollution of ground surface or underground water

It was observed that this requirement had not been complied with by the KFMP as creosote spillage and discharge from the treatment area had spread and contaminated the surrounding

land area. It is evident that creosote had directly absorbed into the soil and ground water and also overflowed to the storm water drain as depicted in photographs below.



- Environmental Protection License obtained on 30 August 2010 in terms of Section 23 B of the National Environmental Act No. 47 of 1980, the following additional terms and conditions had to be complied with;
 - Sawdust should be stored in a temporary shed until disposed from the site
 - It is necessary to follow the rules and regulations stipulated in the Factories Ordinance and its Amendments in relation to the health of the workers of the factory
 - In terms of Section 12(1) of Factories Ordinance No 45 of 1942 effective and suitable provision should be made for the circulation of fresh air in each working room with adequate ventilation in the room as far as practicable
 - Approval of the Dehiwala – Mount Lavinia Municipal Council had not been obtained for the operation of the factory and the Sawmill
- It was observed that sawdust had been disposed of to the open ground without disposing of them under proper condition as required by the National Environmental Act.
- We also observed that workers at the KFMP were not wearing adequate protective gear such as dust masks and protective helmets while engaging the work.

The photographs below depict an instance where workers operate a machine without wearing protective gear.



Implications

- Failure to comply with the environmental regulations, industry best practices, health and safety measures in storing, disposing of and handling harmful chemicals (creosote/ furnace oil), sawdust and by not conducting the factory activities in accordance with the requirement of the Factories Ordinance, the KFMP and the STC could be exposed to potential legal implications

Recommendations

- The floors of the timber treatment area, treated timber storage area and the creosote barrels storage area should be well cemented with provisions to collect any spillage or accidental discharges in order to prevent pollution of ground surface or underground water. Further creosote barrels should be stored in a protective storage area
- Take steps to dispose of waste material (sawdust) according to the regulations
- Make arrangements to provide adequate ventilation and light inside the factory and safety gear to the workers
- Obtain the approval from the Dehiwala- Mount Lavinia Municipal Council to operate the factory and sawmill
- Unusable machines, components and partly assembled and obsolete furniture should be removed from the factory premises and 5S concept should be introduced.
- Take necessary steps to prevent emission of dust to the environment or sell the sawdust without carelessly disposing of to the environment

STC Response

Part - V

General observations

3.16 Lack of coordination and planning among different Sections of Factory, Sawmills and Seasoning Plant

Observations

In relation to the coordination and communication among the sawmill, factory and seasoning plant, following observations were made;

- Factory requests timber from the sawmill based on its production requirements and specifications. In doing so, factory does not check the availability of seasoned sawn timber at the seasoning plant. This will often lead to additional timber being sawn and issued to the seasoning plant despite similar quantities of seasoned timber being available at the seasoning plant, thus leading to ineffectiveness and inefficiencies in operations and the waste of material

Factory often does not communicate the timber requirements clearly to the sawmill. As a result sawmill supply timber which do not meet the requirement of the factory. Finally such timber ended up as waste

- In addition, to timber been cut and sawn for the specifications of the factory, sawmill supplies additional timber to the seasoning plant in order to meet the production targets.

Very often such, these excess timber is sold by auction at a lower rate or end up as waste without being used in the production process

Implication

Lack of coordination and communication among the various sections could lead to inefficiencies and ineffectiveness in the operations resulting in losses of the KFMP.

The auction sale of sawn timber during the period 2007 to 2010 on the grounds that those cannot be used to produce furniture items due to unpopular sizes or deterioration due to exposure elements can be cited as an example.

It was revealed that 18 lots of timber (teak, satin, jak, mahogany, grandis, micro, pinus etc.) with a book value of LKR 1,215,891 had been auctioned for a sum of LKR.193,900 during the period 2007 to 15 September 2010 thereby incurring a loss of LKR.1,021,991.

Recommendations

- Proper production planning process should be introduced and communications and coordination among the sections should be strengthened
- Clear instructions on the sizes and categories of sawn timbers required to be issued to the seasoning plant should be issued to the sawmill.
- Before placing an order with the sawmill, factory should check the availability of the timber with the seasoning plant.

STC Response

3.17 Lack of proper procedure to identify the logs for sawing

Observation

We noted that the employees at the sawmill do not identify suitable logs when planning the sawing process.

The factory normally requires logs 3 feet in circumference for its use. Nevertheless we observed instances where logs of larger circumference being sawed by the mill, thus resulting in production of timber unfit for use by the factory. Such timber remained idle in the stores.

Implication

Timber Logs over 3 feet in circumference can be sold by Depots at a higher prices and issue of such logs for factory purposes is considered as a waste of resources.

Recommendation

The timber requirement of the factory should be planned properly, cut and sawn strictly according to the requirement of the factory to prevent waste.

STC Response

3.18 Unrealistic Production Targets set by STC

Observations

- A special team consisting of the Marketing Manager, Production Manager and Management Accountant of STC sets production targets to sawmill and furniture factory

We observed that in order to achieve the targets, sawmill has been sawing the timber both in popular and unpopular sizes even without requests for such timber from the furniture factory.

These unpopular sizes are rarely used by the factory and accumulate at the seasoning plant and subsequently auctioned at lower prices, thus resulting losses to the KFMP.

The auction sale of 22 lots of different categories of timber (teak, satin, mahogany, micro, jak, grandis, kumbuk, pinus, etc.) costing Rs. 1,241,396 for Rs.145,800 in May, June and September 2010 causing a loss of Rs.1,095,596 can be cited as an example.

We also observed that 17 lots of good quality timber valued at Rs. 1,083,676 offered at the auction remaining unsold due to very low bids received.

- Similarly, the factory also produces furniture not in demand or supported by orders just to achieve the targets. Large quantities of such fully or half assembled and finished products are kept in disarray in the stores. Such practices result in damage and waste. The photographs below depicts clearly the unsatisfactory state of affairs..





Implication

Ineffective planning in the cutting of timber and production of furniture could lead to waste of resources and finally financial losses to the KFMP.

Recommendation

Proper production planning and realistic targets compatible with market demands should be introduced to the sawmill and the factory.

STC Response

3.19 Proper Stock Records are not maintained at the Seasoning Plant

Observations

- We observed that updated/proper stock records are not maintained at the seasoning plant to regulate the receipts and issues of timber
- Further, no proper stacking system is maintained at the stores and no proper storage facilities are available for the seasoned timber which is stored outside the seasoning plant, exposing them to elements resulting in the impairment of timber.

Implications

- It is difficult to identify the timber category and sizes available in the seasoning plant stores due to the poor record maintenance practices adopted by the seasoning plants
- Inadequate and improper storage of seasoned timber could impair the timber and would require further seasoning at additional cost.

Recommendation

Management need to construct new stores for the seasoned timber to store them in a proper manner and need to introduce a proper system to maintain a complete and updated stock ledger at the seasoning plant.

STC Response

3.20 Conduct of stock verification at the seasoning plant as at 31 December 2009

Observation

We noted that a physical verification had not been conducted to verify the stocks held at the seasoning plant as at 31 December 2009. Instead book balances had been accounted as the physical balances.

In the circumstances, we requested the KFMP management to conduct a physical verification of entire stocks along with the officers of STC during the period from 12 August 2010 to 06 October 2010. After completing the verification, physical stocks at seasoning plant were valued at LKR 5,522,777. That valuation, as compared with the value according to book balances amounting to Rs. 6,851,477 revealed that the actual value of stock as at that date was less than the book balances by a sum of Rs. 1,328,700.

Implication

Failure to carry out physical verifications at regular intervals and at the end of each financial year, adjusting the books and investigating the discrepancies could result in-

- a) Confirmation of discrepancies without been detected and revealed; and
- b) Understatement/ overstatement of the value of stocks and profit/ loss in the financial statements.

Recommendation

Physical verification of stock at each location should be performed at regular intervals and at the end of each financial year in the presence of auditors wherever possible. Action should also be taken to investigate any discrepancies with a view to taking immediate action.

STC Response

3.21 Use Sawn Timber Offcuts for the Boiler

Observation

We observed that the sawn timber offcuts which can be used to produce the various components of furniture had been used as firewood for Thermal Firewood Boiler in the seasoning plant.

Photographs below illustrate such timber offcuts being stacked near the boiler.



Implication

Use of quality timber offcuts which could otherwise be used to produce furniture as firewood could lead to uneconomical use of resources and finally add to the losses incurred by the KFMP.

Recommendation

A proper system should be introduced to sort timber offcuts before using those as firewood for the boiler.

STC Response

3.22 Unused Timber Logs in the KFMP

Observation

We noted that in certain instances, management of KFMP visits Depots and request Depot- offices to send timber logs / sawn timber to the KFMP. These timber logs are stored in the KFMP without being used as order had been placed indiscriminately.

Implication

Leaving timber logs and sawn timber without being used in the production of furniture or without being transferred to Sales Depots could lead to decay or impairment.

Recommendation

Timber should be ordered according to a specific plan and use in the production of furniture rather than keeping them idle. Order for timber should be limited only to those categories needed for the production process of the factory.

STC Response

Part - VI

3.23 Transfer of Finished Goods from the Furniture Factories even without Orders from Showroom

Observations

- Furniture factories at various locations manufacture furniture without a proper sales plan. As a result, showroom receives furniture from the factories despite the lack of demand for such furniture.
- A review the stock list at Rathmalana showroom as at 31 July 2010 revealed the following;
 - Twenty percent of the value of stocks as at 31 July 2010 comprised the items received from Ampara and some of those items had not moved for a long period.
 - Seventy seven items of furniture received before the year 2000 still remain in the showroom

Implications

Producing without a proper sales plan and finally holding the finished products at showroom will lead to economic resources being unnecessarily held in stocks indicates the inefficiency of sales promotions.

Photographs below depict instances where excessive stocks of finished goods are being stored at the showroom.



Recommendations

Showroom should not be overcrowded with finished goods as it is not a pleasant environment for discerning customers. The management should ensure that finished goods needed for an eye-catching display only should be displayed to the showroom. Adequate storage space should be made available to store for finished goods and as a marketing strategy customers could be invited to such stores to select their items.

STC Response

3.24 Inspection of Furniture Stocks received at the Showroom

Observation

The showroom staff do not use their discretion in accepting goods received from the factories. We observed many partly assembled and unfinished goods in the stores. Normally such goods should have been returned to the factory concerned.

Implication

Acceptance of partly assembled or unfinished products by the showroom staff reveals poor sales promotion and marketing strategies.

Recommendation

The showroom staff should be given thorough training in the sales, marketing strategies and showroom management.

STC Response

3.25 Recognition of Work-in-progress Inventory

Observations

Work-in-progress inventory should consist of components and partly finished goods. However, we observed KFMP does not value partly finished goods as a part of work-in-progress stock due to proper records not being maintained at the factory.

Implications

As result of considering partly completed components as a part of work-in-progress, inventory balance is understated and loss for the year is overstated.

Recommendations

- Proper records should be maintained to capture the inventory
- Partly finished goods should be valued as a part of work-in-progress

STC Response

3.26 Places orders on outside contractors for items of furniture for which there is no demand

Observation

We noted that the KFMP places orders on outside contractors for items of furniture for which there is no demand. A payment of Rs.1,487,173 had been made to three contractors during the period from January 2009 to 31 July 2010 for assembling and polishing furniture for which there was no demand. This had resulted in the overcrowding of finished products in the stores.

It was also observed that the furniture manufactured by private contractors were of low quality. The return of 50 out of the 500 lecture hall chairs sold to the Department of Police can be cited as an example.

Implications

- Working capital is tied up in a large stocks of finished goods remaining in the factory and the showroom.
- Absence of proper quality control exercised on the work performed by contractors had resulted in sales returns
- Due to inadequate storage facilities finished products had been allowed to be exposed to elements resulting in deterioration of quality
- Loss of reputation

Recommendations

- KFMP should place orders on the outside contractors only if there are orders which cannot be met at the factory due to unavoidable reasons.
- Furniture supplied by the outside contractors should be subjected to the standards quality tests.

STC Response

Part - VII

04. Audit Conclusions

The operations at KFMP are not conducted efficiently, effectively and economically and in an environmental friendly manner. The significant inefficiencies and uneconomical operations as summarized below had led to the operations of KFMP in commercially and financially non-viable manner over the years;

- Selling prices of furniture set below the current market prices;
- Standard cost of furniture is not realistic and has not been revised over a long period;
- The plant is not operated at an optimum sales mix (beyond the break-even sales level);
- Non-maintenance of the showroom as a centre attractive to customers;
- Lack of marketing strategy, action plan and trained staff;
- Inefficiencies such as material wastage, idle labour and machine hours;
- Uneconomical procurement of raw materials and failure to follow Procurement Guidelines;
- Ineffective usage of land and buildings specially the idle lands not been used to provide protective storage stores facilities which is a pressing need: and
- Environmentally harmful conduct of manufacturing process.

Set out below are the Auditor General's recommendations for remedial action.

- Determine the cadre, formulate scheme recruitment, recruit skilled and experienced workers and obtain approval in order to utilize manpower and machinery at optimum level and effectively and efficiently.
- Standard costing structure should be revised in line with the current market prices and set furniture selling prices by considering the current cost structure and competitive market prices.
- KFMP should also consider introducing a sales system with automated pricing, and invoicing procedures in place of the manual procedures followed at present.
- KFMP should identify the most profitable product mix with market demand that providing a positive contribution to the business within the available resource limitations.
- Modernize the showroom and operating hours of the showroom should be extended to attract customers who prefer to shop after office hours and in the weekends.
- KFMP and Marketing Division of STC should develop a comprehensive and appropriate marketing plan and should conduct its marketing activities in accordance with the developed plan.
- Economize the advertising expenses in keeping with the projected sales and prevent violation of management decisions relating to the composition of packages when they are offered to the customers.
- All staff who are engaged in the factory and showroom should be given formal training. Training need should be assessed on regular basis and all workers should be provided on the job and classroom training where necessary.
- Performance of the workers should be monitored monthly and prompt feedback should be provided and action should be taken on staff who are not performing up to the standard. Bonus / incentive scheme should be introduced based on the performance of the workers.

- Management Information System (MIS) should be introduced to produce accurate and timely information for monitoring and strategic decision making in relation to the performance of KFMP.
- Showroom needs to assess its demand in advance and make requests from the factories based on such demand.
- Factory should have a proper production plan which includes job cards where the key managers (head of showroom, head of sawmill, head of seasoning plant and head of factory) should be involved with planning process. Proper production planning and realistic targets should be introduced to the sawmill and the factory.
- The timber requirement of the factory should be planned properly, cut and saw timber according to the plan to be efficient and effective in the production process rather than keeping as them idle stocks. Further, proper system should be introduced to sort timber before them being used as fire wood to the boiler.
- Before placing an order with the sawmill, factory should check the availability of the timber with the seasoning plant.
- Sawmill should be given a plan to dispatch the sawn timber to seasoning plant after arranging the timber according to the sizes and categories.
- KFMP should give orders to the outside contractors only if there are excess orders which cannot be produced at the factory due to shortages of labour or machine hours..
- Management need to strictly comply with the specified Procurement Guidelines.
- Quality assurance function should be established by employing a qualified Quality Assurance Officer who has experience in quality assurance in relation to furniture manufacturing at the plant and work carried out by outside contractors as well.
- The floors of the timber treatment area, treated timber storage area and the creosote barrels storage area should be well cemented with provisions to collect any spillage or accidental discharges in order to prevent pollution of surface or underground water. Further creosote barrels should be stored in protective storage area.
- Take necessary steps to regularize emission of dust to the environment or sell the sawdust without carelessly disposing to the environment
- Make arrangements to provide adequate ventilation and light inside the factory and safety gears to the employees.
- Non-usable machines, unusable components and partly assembled and obsolete furniture should be removed from the factory premises with introduction of 5S system to improve infrastructure and minimizing the wastage.
- Management need to construct new stores for the seasoned timber to store them in a proper manner and need to introduce a proper system to maintain a stock ledger at the seasoning plant.
- Proper records should be maintained to capture the inventory and physical verification of stock at each location should be performed preferably with the auditor as observers at each critical period end date and stock records should be adjusted to reflect the physical stock balances.
- Partly finished goods should be valued as a part of work-in-progress.
- Take immediate actions to survey and revalue the land and buildings and adjust the books of account to reflect current market value

STC Response

We have taken note of the recommendations for remedial action proposed by Auditor General in this Report, and wish to inform you that we have already taken action to implement the applicable relevant recommendations.

Once again we express our sincere appreciation for this Performance Audit conducted on affairs of the Kaldemulla Furniture Manufacturing Plant and for your valuable recommendations to increase the productivity and viability of the Kaldemulla Furniture Manufacturing Complex.

Key acronyms

AG' s D -	Auditor General's Department
STC	- State Timber Corporation
DGM	- Deputy General Manager
HR	- Human Resources
KFMP	- Kaldemulla Furniture Manufacturing Plant
CEA	- Central Environmental Authority