State Development and Construction Corporation – 2015

The audit of financial statements of the State Development and Construction Corporation (SD&CC) for the year ended 31 December 2015 comprising the statement of financial position as at 31 December 2015 and the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information, was carried out under my direction in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with Section 13(1) of the Finance Act, No. 38 of 1971 and Section 29 (2) of the State Industrial Corporation Act, No. 49 of 1957. My comments and observations which I consider should be published with the annual report of the Corporation in terms of Section 14(2) (c) of the Finance Act appear in this report.

1.2 Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards and for such internal control as the management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

1.3 Auditors' Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with Sri Lanka Auditing Standards consistent with International Auditing Standards of Supreme Audit Institutions (ISSAI 1000-1810). Those Standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Sub-sections (3) and (4) of Section 13 of the Finance Act, No.38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the audit.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

1.4 Basis for Qualified Opinion

My opinion is qualified based on the matters described in paragraph 2.2 of this report.

2. Financial Statements

2.1 Qualified Opinion

In my opinion, except for the effects of the matters described in paragraph 2.2 of this report, the financial statements give a true and fair view of the financial position of the State Development and Construction Corporation as at 31 December 2015 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Financial Statements

2.2.1 Comply with Sri Lanka Accounting Standards (LKAS/ SLFRS)

The following observations are made.

(a) LKAS 01- Presentation of Financial Statements

The unusual credit balances in construction debtors and, salaries and wages advance account amounting to Rs. 39,802,226 and Rs. 1,384,951 respectively had been set off against its debit balances and an unusual debit balance of Rs. 84,429,049 in the mobilization advance received from clients had been set off against its credit balance as at 31 December 2014 in contrary to the provisions in the Standard. Therefore, the current liabilities and current assets shown in the statement of financial position as at 31 December 2015 had been understated by similar amounts.

(b) LKAS 08 – Accounting Policies , Changes in Accounting Estimates and Errors

As the useful life of non-current assets had not been reviewed annually as mentioned in accounting policies, 1,440 items of fixed assets costing Rs.331,051,319 were further being used although they were fully depreciated.

(c) SLFRS 10 - Consolidated Financial Statements

Consolidated financial statements had never been prepared by the Corporation even though Devcoshowa (Pvt) Ltd is fully owned Subsidiary of the Corporation.

(d) LKAS 11 – Construction Contracts

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According to Paragraph 12 of the Standard, the amount of contract revenue may decrease as a result of penalties arising from delays covered by the contractor in the completion of the contract. As per the information received, two clients had deducted the delay charges amounting to Rs.117,672,342 from the payments made to the Corporation (contractor) in time to time. However, that amount had been accounted as receivable without having substantial evidence for receiving. Further, the delay charges of Rs.87,587,852 related to the projects that were not in operation during the year under review and completed and handed over during the previous years had been shown as receivables in the financial statements for the year under review. It was revealed in audit that, it is not prudent to accounts such delay charges as receivables.

(e) LKAS 16 – Property, Plant and Equipment

Although an item of property, plant and equipment are revalued, the entire class of property, plant and equipment to which assets belongs should be revalued. Nevertheless, only 86 machineries and motor vehicles received from then Ministry of Economic Development had been revalued during the year under review. Further, an independent valuer had not been involved in revaluation process of such assets.

2.2.2 Accounting Deficiencies

The following accounting deficiencies were observed.

(a) A loss of Rs.5,522,844 relating to 04 projects and a profit of Rs.18,886,039 relating to another 04 projects for which had not been arisen operations of the year under review had been adjusted to the profit of the year under review without being accounted retrospectively.

(b) A sum of Rs.394,934 had been credited to depreciation while an amount of Rs.889,623 and Rs.1,040,750 had been debited to interest income and revenue on ongoing projects respectively for the year under review in view of correcting prior year errors without being adjusted retrospectively.

(c) According to the financial statements presented the carrying amount of property, plant and equipment was Rs.1,483,744,618. However, a sum of Rs.1,475,722,733 had been taken as carrying amount of property, plant and equipment for the computation of differed tax liability. Hence, income tax expenses and differed tax liability for the year had been overstated and understated respectively by Rs.962,626.

(d) An expenditure of Rs.413,537 incurred on repair and maintenance of machineries and equipment had been erroneously debited to fuel deposit account in 2011. However, steps had not been taken to adjust the accounts even in the year under review.

(e) Economic Service Charges (ESC) and surcharges thereon aggregating Rs.7,588,898 payable as at the end of the year under review had not been brought to the financial statements. Hence, ESC payable balance and surcharges payable had been understated by same amount.

(f) According to the assessment notices received during the years 2014 and 2015, a sum of Rs.103,142,189 had to be paid as surcharges on Value Added Tax (VAT) as at the end of the year under review. However, only a sum of Rs.22,794,701 had been provided as surcharges on VAT in the financial statements. Further, surcharges on Nation Building Tax (NBT) amounting to Rs.570,828 had not been taken into accounts as at the end of the year under review.

2.2.3 Un-reconciled Differences

When comparing the balances shown in the financial statements with the corresponding balances of the relevant schedules, differences of Rs.400,102,193 were observed. Details are shown below.

Item	**Balance as per the Financial Statements**	**Balance as per the Schedule**	**Difference**
	Rs.	**Rs.**	**Rs.**
Profit on ongoing projects	480,533,750	492,279,452	11,745,702
Due from customer	1,134,453,828	1,328,932,384	194,478,556
Due to customer	-	189,188,280	189,188,280
Profit on disposal of fixed assets	766,008	576,794	(189,214)
Provision for slow and non-moving stocks	9,564,564	9,663,455	98,891
Tender deposits (Refundable)	199,875	100,000	(99,875)
Refundable deposits	371,909	484,799	112,890
Value Added Taxes	561,051,351	556,862,566	(4,188,785)
Total	**2,186,941,285**	**2,578,087,730**	**400,102,193**

2.2.4 Lack of Evidence for Audit

The following evidence indicated against the each item of account valued at Rs.173,495,156 shown below had not been made available for audit.

	Item of Account	Value	Evidence not made available
		Rs.	
(i)	Debtors – Traffic Light System	9,058,685	Schedules and Age Analysis
(ii)	Prepayments	58,530	-do-
(iii)	Loans and Advances	1,829,736	-do-
(iv)	Advances		
	• Purchase Advance	326,520	-do-
	• Sundry Advance	6,651,193	-do-
(v)	Revalued amounts of Plant and Machineries and Motor vehicles	116,936,543	Certified revaluation report
(vi)	Withholding Tax	38,633,949	Copies of the Withholding Tax Certificates
		173,495,156	
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2.2.5 Accounts Receivable and Payable

The following observations are made.

(a) Out of trade debtor balances relating to Construction Division, a sum of Rs.12,121,011 represented outstanding from Kukuleganga project older than 07 years and a sum of Rs.13,537,401 (excluding debtors of Kukuleganga project and traffic light system) represented debtors older than 03 years. However, no proper action had been taken to recover the above dues.

(b) A considerable delay was observed in Traffic Light System Unit in relation to delivering of bills to respective customers. Hence, out of debtor balance of Rs.65,699,518 in traffic light system, uncertified bills value was Rs.46,735,259 and for 17 projects out of 19 projects completed during the year under review, the bills were sent to respective clients after the year under review. Out of the above debtor balance, a sum of Rs.9,058,685 was remained outstanding for a period of more than 07 years.

(c) Concrete yard debtors amounting to Rs.27,342,601 shown in the financial statements had remained outstanding for more than 03 years as at 31 December 2015.

(d) A building of the Corporation had been given on monthly rent of Rs.1.2 million to a private company for two years period from 01 February 2015 to 31 January 2017. As per the provisions in the lease agreement, rent is to be paid on or before 10th of every month. However, the Corporation had failed to collect the rental of Rs.8, 888,880 receivable from the company as at the end of the year under review.

(e) Out of the purchase advances of Rs.559,739 given by the Head Office, a sum of Rs.305,608 had been older than 06 years. Since the details of advance given were not made available, the recoverability of these advances is in doubt.

(f) Out of mobilization advances of Rs. 385,069,709 received from clients, an amount of Rs.36,334,186 had remained for more than three years without being settled as at 31 December 2015. Out of them Rs. 14,648,421 was remained in the accounts for more than 05 years without being taken any action to settle them.

(g) Out of construction retention payable of Rs.535,993,321 shown in the financial statements, a sum of Rs.240,316,537 had remained outstanding for more than three years. Out of them Rs.93,467,064 was remained outstanding for a period of more than 05 years comprising 35 completed projects.

(h) A sum of Rs.561,051,351 shown in the financial statements as Value Added Tax (VAT) including a penalty of Rs.22,794,701 thereon had to be paid by the Corporation at the end of year under review. No action had been taken to settle them or to wave off.

2.3 Non-compliance with Laws, Rules, Regulations and Management Decisions.

The following instances of non-compliance were observed in audit.

Reference to Laws, Rules Regulations and Management Decisions etc.	Non-compliance
(a) Section 8 (1) of the Finance Act, No. 38 of 1971 and Section 5.2.4 of Public Enterprises Department Circular No. PED/12 of 02 June 2003	Approval for the Board of Directors for the draft budget should be obtained prior to 03 months of succeeding financial year. However, approval for the draft budget for the year under review had been obtained only on 06 October 2015, which is nine months after the year under review.
(b) Section 114 (1) of the Inland Revenue Act, No. 10 of 2006 and Section 8.7 of the Public Enterprises Circular No. PED/12 dated 02 June 2003.	The Corporation had paid a sum of Rs.1,766,606 as Pay As You Earn (PAYE) tax on behalf of salary payments made to its employees without deducting from the salaries of the employees.

(c)	Section 8.8 of the Public Enterprises Department Circular No. PED/12 of 02 June 2003	Approval of the Board should be obtained for the delegation of financial authority, indicating limits of expenditure and no expenditure should be authorized, incurred or paid outside the limits of such delegated authority. Further, such delegation of authority should be updated and approved by the Board at the beginning of each year. However, the Corporation had not complied with those requirements.
(d)	Financial Regulations of the Government of the Democratic Socialist Republic of Sri Lanka	
	- Financial Regulation 395	Considerable delays ranging from 24 days to 146 days was observed in preparing bank reconciliation statements.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Corporation during the year under review, had resulted in a pre-tax net profit of Rs.50,339,247 as compared with the corresponding pre-tax net profit of Rs.112,449,561 for the preceding year, thus indicating a severe deterioration of Rs.62,110,314 in the financial results for the year under review. Increase of employee benefit expenses, surcharges on VAT, repair and maintenance expenses, provision for impairment were the main reasons for this situation.

3.1.1 Value Addition of the Corporation

Even though the pre-tax net profit for the year under review was Rs. 50.34 million, the contribution of the Corporation to the Country during the year under review was Rs. 950.46 million. Further, according to the information made available for audit, it was observed that value addition made by the Corporation had been gradually increased except the year 2013.

3.2 Analytical Financial Review

3.2.1 Significant Accounting Ratios

According to the information made available, some important ratios of the Corporation for the year under review and the preceding year are given below.

Ratios	Year 2014	2015
	Percentage	Percentage
Gross Profit Margin	9.7	6.7
Profit mark up	10.7	7.2
Administrative Cost on Turnover	8.3	5.2
Finance Cost on Turnover	3.6	2.7
Current Ratio	1.04	1.02
Acid Test Ratio	0.9	0.9

The following observations are made in this regard.

(i) In comparing with the preceding year, operating profit of the Concrete Yards and Traffic Light System (TLS) Unit including Asphalt Plants had deteriorated by 139 per cent and 101 per cent respectively during the year under review.

(ii) The TLS Unit and the two Asphalt Plants recorded a gross loss of Rs.228,827,260 and Rs.108,496,320 respectively. The TLS Unit including the Asphalt Plants of the Corporation were running at a gross losses continuously and Concrete Yard had been recorded a gross loss of Rs.15,608,406 for the first time in the year under review.

4. Operating Review

4.1 Performance

No actions and strategies had been taken or identified to perform the following objectives set out in the Corporate Plan prepared for the period 2012-2014.

(a) Investigation, investment, planning, designing, construction operation and management of building, civil engineering, other engineering projects or other ventures in Sri Lanka or abroad, owned by any party, either independently or in collaboration with any local or foreign company and the acquisition and holding of shares in such company.

(b) Execution or supervision of any of the above projects in Sri Lanka or abroad; either independently or in collaboration with any local or foreign firm or company, and the acquisition and holding of shares in such company.

(c) Carrying out of research into construction materials, methods and techniques utilized for the identified purposes.

(d) Achieve a sustainable turnover growth of 30 per cent

4.2 Weaknesses in Financial Management

The following observations are made.

(a) According to the letter No. PED/COP/15(56)/GEN/VOL – I dated 01 July 2013 of the Department of Public Enterprises; the approved overdraft facility was Rs.580 million. However, the Corporation had obtained an overdraft facility up to Rs.664.7 million exceeding the above overdraft facility during the year under review due to absence of proper debt recovery mechanism and working capital management system. An interest amounting to Rs.75.4 million had been paid in respect of these bank overdrafts during the year under review.

(b) Notwithstanding the existence of bank overdraft of Rs.664.7 million as at 31 December of the year under review, fixed deposits, saving deposits totalling Rs.63 million had also been maintained. A sum of Rs.3 million only had been earned from those investments in the year under review.

4.3 Management Weaknesses

The following observations are made.

(a) One of the asphalt plants located at Amithirigala is running at its average production of 100 MT per day that is 17 per cent of its capacity. Hence, its turnover and gross profit had been decreased by 57 per cent and 116 per cent respectively as compared with preceding year. However, no action had been taken by the management to enhance its productivity.

(b) According to the financial statements of the Fujima State Corporation (Pvt) Ltd. a Joint Venture Company, the amount receivable to the Corporation as at 31 March 2010 was Rs. 41,899,490 and no transactions had been taken place thereafter. However, no action had been taken by the management of the Corporation to recover the dues.

4.4 Irregular Transactions

Value Added Tax (VAT) amounting to Rs.15,111,029 had been paid to 05 contractors whose VAT registration had been inactivated by the Department of Inland Revenue during the year 2013.

4.5 Idle and Underutilized Assets

The following observations are made.

(a) Among the Asphalt machineries received from then Ministry of Economic Development, an Asphalt plant valued at Rs.125 million had been located at Polonnaruwa. The production capacity of the plant is 600 Mt asphalt per day. However, this machine and the relevant accessories thereto remained underutilized due to discontinuation of its production after 2014. Further, the Corporation had spent a sum of Rs.876,790 as wages and security expenses during the year under review.

(b) A sum of Rs.113,496 had been remained in a bank account from August 2014 up to the end of year under review without being utilized for any purpose.

4.6 Identified Losses

The following observations are made.

(a) The Corporation had to pay Rs.9,834,605 and Rs.17,265,163 as surcharges on Employee Provident Fund during the year under review and during the preceding year respectively.

(b) Concrete products had not been supplied on time. Therefore, delay charges of Rs.10,103,235 had to be paid by the Corporation for the year under review which is a 60 per cent increase as compared with the preceding year.

(c) As the contract cost had been incurred exceeding the contract value of 09 projects, an accumulated loss of Rs.121,010,326 had been incurred by the end of the year under review. Out of the above project, two projects of which accumulated loss amounting to Rs.44,634,062 were completed at the end of the year under review.

4.7 Contract Administration

The following observations are made.

(a) As failure to adopt a proper methodology in preparation of invoices relating to the Construction Division, there were instances where invoices had been submitted with extremely higher or extremely lower value than the cost and no invoices had been raised even though a considerable cost had been incurred. This situation had given rise to the unusual over calculation and under calculation of the values receivable from and payable to the customer included in the current assets and liabilities.

For an example: -
A cumulative expenditure of Rs.57,358,841 incurred on 06 projects by the Construction Division without issuing invoices.

(b) Out of ongoing projects implemented by the Corporation during the year under review, 44 projects had sustained losses amounting to Rs.223,581,451.

(c) Six ongoing projects with aggregate contract value of Rs.103,629,346 had not been performed since the year 2014.

4.8 Release of Human Resources to other Institutions

Two employees had been released to the line Ministry during the year under review in contrary to the Section 8.3.9 of the Public Enterprises Circular No. PED/12 of 02 June 2003. The Corporation had incurred a sum of Rs.985,861 during the year under review as salaries, wages and allowances on behalf of them.

4.9 Personnel Management

The following observations are made.

(a) The approved cadre as at 31 December of the year under review stood at 475 and the actual cadre stood at 548. Accordingly, there was an excess of 73 employees.

(b) Employees had been recruited on contract basis from time to time including officers of the top management. Accordingly, 02 posts representing senior management had been recruited on contract basis during the year under review. Therefore, it had directly affected to the performance of the Corporation. The employee turnover of these posts had stood at a higher rate during the previous years.

(c) In terms of Management Services Circular No. 28(ii) dated 01 August 2006 and as per the provisions laid down in Paragraph 1.2 of Volume II of the Establishment Code, creations of posts and filling of vacancies shall not be done without the approval of the Department of Management Services. Nevertheless, 20 posts including 11 unapproved posts had been created and 108 employees had been recruited for those posts.

(d) Eight hundred and eleven sub contract labours had been employed at the end of the year under review and a sum of Rs.216,460,758 had been incurred as their salaries during the year under review.

5. Accountability and Good Governance

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5.1 Presentation of Financial Statements

In terms of Public Enterprises Circular No. PED/12 dated 02 June 2003, although the annual financial statements should be furnished to the Auditor General within 60 days from the close of the year of accounts, financial statements pertaining to the year under review had been furnished to the Auditor General only on 02 September 2016, after a delay of 186 days.

5.2 Corporate Plan and Action Plan

The following observations are made.

(a) According to the Circular No. PFD/RED/01/04/2014/01 dated 12 February 2014 issued by the Ministry of Public Finance, the Corporate Plan for the period covering 2015 – 2017 had not been prepared.

(b) Further as per the provisions in the above Circular, an Action Plan incorporating commercial activities to be implemented in next financial year should be prepared based on such Corporate Plan. However, despite that matter an Action Plan including approved budget, estimates and budgeted capital expenditure had been prepared and it had been approved by the Board of Directors on 06 October 2015, after laps of 10 months. The following weaknesses were also observed in that Action Plan.

(i) Unavailability of Human Resources Development Plan and Internal Audit Plan.

(ii) Only financial target were given to each division without including commercial activities to be implemented in the financial year.

(iii) Unavailability of resources requirement to accomplish the targets.

5.3 Budgetary Control

The variances ranging 19 per cent to 61 per cent were observed between the budgeted and the actual income and expenditure thus, indicating that the budget had not been made use of as an effective instrument of management control.

5.4 Procurement Plan

The following observations are made.

(a) Although a Procurement Plan had been prepared in terms of Section 4.2.1 of the Procurement Agency Circular No. 08 dated 25 January 2006, it had been forwarded for the approval of the line Ministry only on 16 February 2016.

(b) Procurement Plan had been prepared only for the raw material items to be purchased during the year under review instead of capital items.

6. Systems and Controls

Deficiencies in systems and controls observed 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.

Areas of Control	Observation
(a) Accounting	**(i)** Almost all of the previous year accounting errors had been adjusted to the current year financial statements without adjusting retrospectively.
	(ii) Failure to adhere with Sri Lanka Accounting Standards.
	(iii) Taxes payable and surcharges thereon had not been accounted.
	(iv) Failure to reconcile control accounts.
	(v) Failure to submit financial statements on due dates.
(b) Trade and other Receivables	**(i)** Poor control over debtors was observed.
	(ii) Debts receivable from government had been increasing gradually.
	(iii) Long outstanding debtors were observed.
	(iv) Considerable delay in invoiced and submission to relevant clients.
	(v) Long outstanding purchase advances.
	(vi) Long Outstanding construction retentions.
(c) Trade and other Payables	**(i)** Long outstanding mobilization advances.
	(ii) Long outstanding taxes and surcharges thereon. Eg: VAT, ESC, NBT

(d) Personnel Management	**(i)** Releasing of human resources to other institutions. **(ii)** Recruitment of employees exceeding the approved cadre. **(iii)** Recruiting officers to the senior management on contract basis.
(e) Assets Management	**(i)** Idling asphalt machine at Polonnaruwa since 2014. **(ii)** Net book values of fixed assets had not been reviewed and reinstated annually. **(iii)** Failure to acquire the ownership of all lands at the end of the year.
(f) Inventory Control System	**(i)** Reconciliations of physical stock balance and ledger stock balance of each and every site were not executed. **(ii)** No proper quotation calling system is adopted especially for the spare parts of machineries and vehicles.