Milco (Private) Limited – 2016

The audit of the financial statements of the Milco (Private) Limited for the year ended 31 December 2016 comprising the statement of financial position as at 31 December 2016 and the statement of comprehensive income, statement of changes in equity and the 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. I was assisted by a Firm of Chartered Accountants in Public Practice in carrying out this audit. My observations on the performance of the Company in the year under review which I consider should be presented to Parliament in terms of Article 154(6) of the Constitution of the Democratic Socialist Republic of Sri Lanka appear in this report.

1.2 Board of Directors' Responsibility for the Financial Statements

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The Board of Directors is responsible for the preparation and fair presentation of these financial statements in accordance with the 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 Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with Sri Lanka Auditing Standards.

1.4 Basis for Disclaimer of Opinion

(a) The yoghurt mixing plant worth Rs.104,177,779 was purchased on lease basis on 20 January 2011, to be installed at the Colombo factory without proper identification of need, however it was installed at the Polonnaruwa factory on 30 August 2013 and could not be used up to July 2017 on the audited date, due to technical deficiencies in the machinery and plant.On the reason of that impairment adjustments should be made to the value of these machinery and plant action had not been made like that.

(b) According to the agreement made with the Treasury for modernization of factories, the company's accounts did not made provision for the default interest rates of 2 percent to the Treasury due to defaulting on the required timeframe. Accordingly, the liabilities shown in the statement of financial position were under stated by Rs.117 million.

(c) According to the financial statements for the year ended 31 December 2016, it has been spent Rs.6,189,574,828 to the above modernization project and Rs.4,831,791,167 for the establishment of milk processing machine at the Badalgama factory, however, the current management reports and management inquiries indicate that there is not sufficient milk for the increased capacity. therefore relevant adjestments had not been made for assets impairment as per Sri Lanka accounting standard 36.

(d) As at 31 December 2016, as per the company's financial statements, the above three factories renovation projects and the Badalgama new factory has obtained Rs. 13,212,970,600 loan from Ministry, however information obtained from the Ministry of Finance website that value was Rs. 10,859,986,560,including the amount of Rs.48,170,797 which was the difference due to exchange rate used therefore it was observed deviation of Rs.2,304,813,243. The reasons for this change were not submitted to the audit and no written evidence was submitted to confirm the value of the financial statements.

(e) There were not provided impairment adjustment or provision to the non-moving items amounting to Rs.30,890,878 and slow moving items amounting to Rs. 35,557,148 included in the inventory register .The rest of inventories have been made provision amounting to Rs.11,352,785,however audit was not provided detail information to verify the accuracy of those calculation.

(f) Audit was not provided with the requested supporting documents for the following balances. Therefore, it was unable to ensure the accuracy and validity of such a balance.

Item of Account	**Value Rs.**	**Evedence of presented**
Fixed Assets	1,460,028,918	Physical verification reports
Cattle food	7,856,860	
Milk Can advance	16,114,541	
Distress Loan (Non-Executive)	41,076,727	Detail schedules and age analysis
Distress Loan (Executive)	21,377,987	
Accrued expenses	4,207,457	Subsequent settlement details
Other creditors	12,005,844	Subsequent settlement details
Capital work- in progress	21,895,870	Relevant written evidence to verity the expendilure of sample
Debtors	394,798,089	
Balance Receivables from Ministry of livestock Development	6,616,885	Balance Confirmations
Balance Receivables from Ministry of Parliament Affairs	94,333	Balance Confirmation
Total Amount	**1,986,073,511**	

2. Financial Statements

2.1 Disclaimer of Opinion

Because of the significance of the matters described in Basis for Disclaimer of Opinion paragraph of this report, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on these financial statements.

2.1.1 Report on Other Legal and Regulatory Requirements

As required by Section 163 (2) of the Companies Act, No.07 of 2007, I state the followings:

a. The basis of opinion and scope and limitations of the audit are as stated above.

b. I have not been able to obtain sufficient appropriate audit evidence to provide a basis for opinion paragraph of this report. Accordingly, I do not express an opinion on these financial statements.

3. Financial Review

3.1 Financial Result

According to the financial statements presented, the financial result of the Company for the year ended 31 December 2016 had been a surplus of Rs.327,084,631 as compared with the corresponding deficit of Rs.12,299,511 for the preceding year, thus indicating an improvement of Rs.339,384,142 in the financial result as compared with the preceding year. The improvement was mainly due to the increase in the gross profit of Rs.262,835,367 and the reduction of administrative expenses of Rs.83,913,542 compared to the previous year.

In analyzing financial results of four preceding years, net profit after tax for the year 2013 Rs.267,468,281 had rapidly increased from year 2014 surplus for the year under review has increased up to Rs.327,084,631. However, when taking into consideration of employees remunerations and depreciations on non-current assets, company contribution has continuously increased in the year under review up to Rs. 1,507,168,721 from Rs.773,035,900 in year 2013

3.2 Analytical Financial Review

The loans obtained for the factory modernization project and the Badalgama project has resulted in company's high gearing.

4. Operating Review

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4.1 Performance

4.1.1 Planning

The following observations are made

(a) Corporate plan should include the production and operational facilities, management skills, technical knowledge, market and suppliers, organizational structure and designs currently available to the organization, the management responsibilities included in the action plan with regard to the goals and objectives to be fulfilled within the policy period, however those facts were not included in the corporate plan 2015-2017 accordance with paragraph 5.1.2 of the Public Enterprises circular No. PED/12 dated 02 June 2003.

(b) Only Capital expenditure alone had been budgeted in the annual budget for the year under review and no operating expenditure had been included.

(c) The budget had been made for purchasing of capital assets and renovation of capital assets Rs.514.61 million respectively by the company but procurement plan had not been prepared for that during the year under review.

4.1.2 Operating and Review

According to the Central Bank reports, although it was working to increasing dairy production in the country from 2014 to 2016 Milco (Private) Limited collection of dairy products under the government was 22.51 per cent in 2014, in the year 2016 that was 22.04 per cent.

4.2 Management Activities

The following observations are made

(a) It was observed that the performance reports were not prepared quarterly,bi-annually and annually in the year 2016, as per clause 4.2.3 and 4.2.6. of the Public Finance Circular No.12 dated 02 June 2003,

(b) Sufficiently insured cover had not been obtained for the stocks.

(c) Engineer stock items which had been received from Nestle company prior to 8 -10 year period had not been taken to books at the Polonnaruwa milk factory, therefore company assets had been understated.

4.3 Operating Activities

The following observations are made

(a) Factory Modernization Project

(i) The modernization of four factories, repair of 80milk collecting centers and the construction of 20 new centers according to a proposal forwarded by the contractor to the Ministry of Finance and Planning had been evaluated by a Technical Evaluation Committee appointed by the Cabinet of Ministers and based on the respect of that committee, an agreement for Euro 39.1 million had been entered into on 31

December 2009 between the company and foreign institute to improve the milk consumption in Sri Lanka. But the Chairman of the company had issued a letter to that institute on 24 June 2011 an agreement had been entered into again on 12 January 2012, In accordance with a new proposal for Pollonnaruwa Digana, Ambewala factories modernization project for Euro 33.78 million by allocating Euro 2.37 million allocated for the cost of repair to 80 milk collecting centers and the construction of 20 centers including several other tasks.

The Technical Evaluation Committee had evaluated the first proposal on the assumption the capacity would be available at the maximum level, however the milk collecting centers had been eliminated in the project agreement approved on 12 January 2012 without giving any alternative arrangement ,therefore milk production had been wasted.

(ii) The period of the contract according to the agreement aforementioned proposal entered between Milco (Private) Limited and foreign contract institute, It should have been completed by 12 July 2014, the contract awarded under the turnkey procedure for the modernization of factories in Polonnaruwa, Digana and Ambewela without tender calling. However, the modernization work of Digana and Ambewela dairy factories had not been completed up to 31 July 2017, and none of two parties had taken any action for the extension of the contract period whilst the company had not taken action for the recovery of the agreed as liquidated damages. The delays had exceeded more than 36 months at the month of July 2017, Even though Euro 1,688,961 remains recoverable as liquidated damages, but no action had been taken.

(iii) As per the contract agreement entered in the year 2012 with company and a foreign company for factory modernization project, the loan agreement entered into between the HSBC Bank and the Department of External Resources of the Treasury as well as between the Department of External Resource and the company in the year 2013 was 2 percent interest rates in the amount of Euro 28,712,328 and 6 per cent interest rates plus London Inter Bank Offer rates as commercial rate on Euro 5,066,881,Accordingly sub Loan agreement was signed under the same interest rate between department of external resource and the company. The company has to repay the loans to the Treasury as at 31 December 2017 amounting to Rs. 3,554,761,168. It was observed that the company had not taken any action to pay as per the agreement.

(b) Badalgama Project

According to the letter dated 25 November, 2013, the Secretary to the Ministry of Livestock and Rural Community Development, the Evaluation Committee of the Ministry has evaluated 2 foreign companies and selected the most favourable institution for the project to transfer the company's Narahenpita Plant to Badalgama on 05 June 2013. However, on the advice of the Chairman of the company, contrary to the Evaluation Committee selection the contract awarded and approved by the Cabinet of Ministers on 23 April 2015 then entered into an agreement on 19 May 2015.This project has been implemented under a loan of Rs.9,932,709,286, for a portion of loan charged 1.90 percent interest rates and remain portion charged 5 per cent plus London Inter Bank offer rates. The following facts were observed in this regard.

(i) Contrary to the Ministry Evaluation Committee recommendation on 05 June 2013 the contract had been offered to the bid higher than Euro 10 million (Rs.1750 million),

(ii) According to the committee report submitted on 20 August 2014 with regard to the above project, the value of the buildings and other utility was roughly Euro 4,000,000 (Rs. 596,952,800), above the estimated reasonable amount further the expected daily milk of 650,000 litters was the limiting factor under the modernization project of Milco (Private) Limited.

(iii) Cabinet approval was granted on 07 March 2015 for the Cabinet memorandum submitted on 4 March 2015 to refrain from the project due to the inability of loan repayment, company has faced cash flow crisis and crisis in milk supply to the modernization project. However, subject to a concessionary period of three years and subject to sub loan agreement has been approved by the Cabinet of Ministers on 23 April 2015 based on Cabinet Memorandum dated on 8 April 2015. However, the company and the Treasury was not entered into the sub loan agreement up to 19 October 2018 for the above project.

4.4 Staff Administration

Schemes of recruitment for the staff as per Management Services circular No. 30 had not been prepared and had not been approved until 25 October 2018. The position of the staff of the company as at 31 December 2016 had been as follows.

Category of Employees	Approved Staff	Actual Staff	Excess/(Vacancies) Staff
Executive	12	57	45
Tertiary	179	150	(29)
Secondary	802	468	(334)
Primary	427	779	352
Trainee and Others		17	17
Total	1420	1471	51

5. Systems and Control

Weakness observed in systems and controls in audit were brought to the notice of the Chairman of the company in time to time. Special attention is needed in respect of the following areas of controls.

Areas of Control	**Observations**
Planning	Sufficient information was not included in the corporate plan, action plan, budget, and performance reports needed to achieve the desired objectives and targets.
Inventory Management	Deterioration due to non-storage of stocks, existing of destroyed inventory, informal stock counting