Milco Private Limited – 2017

The audit of operations of the Milco Private Limited for the year ended 31 December 2017 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. My observations on the performance of the Foundation for the year under review which I consider should be presented to Parliament in terms of Article 154(6) of the Democratic Socialist Republic of Sri Lanka, appear in this report.

1.2 Responsibility of the Board of Directors for the Financial Statements

The Board of Directors 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.

2. Financial Statements

2.1 Presentation of Financial Statements

In terms of Section 6.5.1 of the Public Enterprises Circular No. PED/12 of 02 June 2003, the financial statements and the Draft Annual Report should be presented to the Auditor General within 60 days after the closure of the year of accounts. Nevertheless, the financial statements and the Draft Annual Report for the year 2017 had not been presented to the Auditor General even by 25 October 2018.

2.2 Existence of Assets and Liabilities

Particulars relating to assets, liabilities, and equity, shown in the financial statements last prepared by the Company as at 31 December 2016 are as follows.

Assets	12/31/2016	12/31/2015
	Rs. Million	Rs. million
Non-current assets	14,764	12,262
Current Assets	2,634	1,785
Total Assets	17,398	14,047
Liabilities		
Equity	2,349	1,941
Non-current liabilities	14,086	10,078
Current liabilities	963	2,028
Total liabilities	17,398	14,047
Income	9,006	8,011
Expenditure	8,679	8,023

Surplus / Deficit	327	(12)

2.3 Non-compliances with Laws, Rules, Regulations, and Management Decisions

Reports relating to all fixed assets of the Company should be presented to the Comptroller General in terms of Assets Management Circular, No. 01/2017, dated 28 June 2017. Nevertheless, such reports had not been presented even up to 29 October 2018.

3. Financial Review

The gearing ratio of the Company had increased from 0.64 to 5.99 during the period 2012 – 2016 owing to the loans obtained in respect of factory renovation project and Badalgama project.

4. Operating Review

4.1 Performance

4.1.1 Planning

The following observations are made.

(a) The Action Plan indicating the responsibility of the management relating to the current technical know-how of the Company, market and suppliers, organizational structure, and targets and objectives to be achieved during the schedules, had not been included in the Corporate Plan for the period 2015 – 2017 in terms of Section 5.1.2 of the Public Enterprises Circular, No. PED/12, dated 02 June 2003.

(b) Only the capital expenses had been included in the annual budget for the year under review whereas no operating expenses had been included.

(c) Even though sums of Rs. 660.42 million and Rs. 207.95 million had been allocated by the Company in the budget for purchasing capital assets and repairing the capital assets respectively during the year under review, a main Procurement Plan had not been prepared in terms of Guideline 4.2 of the Government Procurement Guidelines – 2006.

4.1.2 Functionality and Review

In examining the progress of milk production of the Company, the production of pasteurized milk had increased by 47 per cent in the year 2016 as against the year 2015. However, as compared with the year 2016, the said production had decreased by 36 per cent in the year under review. Furthermore, the production of cheese had decreased by 59 per cent and 29 per cent in the year 2016 and the year under review respectively. As compared with the year 2015, the production of butter had increased by 32 per cent whilst the production of milk powder had continuously increased up to 69 per cent in the year under review.

4.2 Management Activities

The following observations are made with respect to the supervision on stocks survey.

(a) Factory in Ambewela

It was observed in the supervision on the stocks survey carried out at the factory in Ambewela from 26 – 30 December 2017 that the stores administration had been weak. It was further observed that stocks of milk powder of which the market price amounted to Rs. 13 million, had been damaged. Particulars in that connection are as follows.

(i) Milk powder had mainly been stored in 02 stores. Rain water had leaked through the holes in the roof of the main stores thus paving way for water to accumulate on the floor up to a height of about 3 inches. Furthermore, there had been holes on 178 containers each with 25 Kg of milk powder in total of 4,450 Kilograms with market value of Rs. 03 million, and milk powder had come out of the packages. Various damages such as, getting wet by the rain, cracks on the bags, and damages caused by pallets , had occurred.

(ii) The stocks of milk powder had not been stored properly and safely in the stores in accordance with codes, batch numbers, and dates of expiry. Furthermore, in issuing the stocks, the stocks received first by the stores had not been issued first, and the reason thereto was that the stores had been maintained preventing easy access to the stocks. As at 01 February 2018, there existed 3,900 Kilograms of milk powder on the verge of expiry of which the market value amounted to Rs. 2.6 million along with 10,750 Kilograms of milk powder to be used for animal food due to being expired and the market value thereof amounted to Rs. 7.4 million.

(b) Factory in Polonnaruwa

The following observations are made.

(i) It was observed that stocks of diesel had been shown in the reports without being physically verified.

(ii) Chemicals had been valued for a sum of Rs. 174,420 as at 31 December 2017. However, 26 different chemicals either expired during the period 2007 – 2017 or not in use at present had been include therein. The dates of manufacture and expiry had not been indicated on many chemicals. Moreover, it was also observed that 05 items of packaging materials valued at Rs. 3,164,057 that could not be made use of, had been included in the stock as at 31 December 2017. Nevertheless, stock valuation reports had not been presented to Audit even up to the date of this report.

4.3 Operating Activities

The following observations are made.

(a) When collecting milk, payments had been made for a volume of milk more than that of being received by the factories. Hence, the Milco Private Limited had made an overpayment of Rs. 73,343,796 in the year 2017. The reasons such as, lack of supervision on the centers collecting milk, and failure to establish new milk collecting centers under the project for renovating the factories enabling automatic supervision by transmitting data to the Head Office, had mainly attributed to this situation.

(b) According to the Performance Report of the year 2017, an unusual damage on a stock of 1,813,226 liters of milk worth Rs. 124,587,211 , and the average waste of 2 per cent up to July 2017 increasing up to 4 per cent from August of the year under review, had been observed in regard to the factory in Ambewela.

4.4 Staff Administration

A Scheme of Recruitment for the staff had not been prepared and approved even up to 25 October 2018 in terms of Management Services Circular, No. 30. Furthermore, the staff approved by the Department of Management Services on 07 November 2008 had been 1420, but the actual cadre had been 1471 thus indicting 51 vacancies.

5. Sustainable Development

5.1 Achievement of Sustainable Development Goals

The United Nations had introduced the Sustainable Development Agenda for its member countries to achieve economic development, social development, and environmental protection by the year 2030. However, the Milco had not identified the targets and indicators in line therewith, nor had the methodologies to collect accurate data and manage the physical resources, been identified.

6. Accountability and Good Governance

6.1 Procurements

(a) Factory Renovation Project

The following observations are made.

(i) The proposal presented by the foreign institution, Desmi, to the Ministry of Finance and Planning, in respect of the project to renovate 4 factories, repair 80 collecting centers for milk, and construction of 20 new centers, had been evaluated by a Technical Evaluation Committee appointed by the Cabinet. In accordance with the report thereof, a contract agreement to the value of 39.1 million Euros had been signed between the Company and the said institution on 31 December 2009. However, having sent a letter to that institution on 24 June 2011 by the Chairman of the Company, the activities of repairing 80 milk collecting centers, and constructing 20 centers for which a sum of 2.37 million Euros had been allocated, had been removed, thereby presenting a new proposal valued at Rs. 33.78 million and entering into a new agreement on 12 January 2012 . However, the Technical Evaluation Committee had initially evaluated the project under the assumption that the machines would be made use of maximally. As such, despite the necessity to repair the milk collecting centers, and construct new centers, such activities had been removed under the new contract agreement with no alternatives being made available. Hence, it was observed in audit that the productivity of the project would be adversely affected.

(ii) An agreement had been entered into between the Milco and the foreign contractor selected through turnkey method without calling for bids for the project to renovate the factories in Polonnaruwa, Digana, and Ambewela under a loan of Rs. 5,854,450,856 (33,779,210 Euros). According to the agreement, the contract period of the project should have been ended as at 12 July 2014. However, renovations of the factories in Digana and Ambewela had not been completed even up to 31 July 2017. But, the Company had not taken action either to extend the contract period or to recover the penalties for delay. Therefore, the agreement had been delayed for over 36 months by July 2017, and a sum of 1,688,961 Euros had remained recoverable as penalties for delay.

(iii) In terms of the loan agreement entered into between the HSBC and the Department of External Resources of the Treasury in the year 2013 along with the loan agreement entered into between the Department of External Resources and the Company following the contract agreements signed in the year 2012 in regard to the said factory renovation project, a commercial loan had also been agreed upon for the loan amount of Rs. 5,854,450,856 (33,779,210 Euros) at the non-commercial interest rate of 2 per cent and a commercial interest rate of 6 per cent + LIBOR. Accordingly, a sub-loan agreement had been entered into between the Department of External Resources and the Company under the same interest rates as well. According to the initial loan amount, the due amount payable to the Treasury by the Company had been Rs. 3,554,761,168 as at 31 December 2017. Therefore, it was observed that the Company had not taken action to make payments in accordance with the relevant agreements.

(b) The Project in Badalgama

In terms of the agreements entered into between the Department of External Resources and the HSBC, the project for shifting the factory in Narahenpita owned by the Company, to Badalgama had been implemented under the loan of Rs. 9,932,709,286 that had been agreed at 1.90 per cent of non-commercial interest rate and a commercial interest rate of 5 per cent+ LIBOR. The following matters were observed in that connection.

(i) According to the Cabinet Memorandum presented on 04 March 2015, the Cabinet had decided on 07 March 2015 to turn down the project due to the following matters. However, in the wake of a Cabinet Memorandum presented on 08 April 2015 , approval of the Cabinet had been granted to implement the project on 23 April 2015 subject to provide a grace period of 3 years for the relevant loan, and grant a reloan to the Milco Limited. However, the Company and the Treasury had not entered into a reloan agreement even up to 19 October 2018.

- Inability of the Milco Limited to repay the loan.

- The Company faced a severe financial crisis due to decrease in the cash flow in the wake of increasing the price of milk as per the Government policy but failing to increase the prices of milk products in accordance therewith. Obtaining loans further would aggravate the financial crisis.

- About 200,000 liters of milk would be required per day for the manufacturing process following the proposed renovation of factories. As such, the Company should obtain about 600,000 liters of milk equivalent to 75 per cent of the production of the country. In the case of establishing the factory, supplying milk would face severe difficulties.

(ii) The Desmi Contracting Agencies, and Boccard Food Firma had been evaluated by the Evaluation Committee of the Ministry on 05 June 2013, thus recommending Boccard Food Pharma, as being more favorable. However, as per the Cabinet Decision, dated 23 April 2015, it was decided to award the contract to the Desmi Contracting Agencies, under the Turnkey basis without calling for bids after having considered as a standalone and unsolicited proposal. As such, a contract agreement had been entered into with the said Company on 19 May 2015. The following matters were observed in that connection.

- According to the proposal of the Evaluation Committee of the Ministry, dated 05 June 2013, it was observed that the price of Desmi Contracting Agencies, had been higher than that of the Boccard Food Pharma by a sum of 10 million Euros (Rs. 1750 million)

- According to the report of the Committee appointed by the Cabinet with respect to the said project that had been presented on 20 August 2014, it had been stated that the value of constructions expected to be made by the Desmi Contracting Agencies, had been higher than the fair value of 4,000,000 Euros (Rs. 596,952,800). Furthermore, after completing the renovations of Milco, it had been estimated that a daily volume of 650,000 liters of milk would be required for the production process. However, the volume of milk produced daily in Sri Lanka had been 1,085,473 liters, and hence, the Company should collect milk over 50 per cent, thus stating that this would be a limiting factor.

(c) A yoghurt mixing machine had been obtained at a value of Rs. 104.17 million on lease for the factory in Colombo on 20 January 2011 from a supplier who had been selected by deviating from the procurement process without properly identifying the requirement. The machine had not been made usable and handed over to the Company up to July 2017.

7. Systems and Controls

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

Areas of Systems and Controls	Observation
(a) Control of Operations	(i) Corporate Plan, Action Plan, budget, and performance reports had not been prepared in accordance with the expected objectives and targets of the Government.
	(ii) Due to reasons such as, failure to properly supervise the milk collecting centers, and failure to construct an adequate number of milk collecting centers, waste of milk occurred.
(b) Stocks Management	Due to failure in properly storing the stocks, damages and expirations occurred, and valuation of stocks was irregular.