# State Development and Construction Corporation

## 1 Financial Statements

### 1.1 Qualified Opinion

In my opinion, except for the effects of the matters described in paragraph 1.2 of this report, the Financial Statements give a true and fair view of the financial position of the State Development and Construction Corporation as at 31 December 2011 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

### 1.2 Comments on Financial Statements

#### 1.2.1 Non-compliance with Sri Lanka Accounting Standards (SLAS)

Instances of non-compliance with the following Sri Lanka Accounting Standards were observed in audit.

(a) SLAS. No. 13

(I) Deficiencies in Contract Revenue

Progress billing made during the year under review totaling to Rs.2,256,780,520 had erroneously been considered as the contract revenue for the year and shown in the financial statements.

(II) Deficiencies in Contract Expenditure

No contract accounts were maintained in the ledger for each project undertaken by the Corporation. Following observations are made in this regard.

(i) Construction cost incurred amounting to Rs.2,033,585,271 during the year under review had been charged to profit and loss account as period cost without allocating to each contracts due to the above reason.

(ii) The Corporation had not identified cost relevant to each contract in accordance with the SLAS 13.

(iii) The Corporation had identified delay charges of Rs.67,452,671 as receivables from the clients up to the year 2011. As a result, current assets and profit had been overstated by that amount.

(iv) A sum of Rs.14,548,960 paid in respect of three projects were not recorded and identified in ascertaining contract expenditure for the year 2011 and accordingly Profit / Loss determined for such contracts were not accurate.

(III) Deficiencies in due from/ to customers

The Corporation had identified construction income of 23 projects amounting to Rs.1,941,936,269 in previous year based on uncertified bills. Out of that four projects had been completed in the year 2011 for different values than identified in 2010. Hence uncollectable and non-realizable values had been identified as revenue and the corresponding entry had been recorded under due from customer in the year 2010. As a result, retained profit and current assets had been overstated by Rs.63,404,979.

(IV) Deficiencies in Mobilization Advances

(i) Following deficiencies were observed with regard to the payments of mobilization advances and the liabilities disclosed in the financial statements.

- A difference of Rs.25, 582,615 had been noted between the balances shown in the ledger and the amount computed by audit based on client certified bills.
- An unusual debit balance of Rs.1,207,134 had been included in the schedule of mobilization advances.
- A sum of Rs.31,299, 371 relating to 29 non-operated projects had been included in the outstanding balance of the mobilization advances.
- Mobilization advances amounting to Rs.7,113,477 remained unsettled for a period exceeding 5 years.

(V) A sum of Rs. 128,863,490 had been shown as retention for 31 projects as per schedule. However as per certified bills sent by clients, it was identified that Rs.134,862,423 had been deducted as retention and a difference of Rs.5,962,933 had been identified.

(b) SLAS No. 3

Debit balance in the creditor accounts amounting to Rs.790,497 had been set off against VAT receivable and ETF without considering the requirements of the Standard.

(c) SLAS Nos. 10 and 12

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The Corporation had changed its revenue recognition policy in the current year. Therefore the impact on the policy changes had not been disclosed in accordance with SLAS 10 and its tax effects in accordance with SLAS 12.

(d) SLAS No. 14

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The deferred tax had not been computed and shown in the financial statements.

(e) SLAS No. 18

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When the fair value of revalued assets differs materially from its carrying amount shown in the balance sheet, a further revaluation is needed. But there were zero value of assets in the assets ledger even they were being used. The corporation had not taken action to revalue of these assets in terms of SLAS.

(f) SLAS No. 26

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Although investments amounting to Rs.9,210,740 had been shown in the financial statements no consideration had been made for falling value of market value of such investment because this organization had not been in operation since 2003.

(g) SLAS No. 28

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Financial results, assets and liabilities of each segment of the Corporation such as Construction, Concrete products and Mechanical unit as at the date of the balance sheet had not been disclosed in the financial statements.

(h) SLAS No. 29

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(i) The income of mechanical division had been identified on cash basis instead of accrual basis. Hence the divisional income and receivable had been understated by Rs.3,416,092.

(ii) Sales of the concrete yard had been recognized on cash basis instead of accrual basis. Following observations are made in this regard.

- Cash received in the year 2010 amounting to Rs.4,962,885 had been accounted for as sales in the year 2010, whereas goods were delivered in the year 2011 and as a result sales for the year 2011 had been understated.
- A sum of Rs.1,948,940 had been received and accounted for as sales in the year 2011, whereas related goods were delivered to the customer in the year 2012 and as a result sales for the year 2011 had been overstated by the same amount.

(iii) Advance of concrete yard amounting to Rs.5,312,004 had not been adjusted in the final ledger balance of Rs.37,905,694 shown in the balance sheet and as a result sales revenue and advance of the concrete yard had been understated and overstated respectively by Rs.5,312,004.

(i) SLAS No. 31
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The Corporation had not maintained separate ledger accounts for the joint venture entered with MAS Trust Holdings Co. Ltd.

(j) SLAS No. 36
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(i) Economic Services Charges (ESC) and penalties payables since 2004 amounting to Rs.13,496,967 and Rs.5,513,429 respectively had not been shown in the Financial Statements for the year under review.

(ii) ESC receivables amounting to Rs.25,684,943 from the Department of Inland Revenue had been shown in the Financial statements. But it is doubtful whether the Corporation would be able to claim this amount as a Tax credit in the future as the assessments had already been called for such amounts by the Department of Inland Revenue.

(iii) Penalties imposed on outstanding VAT as estimated at Rs.52,024,597 had not been taken into accounts.

(k) SLAS No. 41
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Procedure relevant to write off of any investment had not been followed up because possible market value of the Lath Lodge Ship Lay Machine costing Rs.600,000 had not been considered and it had not been taken into the accounts of the Corporation even after writing off of such assets.

## 1:2:2 Accounting Deficiencies

The following accounting deficiencies were observed in audit.

(a) Differences of Rs.4,363,699 , Rs.1,548,588 and Rs.524,470 had been observed between the assets ledger and assets register in relation to cost of non-current assets, cumulative depreciation and depreciation for the year under review respectively.

(b) Difference of Rs.827,945 had been identified between the previous year closing balance and current year opening balance in relation to Nation Building Tax (NBT) payable account.

(c) A difference of Rs.953,140 had been identified between the detail schedule and general ledger in relation to NBT payable accounts.

(d) A sum of Rs.12,207,489 had been shown as income receivable from work services in the Financial Statements. However, it should be Rs.2,614,082 as per invoices. No evidence was made available to check remaining balance due. Hence the current assets had been overstated by Rs.9,593,407.

(e) Un-reconciled stock adjustment amounting to Rs.4,020,559 had been shown in the financial statements due to the weaknesses in the stock control system and related accounting system.

(f) A sum of Rs.8,796,308 had been shown continuously as prepayment for more than five years.

(g) A difference of Rs.21,751,898 was observed between the VAT payable account and the detailed schedule submitted for such payables since 2002 and hence the validity of the VAT payable account is in doubt.

(h) According to the ledger accounts, the amount of With Holding Tax available to be set off against the income tax payment was Rs.134,577,672 whereas as per the income tax returns it was Rs.165,592,952 and the reasons for such difference was not explained to audit.

(i) A difference of Rs.8,439,566 had been observed between the cost as per certified bill and cost as per the ledger in relation to project No 915.

(j) Even though a sum of Rs.9,026,412 had been shown in the Financial Statements of 2011, as Corporate tax it had been calculated based on taxable income of 2010 instead of taxable income of 2011.

(k) A difference of Rs.24,407,931 was observed between the value in the VAT returns and the ledger balance. There were amounts totaling to Rs.6,082,537 identified as VAT outputs for which no valid reasons and documents were made available to the audit.

**1:2:3 Accounts Receivables and Payables**

The following observations are made.

(a) Debtors outstanding for more than 3 years of the Construction Division and Concrete Yard were Rs.38,997,630 and Rs. 26,299,359 respectively. Out of that sums of Rs.20,242,899 and Rs.19,314,980 respectively had been older than 05 years. An age analysis of sundry debtors amounting to Rs.1,399,566,905 had not been furnished to audit.

(b) Six purchase advances account balances aggregating Rs.181,475,811 had been shown in the accounts since 1995. It was revealed in audit that although the advances were settled, proper accounting entries had not been made for the relevant settlements in the accounts.

(c) Forty per cent provision for bad debts had not been made for debtors older than 01 year as per the accounting policy 2.3.2.2. Further no any provision had been made on concrete yard debtors, and it was estimated as Rs.20,266,015, hence profit had been overstated by that amount.

(d) A sum of Rs.59,915,767 had been outstanding as income tax payable to the Department of Inland Revenue since 2002.

**1:2:4 Lack of Evidence for Audit**

The following items could not be satisfactorily vouched in audit due to the non-availability of evidence indicated against each item.

| | Item of Accounts | Value Rs. | Evidence not made available |
|---|---|---|---|
| (a) | Itasri Join Venture | 48,488,000 | Joint Venture Agreement |
| (b) | Trade Creditors | 920,513,662 | Age Analysis |
| (c) | Bond Operated project loan balance | 23,155,500 | Agreement |

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|---|---|---|---|
| (d) | Loan facility from Bank of Ceylon | 180,000,000 | Confirmations |
| (e) | Trade Debtors and Other Receivables | 846,756,850 | Confirmations |
| (f) | Trade Creditors and Other Liabilities | 311,531,660 | Confirmations |
| (g) | Refundable deposits | 3,821,300 | Confirmations |
| (h) | Deposit balance | 14,668,422 | Original deposit slips |
| (i) | Liquidator – River Valley Development Board Weraganthota | 2,856,252 | Detailed Schedules |
| (j) | Liquidator – River Valley Development Board Haragama | 2,425,859 | Detailed Schedules |
| (k) | Sri Lanka Samurdhy Authority | 1,696,199 | Detailed Schedules |
| (l) | Provision for Doubtful Debtors-Construction | 41,026,948 | Detailed Schedules |
| (m) | Provision for Advances and deposits | 1,724,142 | Detailed Schedules |
| (n) | Prepayments | 8,997,318 | Detailed Schedules |
| (o) | Provision for Doubtful Sundry Debtors | 2,184,627 | Detailed Schedules |
| (p) | Provision for Suppliers and Sub Contracts | 19,769,831 | Detailed Schedules |
| (q) | Salaries and Wages Advance Account | 15,149,045 | Detailed Schedules |
| (r) | National Security Levy- Payable | 885,971 | Detailed Schedules |

### 1:2:5 Non-compliance with Laws, Rules, Regulations and Management Decisions

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

| | Reference to Laws, Rules, etc. | Non-compliance |
|---|---|---|
| (a) | Finance Act, No. 38 of 1971 Section 14(1) | The Draft Annual Report for the year 2011 had not been submitted to the Auditor General. |
| (b) | Section 16 of the Employees' Provident Fund Act No. 15 of 1958 as amended by the Employees' Provident Fund Act, No. 26 of 1981. | Employees' Provident Fund contributions had not been remitted in time and a sum of Rs.17,457,712 was outstanding as at 31 December 2011. |
| (c) | Section 5.1 of the payment of Gratuity Act, No. 12 of 1983. | A sum of Rs.7,689,840 payable to 19 officers who had retired in 2011 had not been paid even up to 30 April 2012. |

| | | |
|---|---|---|
| (d) | Nation Building Tax (NBT) Act No. 09 of 2009<br>(i) Section 3.4 | NBT should be remitted to the Department of Inland Revenue before 20 of the following month. However, the Corporation had not taken action to comply with this requirement. |
| | (ii)Section 2.2 | NBT should be paid on accrual basis but the Corporation had calculated NBT based on cash basis. As a result, NBT payable had been over estimated by Rs.1,360,047. |
| | (iii) Part (iii) Section 1of the Nation Building Tax (NBT) (Amendment) Act No. 10 of 2011 | The Corporation had not considered income amounting to Rs.29,335,198 for calculating the NBT. |
| (e) | Economic Service Charges (ESC) (Amendment) Act No. 15 of 2007 | The Corporation had not paid ESC for the year under review. |

**2. Financial and Operating Review**

**2:1 Financial Results**

According to the financial statements presented, the operations of the Corporation for the year under review had resulted a pre-tax net profit of Rs.88,750,466 as compared with the corresponding pre-tax net profit Rs.22,373,957 for the preceding year, thus indicating an increase of net profit by Rs.66,376,509.

**2:2 Analytical Financial Review**

The following observations are also made.

(a) The Corporation had earned a net profit of Rs.88.75 million during the year under review by utilizing its staff members of 475 (as per financial statements) and the total assets of the Corporation valued at Rs.3,586 million. The net profit represented 2.47 per cent of the total assets of the Corporation.

(b) Out of the total turnover of the Corporation 89 per cent was covered by earnings from construction works as compared to 63 per cent in the preceding year.

## 2:3 Financial Control

Cash at bank and Bank overdraft (OD) were shown in the Financial Statements of Rs.95,382,965 and Rs.216,628,349 respectively and it represent seven bank balances and eight over draft balances. Thirty eight bank accounts had been maintained and out of that 15 bank accounts were not operated during the year under review. Further, OD interest amounting to Rs. 20,114,416 had been charged during the year under review.

## 2:4 Performance Review

The Corporation had handled 50 construction contracts valued at Rs.8,954.21 million in the year 2011. The following observations are made in this connection.

(i) Delays had been occurred in the range of 06 to78 months in 50 ongoing projects by end of the year 2011.

(ii) Clients had claimed liquidation damages amounting to Rs.56 Mn from the Corporation with regard to above 50 projects.

(iii) Due to poor project management and cost control, expected profit margin of 14 per cent to 20 per cent for the ongoing projects had been converted into losses and the loss margin percentage was in the range of 2 per cent to 21 per cent.

(iv) The Corporation had carried out 50 projects during the year under review and 95 per cent of them had been extended for more than six months. However the Corporation had not completed the projects even within the extended period.

## 2:5 Management Inefficiencies

The following observations are made.

(a) Effective courses of action had not been made to recover retention receivables amounts on time after the expiry of guarantee period. It was revealed that a sum of Rs.26,161,933 being remained as outstanding for a period exceeding 04 years.

(b) A sum of Rs.134,577,672 had been shown in the ledger accounts as With Holding Tax (WHT) receivable from the Department of Inland Revenue (DIR) for the period from 2000 to 2011 and negotiations had not been carried out to set off these balances against the income tax.

(c) According to Paragraph No 28 of Sri Lanka Accounting Standard No 13, it is necessary for the enterprise to have an effective internal financial budgeting and reporting system to review the estimated contract cost and the actual cost when the contract is in progress. However it was observed that the management attention in this area was not adequate. As a result, the Corporation had not revised the contract prices and avoid possible losses in projects.

(d) An un-reconciled stock adjustment amounting to Rs.4,020,559 was observed in audit due to non-recording of stock movements.

(e) The Corporation handled number of road projects in Kegalle and Polonnaruwa Districts and for the material requirements on those projects were fulfilled by purchasing goods in advances. In the year 2011, the Corporation had issued significant amount of funds as advances and unsettled advances amounting to Rs.73,514,218 had been observed as at 31 December 2011. Following observations are made in this regard.

- A sum of Rs.69,367,950 had been given as advances without the required approval.
- A sum of Rs.144,546,862 had been paid as advances without the purchase orders.

(f) Effective and efficient project management techniques had not been carried out in the execution of construction projects and, it is evidenced that the SD&CC had to pay liquidated damages amounting to Rs.92,272,840, due to delay in completion of projects.

(g) Liquidated damages of the Daraniyagala Project amounting to Rs.51,572,325 had been charged against the profit for the year 2009. The Corporation had not taken any follow up action in this matter.

## 2:6 Uneconomic Transactions

The following observations are made.

(a) Investment in a Subsidiary Company

(i) Even though it was disclosed in the Notes to the Financial Statements that the Devcoshowa Company (Pvt.) Ltd. has ceased business operation and the liquidation is going on it had not been re-registered in terms of Section 487(1) of the Companies Act, No. 07 of 2007. Accordingly when it was not re-registered there is a risk to the Corporation where a company's name had already been struck off from the register under section 487(5) which shall effect property and rights what so ever would be vested with the State.

(ii) Initial investment made amounting to Rs.9,210,740 is to be considered as a loss to the Corporation.

(iii) In addition, the Corporation had paid Rs.6.4 million during the year under review on account of the salaries of security officers of the company and a sum of Rs.27,591,298 had been outstanding as receivable from the Company.

(b) Fujima State Corporation (Pvt.) Ltd
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(i) The Cabinet of Ministers had given authority to the Corporation to establish a Joint venture by facilitating the settlement of liabilities and wind up the Devcoshowa Company (Pvt) Limited.

(ii) This joint venture also had not been in operation successfully and it was going to the same fate of Devcoshowa Company. A sum of Rs.19,641,511 had been paid to Fujima State Company (Pvt.) Ltd, for contract labour, salary allowances, mining licenses, land payments and petty cash for the period of January 2008 to December 2011, without receiving any benefits to the Corporation and its recoverability is doubtful.

(iii) Five permanent and 17 contract employees have been deployed by Fujima State Corporation (Pvt.) Ltd of which no any work being carried out.

(c ) MAS Trust Holdings Company Ltd
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(i) According to the joint venture agreement, MAS Trust Holdings Company Ltd. had agreed to provide within 08 months, a sum of Rs.75 million required for the liquidation of the Devcoshowa Company subject to agreement that the amount to be recovered from future dividends of the joint venture. Nevertheless, the MAS Trust Holdings Company Ltd had failed to provide funds as agreed, as a party to the agreement and the Corporation had not taken any legal action against the second party on the failure to fulfill the conditions of the agreement.

(ii) According to the joint venture agreement, the Corporation had been nominated as a financial controller to conduct proper accounting of all transactions with the concurrence of the other party and signature of both party were mandatory for the payment of the joint venture .But all these transactions had been carried out by the Corporation without any fee being charged to the joint venture.

(d) Lanka Machine Leasers (Pvt) Ltd

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The Corporation had written off its investment of Rs.2, 500,000 made in machine Leasers during the year under review. But no evidence was made available that relevant approval was obtained from the Treasury and there was no evidence whether the investee had been liquidated or not.

**2:7 Identified Losses**

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The following observations are made.

(a) According to the profit and loss account in project wise, the Corporation had sustained a loss of Rs.13,890,526 from one project in the year under review.

(b) A provision of Rs.3,857,157 had been made for the surcharges arising from the failure to remit the contribution to the Employees' Provident Fund (EPF) on the specified dates.

(c) Penalty amounting to Rs.9,202,927 and Rs.531,854 had been paid during 2011, due to non-payment of the EPF and ETF dues respectively in time.

(d) Penalty amounting to Rs.187,552 had been paid during the year under review due to non-payment of gratuity in time.

(e) A sum of Rs.1,930,780 had been shown in the profit and loss accounts as liquidated damages which was occurred in the concrete yard.

(f) The land and building owned to the Corporation located at Gregory's avenue, Colombo 7 had been idling since September 2011.

(g) In order to claim With Holding Tax (WHT) as tax credits, it is required to submit all original WHT certificates to the Department of Inland Revenue. However original certificates were available to the audit only for a value of Rs.130,746,956 against the amount of Rs.165,592,952 claimed as tax credit. Therefore there is a doubt that the difference of Rs.34,745,996 could be disallowed by the Inland Revenue Department as tax credits.

(h) Due to the non- payment of VAT on due dates for 2011 penalties had to be paid and it was estimated as Rs.7,587,108.

## 2.8 Accountability and Good Governance

(a) Corporate Plan, Action Plan and Its Progress

(i) According to Organizational Chart in the Corporate Plan, seven divisions had been identified. However divisional objectives had been identified only for Construction Division and Production unit under Development and Planning.

(ii) Even though the Corporate Plan for the period 2011-2013 had been prepared, an adequate attention had not been paid for the timely review of the progress on the achievement of the targets and year by year Action Plans had not been included in the Corporate Plan in accordance with the Public Enterprises Circular No. PED/ 12 of 02 June 2003.

(iii) Setting of Targets for the Corporation

When analyzing identified targets in the Corporate Plan with actual results, certain targets had not been achieved in the year 2011. For instance, the Corporation had expected pre-cast concrete revenue of Rs.650 Mn, profit before tax Rs.152 Mn, net profit margin of 6% and average debt collection of 50 days but the Corporation had achieved Rs.282 Mn, Rs.88 Mn, (0.48%) and 261 days respectively. Furthermore targeted turnover growth for the year under review had not been identified.

(iv) Setting of strategies to achieve the Vision of the Corporation

Following strategies had not been implemented during the year under review.

- ✓ Implementing of cost control and accounting system to set competitive prices for concrete products.
- ✓ Disposal of non-moving concrete items
- ✓ Carrying out sales promotion and advertising programmes for concrete products.
- ✓ Implementing a proper cash disbursement system in respect of internal sales in order to minimize the delays of orders due to cash flow problems.

(b) Annual Action Plan

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Following observations are made.

(i) Even though an Annual Action Plan for the year 2011 had been prepared, it had not been identified the responsibilities of managers with goals and targets to be achieved during the year under review. Furthermore no any reference had been made for goals and targets relevant to each division, timely review of each target and those who are responsible for such actions.

(ii) The Action Plan had not been prepared in line with the Corporate Plan and the Annual budget. For instance, Corporation had expected a total income of Rs.3,180 Mn from projects but action plan had targeted only Rs.2,400 Mn. No any income from traffic lights department was targeted in the Corporate Plan.

(iii) Annual Action Plan had not been prepared in division wise and therefore contribution from each division and the achievement thereon could not be identified.

(c) Budgetary Control

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Significant variances were observed between the budget and the actual, thus indicating that the budget had not been made use of as an effective instrument of management control.

**3. Systems and Controls**

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Deficiencies in systems and controls observed during the course of audit were brought to the notice of the Chairman of the Corporation by my detailed report issued in terms of Section 13(7)(a) of the Finance Act. Special attention is needed in respect of the following areas of control.

(a) Accounting
(b) Recovery of Debtors and Receivables
(c) Settlement of Creditors and Advances
(d) Achievement of Performance Targets
(e) Deposits
(f) Investments
(g) Revenue recognition on Construction Contracts
(h) Statutory Allowances relating to the Staff