State Pharmaceuticals Manufacturing Corporation of Sri Lanka - 2014

The audit of financial statements of the State Pharmaceuticals Manufacturing Corporation of Sri Lanka for the year ended 31 December 2014 comprising the statement of financial position as at 31 December 2014 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 notes 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 of the State Industrial Corporations 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

The 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 Auditor's 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 misstatements 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 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 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 State Pharmaceuticals Manufacturing Corporation of Sri Lanka as at 31 December 2014 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 Sri Lanka Accounting Standards

(a) According to LKAS 17, the lease value of lands should be classified as operating leases in the statement of financial position. However, the land received from the State Pharmaceutical Corporation under 99-year lease, had been shown under Property, Plant, and Equipment of the Corporation.

(b) In accordance with the policy of depreciation for the non-current assets of the Corporation, an asset is fully depreciated in the year purchase , but not depreciated in the year it is sold. According to LKAS 16, depreciation of non-current assets should be commenced from the date it is made use of, whereas depreciation should be discontinued from the date an asset decided to be sold in accordance with SLFRS 05. Accordingly, the depreciation policy of the Institute contravened the accounting standards.

2.2.2 Accounts Payable

Action had not been taken up to the date of audit on 08 April 2015 to settle 03 liabilities valued at Rs. 1,305,578 remaining unsettled since the year 2010.

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

Following Instances of non-compliance with laws, rules, regulations and management decisions were observed.

Reference to Laws, Rules, Regulations and Management Decisions	Non compliance
(a) Establishments Code of Democratic Socialist Republic of Sri Lanka	
Paragraph 5 of Chapter XIX	Action had not been taken to recover rental for an official quarters occupied by an officer of executive grade during November and December of the year under review.

Chapter XXIV – 3.18.1	The Corporation had not taken action to recover a distress loan balance of Rs. 40,893 from an officer who proceeded abroad on no pay leave with effect from 08 November 2013.
(b) Public Finance Circular No. PF/PE/6 of 31 January 2000	PAYE tax amounting to Rs. 1,154,484 with respect to January to June of the year under review had been paid from the Corporation Fund contrary to instructions of the Circular.
(c) Public Enterprises Circular No. PED/57 of 11 February 2011	The Corporation had made payments amounting to Rs. 3,507,000 to non-Government organizations as donations and sponsorship allowances in 09 instances during the year under review without obtaining the approval of the Minister of Finance and Planning.
(d) The letter No. DMS/E4/10/4/090/2 of the Director General of Department of Management Services of the General Treasury dated 09 March 2009 addressed to the Secretary to the Health	
(i) Paragraph No. 02-01	Transport allowances amounting to Rs. 4,700 and Rs.3,000 had been paid monthly to each of the executive and non-executive grade officers respectively since 2009 without deciding on the transport allowance that should be paid to every officer based on the distance travelled. Transport allowance had been paid to officers who report for duty from areas close to the roads for which transport facilities had been provided by the Institute.
(ii) Paragraph No. 02-02	The entire staff had been paid the production incentives with effect from 01 July 2011 with a monthly maximum of Rs. 12,000 without the approval of the Department of Management Services.

According to the letter addressed to the Secretary to the Health , the maximum production incentive payable to the 224 officers during the year under review , amounted to Rs. 10,752,000. Nevertheless, the Corporation had paid a sum of Rs. 14,275,348. Accordingly, an approximate sum of Rs. 3,523,348 had been over paid as the production incentive.
This had been shown in the previous year.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the financial result of the Corporation for the year ended 31 December 2014 had resulted in a net profit of Rs.172,047,692 as compared with the net profit of Rs.207,601,451 for the preceding year , thus indicating a deterioration of Rs.39,553,759 as compared with the preceding year. Increase in the administrative expenses, selling and distribution expenses , and research and development expense by 26.23 per cent, 58.78 per cent, and 278.42 per cent respectively had been the main cause for this situation.

3.2 Analytical Financial Review

As the current ratio was 11.56 , and the liquidity ratio was 7.72 in the year 2014, it was observed that the additional working capital had not been made use of in an effective manner.

3.3 Legal Cases Instituted by or Against the Corporation

A case had been filed under case No.B/5019/10 at the Court in Mount Lavinia against a debtor defaulted to pay a sum of Rs. 570,257 that remained recoverable since 2007. The case remained unsolved as the accused could not be found. This had been referred to the Attorney General's Department for legal instructions.

4. Operating Review

4.1 Performance

(a) Manufacturing Process

Comparative information in respect of types of drugs manufactured by the Corporation during the year under review and 04 preceding years is given below.

Year	No. of types of Drugs Manufactured	Production Units in Millions
2010	38	1614.1
2011	37	1796.4

2012	40	1920.2
2013	40	2005.1
2014	38	1909.2

The following observations are made in this connection.

(i) Manufacture of drugs had improved by 4.4 per cent in the year 2013, whereas it had decreased by 4.8 per cent during the year under review.

(ii) In comparing the drugs manufactured in the year 2013 with that of the year under review, the number of items of drug, and the number of units manufactured had decreased by 02 numbers and 95.9 million respectively.

(iii) Out of the total production of 1,909.2 million units of the 38 types of drugs manufactured during the year under review, 1,303.8 million units representing 68.3 per cent depended on 8 types of drugs, whereas 605.4 million units equivalent to 31.7 per cent of the total production, depended on 30 types of drugs.

(b) Research expenses amounting to Rs. 685,131 had been incurred on 04 items of drugs that were at research level over a duration of 4 – 14 years as at 31 December 2014. Nevertheless, it was failed to introduce those drugs into the market.

(c) Utilization of Machinery in the Process of manufacturing Drugs
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The Corporation had utilized 12 machines during the year under review to manufacture 1,909.2 million units of drugs .
Details are given below.

Type of Machinery	**Production in the year 2014 Units in million**	**Production in the year 2013 Units in million**
Tablet manufacturing machines 01, 02, 03, 04, 05, 06, ST 49, PP800, AP22	1,667.7	1592.96
Capsule manufacturing machines GKF 800, GKF 1500, SF 135	241.5	412.13
	1,909.2	2005.09

The following matters were observed in this connection.

(i) Number of units of Amoxicillin manufactured by the capsule machines, *GKF 1500* and *SF 135* had decreased by 166.7 million units or 61 per cent during the year under review as compared with that of the year 2013.

(ii) The speed in the production of 'Bosch *G. K F. 800'* machine received in the year 1987 as a donation from Japan was low, and the '*Sanjin SF 135'* machine had developed mechanical faults during the year under review.

(d) Marketing and Pricing

Information relating to the sales of the Corporation for the year under review and the preceding year is as follows.

Party of sold	Sales of Drugs Units in Millions		Sales Income Rs. Million	
	2014	**2013**	**2014**	**2013**
State Pharmaceutical Corporation	6.8	13.5	8.1	9.6
Director General of Health Services	1,397.0	1,507.1	1,099.5	1,412.1
Distributors	548.7	478.5	604.5	519.4
Total	1952.5	1999.1	1712.1	1941.1

The following observations are made in this connection.

(i) The overall sales income of the corporation under review for the year amounting to Rs.1,712.1 million. As compared with that of the previous year amounting to Rs. 1,941.1 million, the overall income of the year under review had decreased by a sum of Rs. 229 million representing 11.8 per cent. The number of units sold had also decreased by 46.6 million or to 2.3 per cent.

(ii) Drugs worth Rs. 1,099.5 million from the overall sales income of the year under review had been sold to the Director of Health Services, representing 64.2 per cent of the total sales. However, in comparison with the preceding year, the sales made to the Director of Health Services during the year under review had decreased by a sum of Rs. 312.6 million, representing 22.1 per cent.

(iii) An income of Rs. 604.5 million had been earned during the year under review by selling drugs to the distributors, representing 35.3 per cent of the overall income. Discounts and allowances aggregating Rs.80,016,821 comprising a trade discount amounting to Rs.61,382,,388 , and a sum of Rs.18,634,433 as an allowance for fulfilling the targets for each month, had been paid to the distributors.

(iv) In considering the sale of drugs, 61.07 per cent of the total units of sales of drugs and 71.17 per cent of sales value had depended on 09 types of drugs.

Item of Drug	Units Sold Millions	As a Percentage of Total Sales	Sales Value Rs.	As a Percentage of Sales Value

		Units	Million	
Amoxicillin Cap BP 250 mg	99.05	5.1	205.5	12.00
Cloxacillin Cap BP 500 mg	24.82	1.27	89.32	5.21
Paracetamol Tab BP 500 mg	239.01	12.24	189.03	11.04
Prednisolone Tab 5 mg	189.98	9.73	220.11	12.85
Metformin Tab BP 500 mg	86.32	4.42	64.95	3.8
Cloxacillin Cap BP 250 mg	93.48	4.79	182.51	10.67
Folic Acid 1 mg	333.95	17.11	115.20	6.7
Diltiazem HCL 60 mg	105.37	5.4	75.41	4.4
Amoxicillin Cap BP 500 mg	19.68	1.01	77.64	4.5
	1,191.66	61.07	1,219.67	71.17

(v) Out of the drugs ordered by the Medical Supplies Division for the year under review, 300.929 million units of 11 drug items valued at Rs. 299,479,285 could not be supplied during the year under review owing to reasons such as, technical faults of raw materials, inability to supply the raw materials in compliance with proper standards, faults of the production formulae, inadequacy of the capacity of the machines used to cover the tablets, and lack of adequate capacities of the laboratories.

(e) Pricing of Drugs

The Corporation had maintained 2 pricing strategies in the current year for the Medical Supplies Division, and the distributors who sold drugs. The following observations are made in that connection.

(i) Prices of the drugs for the Medical Supplies Division had been decided with a 12 per cent profit margin on the standard cost of production. For the first half of the year 2014, the prices decided by the committee on 19 December 2013 and prices decided by the committee on 25 June 2014 had been used for the first and the second half of the year, 2014 respectively.

(ii) Prices had been decided with a 15 per cent profit margin for the State Pharmaceutical Corporation the permanent distributor of the Corporation up to the year 2012, whereas the Corporation had not maintained a pricing strategy with a specific profit margin with respect to the distributors since the year 2013. Instead, each drug had been priced with variant profit margins.

Furthermore, prices relating to 23 items of drugs out of 54 included in the price list as at 31 December 2014 , had remained unrevised over a period of 02 years. The profit margin of 05 items out of the said 23 items of drugs , had been at a very low level.

4.2 Management Inefficiencies

The following observations are made in connection with the new wholesale outlet commenced by the Corporation at No. 22 , Dharmapala Mawatha, Colombo 07 on 06 January 2015 with the objective of wholesale marketing, and selling drugs to the medical officers.

(i) The commencement of the said whole sales outlet had been approved by the procurement Board of the Department on 25 June 2014. However , no written agreement in connection with the renting of the premises at which the outlet is located, had been entered into with the owner of the building namely Medicom (PVT) Ltd.

(ii) Even though the Board of Procurement had informed that a feasibility study on the commencement of a sales outlet be conducted at the said location prior to opening the wholesale outlet, the Board of Directors had granted approval to open the sales outlet under a supervisory period of one year after the Board of Directors had been informed by the Assistant Manager, marketing and Promotions, that it was not possible to prepare an accurate feasibility report.

(iii) Following a decision made by the Management Committee meeting held on 02 April 2015, the sales outlet had been closed down due to the fact that a loss aggregating Rs. 1,031,013 had incurred during the months of January, February, and March of 2015 in which the sales outlet had been maintained. It is the opinion of the audit that the Corporation would not have incurred the said loss , had a formal market research been conducted prior to the establishment of this sales outlet.

4.3 Operating Inefficiencies

The following observations are made.

(a) The stock of Chloramphenicol BP – 2010 raw material, 935.8 Kg in weight valued at Rs. 5,041,649 had expired during the year 2014. Even though the audit had been informed by the Corporation that the expiry period of those raw materials could be revalidated by an year and be used in manufacturing drugs, only 2.96 million units of the said drug had been manufactured during the year 2014 by utilizing 66.9 Kgs of that raw material. The rest of the raw material lies in the warehouse even at present without being used, and 18.5 Kg of that had expired in the month of March, 2015, whereas the remaining 917.3 Kg is to be expired in the month of July, 2015. Hence , the audit observed that the Corporation would inevitably incur a financial loss amounting to Rs. 5,041,649 in case the stock of raw material was not made use within the next 2 months. No provision had also been made in the financial statements in that connection.

(b) The stock of raw material, Folic Acid BP – 2010 brought under Indent No. 20142952 , had been received by the Corporation in the month of January 2015. However, the quality control division of the Corporation had not issued a report on the quality of the stock of raw materials even by April 2015 .

(c) An agreement had not been entered into with the supplier even by the date of audit to obtain a stock in compliance with the specifications in place of the stock of raw material, Frusemide – BP 2010 valued at Rs. 4,084,816 that was reported to have failed the quality tests on 10 September 2014.

4.4 Transactions of Contentious Nature

The following observations are made.

(a) Expenses amounting to Rs. 3,686,,312 had been incurred in 05 instances on the activities contrary to the objectives of the establishment of the Corporation.

(b) The State Engineering Corporation had been paid a sum of Rs. 1,349,312 without calling for competitive bids for the construction of a waiting hall for the patients visiting the Ward No. 01 of the Colombo South Teaching Hospital. The Corporation had not drawn the attention of the possibility of getting the aforesaid activity achieved at a lesser expense.

4.5 Irregular Transactions

A housing rental amounting to Rs. 60,000 for a period of 2 months had been paid to the owner in spite of the house not being occupied by an officer of the Corporation.

4.6 Idle and Under Utilized Assets

The following observations are made.

Due to damages and non-utilization, 112 units relating to 05 items of assets valued at Rs. 49,957,886 had remained idle at various divisions of the Corporation since the year 2009 to the date of audit in the year 2015

The reply to the audit query No. HM/A/SPMC/2014(02) dated 21 May 2014 about the damaged assets not being disposed if it was not possible to reuse after being repaired in an economically and effective manner, stated that action is being taken as per the report made by a Board of Survey appointed for that purpose. Nevertheless, those activities had not been completed even by February, 2015.

4.7 Un -economic Transactions

The following matters were observed.

(a) The meeting of the Board of Directors had been held at a hotel in the month of December of the year under review. An additional expense amounting to Rs. 219,600 as food and accommodation charges had incurred due to the fact that 28 officers who had attended the meeting, and their family members who stayed at the said hotel.

(b) Hotel charges amounting to Rs. 123,200 had been spent on the workshop for the preparation of the corporate plan of the Corporation for the period 2014 – 2018 year.

4.8 Identified Losses

The following observations are made.

(a) Due to failure in quality tests, faults in formulae , non-issuance, and expiration, 6,202,.61 Kg of raw materials of 16 items of drugs valued at Rs. 19,767,957 , and 45.854 million units of raw materials of drugs , had remained in the warehouses without being used for manufacturing as at 31 December 2014. The Chairman had informed the audit that the Corporation had recovered a sum of Rs. 730,589 by June 2015 on behalf of those stocks , whilst the rest of the stocks valued at Rs. 19,037,368 had remained in the stores without being used for manufacturing.

(b) As per a decision taken at the Board of Directors meeting, No. 339 held on 12 September, 2014 , drugs and drug compounds of 261.58 Kg relating to 6 items of drugs totaling Rs. 455,496 that had expired in the during the years 2009, 2010, 2011, and 2012, had been destroyed.

4.9 Human Resources Management

There had been 27 vacancies as the approved cadre and actual cadre had been compared as at 31 December 2014.

5. Accountability and Good Governance

5.1 Budgetary Control

The budget relating to the year under review had been revised. In comparing budgeted expenses with the actual expenses, variations ranging from 25 per cent to 257 per cent had been observed relating to 03 Heads, whereas variations ranging from 30 per cent to 481 per cent had been observed relating to assets and liabilities, thus, the budget had not been use of as an effective instrument of management control.

6. Systems and Controls

Weaknesses observed in systems and controls 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.

(a) Fixed Assets
(b) Stocks
(c) Pricing
(d) Production
(e) Personnel Administration