## MILCO (PRIVATE) Limited - 2015

The audit of the financial statements of the MILCO (PRIVATE) Limited ("the Company") 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.

This report is issued in terms of provisions in Article 154(6) of the Constitution of the Democratic Socialist Republic of Sri Lanka.

### 1.2 Board's Responsibility for the Financial Statements

The Board of Directors ("Board") 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 Board 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. 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 judgment, 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 Company'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 Company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board, as well as evaluating the overall presentation of the financial statements.

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

**(a) Capital Work-in-Progress**

**(i)** This includes a Yoghurt Mix Plant amounting to Rs. 104,177,780 which had been idling for a considerable period of time as at the reporting date. A plant being idle for such a considerable time could be considered as an indication of impairment of the plant and hence, needs to be tested for the impairment as required by LKAS 36 - Impairment of Assets.

However, the above asset had not been tested for impairment by the management as at the reporting date and as a result, I was unable to satisfy myself as to the valuation of the same as at the reporting date.

**(ii)** This includes the cost incurred on the modernization of three factories of the Company amounting to Rs. 6,617,560,269 and the cost incurred for setting up a dairy processing plant at Badalgama amounting to Rs. 429,172,328. Based on the current management reports/correspondence and inquiries made with the management, it was noted that the expected milk supply would not be sufficient to support the enhanced capacity of the Company. This is an indication of impairment of the balance stated as mentioned above and hence, needs to be tested for the impairment as required by LKAS 36- Impairment of Assets.

However, the said assets have not been tested for impairment by the management as at the reporting date and as a result, I was unable to satisfy myself as to the valuation of the same as at the reporting date.

**(b) Long Term Payable on Shipment Received**

I was not provided with third party confirmations in respect of payable balance amounting to Rs.300,640,103 on the modernization of three factories of the Company as detailed in Note No 23.

Owing to the nature of the company's records, I was unable to perform other audit procedures to satisfy myself as to the completeness and the accuracy of the aforesaid balances as at the reporting date.

## 2. Financial statements

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### 2.1 Qualified Opinion

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

#### 2.1.1 Report on Other Legal and Regulatory Requirements

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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) In my opinion :

- I have obtained all the information and explanations that were required for the audit and as far as appears from my examination, proper accounting records have been kept by the Company.
- The financial statements of the Company comply with the requirements of Section 151 of the Companies Act, No. 07 of 2007.

**2.2 Transactions not Supported by Adequate Authority**

During the year, the Company has made a bad debt provision of Rs.447,981,206 against receivable from Government of Sri Lanka. However, prior approval of the Board of Directors of the Company has not been obtained in this regard.

**3. Financial Review**

**3.1 Financial Results**

According to the financial statements presented, the operations of the Company during the year under review had resulted in a pre-tax net profit of Rs.3,817,741 for the year under review as compared with the pre-tax net profit of Rs.248,159,134 for the preceding year, thus indicating a deterioration of Rs.244,341,393 in the financial results for the year under review. Increase of administrative expenses by Rs.144,765,566 was the main reason attributed for the deterioration in the financial results for the year under review.

**4. Operating Review**

**4.1 Performance**

According to the memorandum of Association of the Company the primary objectives of the Company are: to promote, plan and organize programs for the purpose of development of dairy and other agriculture based and allied industries on an intensive and nationwide basis and to render assistance and adopt the corporative strategy in the implementation of such programs, and to carry on the business of collecting, processing, manufacturing packing, distributing, marketing and such other dealing in various milk and milk products and other agricultural produce in Sri Lanka.

However, the Company had failed to set out Annual Targets / Key Performance Indicators (KPI's) in order to achieve the above objectives. Therefore, it was unable to compare the actual performance with the expected targets in audit. Further, the Progress Reports had not been prepared in the manner to facilitate the separate identification of the performance of each Factory. As such the achievements of expected manufactory targets could not be ascertained in audit.

The various milk and milk products manufactured in the year 2015 as compared with the previous year are given below.

| Name of Product | Production | | Increase/(Decrease) | |
|---|---|---|---|---|
| | 2014 | 2015 | Litre/ Kg | Percentage |
| Pasteurized Milk (Litre) | 3,118,349 | 3,182,754 | 64,405 | 2.07 |
| UHT Milk (Litre) | 11,204,940 | 11,129,400 | (75,540) | (0.67) |
| Sterilized Milk (Litre) | 2,900,308 | 2,026,712 | (873,596) | (30.12) |
| Curd (Litre) | 525,173 | 609,585 | 84,412 | 16.07 |
| Ice Cream (Litre) | 4,922,780 | 5,567,874 | 645,094 | 13.10 |
| Ghee (Kg) | 36,497 | 74,660 | 38,163 | 104.57 |
| Cheese (Kg) | 59,718 | 49,474 | (10,244) | (17.15) |
| Butter (Kg) | 684,741 | 691,503 | 6,762 | 0.99 |
| Condensed Milk (Litre) | 418,082 | 351,297 | (66,785) | (15.97) |
| Yoghurt (Litre) | 5,469,870 | 6,276,520 | 806,650 | 14.75 |
| Flavoured Milk (Litre) | 605,391 | 50,716 | (354,675) | (58.59) |
| Milk Powder (Kg) | 4,282,048 | 4,298,377 | 16,329 | (0.38) |
| Cooking Milk (Litre) | 9580 | 3024 | 6556 | 68 |

## 4.2 Operating Activities

### 4.2.1 Factory Modernization Project

The Modernization Project of the Polonnaruwa, Digana and Ambewela Factories carried out under the loan of Rs.5,854,450,856 (EURO 33,779,210) obtained on 2 per cent non-commercial interest rate and 6 +LIBOR per cent commercial interest rate in terms of loan agreements entered into between the HSBC Bank and the Department of External Resources of the Treasury as well as between the Department of External Resources and the Company in the year 2013.

The following observations are made in this connection.

(i) The contractor for project works had been selected without being followed accepted procurement procedure.

(ii) The assets received by the Factories under the Project from 09 January 2013 to 21 October 2015 were kept at the premises of the Factories without being fully utilized even by 31 July 2017.

(iii) The modernization of 4 factories, repair of 80 Milk Collecting Centres and the construction of 20 new centres according to a proposal forwarded by the Desmi Contracting A/S 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 report of that Committee, an agreement for EURO 39.1 million had been entered into on 31 December 2009 between the Desmi Contracting A/S. But, the Chairman of MILCO had issued a letter to the Desmi Contracting A/S on 24 June 2011 making a new proposal. According to that proposal, an agreement for EURO 33.78 million had been entered into again on 12 January 2012 by deducting EURO 1.56 million allocated for modernization of the Colombo Factory, EURO 2.37 million allocated for the cost of repairs to 80 Milk Collecting Centres and the construction of 20 Centres and the cost of UHT Machine of Digana Factory. Nevertheless, the Technical Evaluation Committee had evaluated the original project on the assumption the capacity would be available at the maximum level and the number of Milk Collecting Centre should exist accordingly. As the Milk Colleting Centre had been eliminated in the project agreement approved subsequently without giving any alternative arrangement, the possibility of the risk of adverse impacts on the effectiveness of the project was observed.

(iv) The period of the contract, according to the agreement entered into between the MILCO (Pvt) Ltd, and Desmi Institution, should have been completed by 12 July 2014. Nevertheless, the modernization of the Milk Factories at Digana and Ambewela had not been completed by 31 July 2017 and none of the two parties had taken any action for the extensions of the contract period whilst the Board had not taken action for the recovery of the amount agreed as liquidated damages. The delays had exceeded 36 months. Even though EURO 1,688,961 remains recoverable as liquidated damages, there was no correspondence exchanged in this connection.

(v) The loan agreement entered into between the HSBC Bank and the Department of External Resources of the Treasury had been extended up to 31 December 2016 as the Desmi Contracting A/S had not completed the project work of this factories at Digana and Ambewela on due date. Despite the non-completion of the above project work even by 31 July 2017 action had not been taken to extend the period of the loan agreement entered into with Bank and the final retention money payable to the Desmi Contracting A/S amounting to 10 per cent of the contract value, that is, EURO 3,071,693 had been paid contrary to the agreement, on 27 March 2016 on a Bank Guarantee. The Bank Guarantee obtained in this connection from the Desmi Contracting A/S is due to expire on 31 August 2017.

**4.2.2 Badalgama Project**
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The Cabinet of Ministers had given the approval on 23 April 2015 for the award of the contract for Relocation of Narahenpita Factory of the Company to Badalgama Project implemented under the loan of Rs.9,932,709,286 obtained at the non-commercial interest rate of 1.9 per cent and the commercial interest rate of 5 + LIBOR per cent in terms of a loan agreement entered into between the HSBC Bank and the Department of External Resources of the General Treasury to the Desmi Contracting A/S selected on the Turn Key basis without being followed accepted procurement procedure. The following observations were also made in that connection.

(i) According to the letter No. NLRCD/03/117 dated 25 November 2013 of the Secretary to the Ministry of Livestock and Rural Community Development; the Ministry Evaluation Committee had evaluated the Desmi Contracting A/S and the Boccard Food Pharma on 05 June 2013 and selected the Boccard Food Pharma as the best favourable institution. Further, it had been observed the value of the offer of Desmi Contracting A/S exceeded the offer of Boccard Food Pharma by EURO 10 million. (Rs.1,750 million)

(ii) The Committee Report on the Project furnished on 20 August 2014 indicated that the value of constructions show a higher value than a fair value of EURO 4,000,000 (Rs.596,952,800) and the daily quantity of 650,000 litres of milk expected under the modernization of the Milco Company is a limiting factor.

(iii) According to the following matters appearing in the Contract Memorandum forwarded on 04 March 2015, prior to entering into the agreement, the approval of the Cabinet of Ministers for the rejection of the project had been granted on 07 March 2015.

- Inability of the Milco Company to repay the Loan.
- The Company is in a severe financial crisis due to the Government Policy of increasing the price of milk and the non-increase of the prices of the products as compared with that and obtaining a loan would further aggravate that financial crisis.
- The proposed factory modernization will result the requiring about 200,000 litres of milk per day and accordingly, the company has to obtain about 600,000 litres which represent about 75 per cent of the production of the country If this factory is established, the supply of milk would face a severe crisis.

Nevertheless, the concurrence of the Cabinet of Ministers for the Project had been obtained by presenting a Cabinet Note on 08 April 2015 subject to obtaining a Contra Loan to the MILCO with a grace period covering the initial 3 years.

(iv) The Company and the General Treasury had not entered into a Contra Loan Agreement for the period even by 31 July 2017.

**4.3 Identified Losses**

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The following observations are made

(a) The payments had to be made for a number of litres more than actually received by the factories due to lack of proper supervision on the operation of the Milk Collection Centres, and as such it was observed that an amount approximately Rs. 764,304,989 had been wasted by the Company up to the date of audit on 30 June 2017. The new project in this connection not being in full operation (Storage capacity) even by 31 July 2017 had an impact on that matter.

(b) The Company had procured 160,690 Kilograms of Metalized Polyester with 400 gram packs by accepting higher price quotations with the recommendations of Procurement Committee at a cost of Rs.92,676,969 by rejecting the lowest price quotations without adducing justifiable reasons. As a result, the Company had sustained a loss of Rs.19,885,269 during the period from January 2011 to March 2015.

**4.4 Staff Administration**

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In terms of Management Services circular No. 30, the staff had not been reorganized. Nevertheless, a staff with 1420 personnel had been approved by the Department of Management Services on 07 November 2008 emphasizing the necessity of reorganization of the staff.

**4.5 Market share**

The company had not carried out a market survey to determine the market share of the Company.

**5. Accountability and Good Governance**

**5.1 Action Plan**

The main business activities of the Company had not been included in the Action Plans prepared for the years 2015, 2016, and 2017.

**5.2 Procurement Plan**

Without a Procurement Plan, in the year 2015 the Company had made budgetary provisions of Rs.616 million and Rs.653 million and in the year 2016, Rs.806 million and Rs.814 million for purchases of capital items and raw materials respectively.

**6. Systems and Controls**

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 control.

| Control Area | Weaknesses Observed |
| --- | --- |
| Procurements | i. Purchase of goods and services in contrary to the procurement Guidelines.<br>ii. Purchasing similar items by placing several orders within the limit of Sales Manager. |