MILCO (PRIVATE) LIMITED -2017
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The audit of the financial statements of the MILCO (PRIVATE)LIMITED ("the company") for the year ended 31 December 2017 comprising the statement of financial position as at 31 December 2017 and the statement of profit and loss and other 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 contains my observations regarding the company's performance during the year under review, which I consider should be report to Parliament in accordance with Article 154 (6) of the Constitution of the Democratic Socialist Republic of Sri Lanka.

1.2 **Board's Responsibility for the Financial Statements**
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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.

1.4 **Basis for Disclaimer of Opinion**
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(a) The yoghurt mixing plant worth Rs.104,177,779 was purchased on lease basis on 20, January 2011 for installation at the Colombo factory without identifying the properly requirement therefore it was installed at the Polonnaruwa factory on 30th August 2013 but due to technical faults of the machine it has not been used from the date of purchase till the date of audit December 2019. According to the Sri Lanka Accounting Standards 36, the impairment adjustments have to be made in accordance with for the value of the relevant machine, but no action have been taken accordingly.

(b) The Company had not carried out a physical verification of the fixed assets and could not verify the existence of the fixed assets. The audit could not verify the existence of fixed assets of Rs. 6,698.63 million have been reported in the financial statements for the year 2017.

(c) The project was under construction at a cost of Rs. 8,083,216,612 as at 31st December 2017 for the establishment of the Badalgama Dairy Processing Plant. According to the company's management and performance reports, the Ambewela factory, which was completed under the modernization project, received liquid milk in 2018 and 2019 with only 26 percent and 25 percent of the total plant capacity, respectively. After the completion of the Badalgama factory which is currently under construction, it has been reported that the company needs 600,000 liters of liquid milk per day according to the plant capacity of the factory, it was observed that these machines were not used at full capacity as the daily volume of liquid milk was about 200,000 liters. Accordingly, impairment adjustments had to be made in accordance with Sri Lanka Accounting Standards 36 for the value of this machine, but no action had been taken accordingly.

(d) Examining the financial statements from 2013 to 2017, both the factory modernization project and the Badalgama project were mentioned in the financial statements as a collection. According to the Note No. 15.1.3 of the Company's Financial Statement for the year under review, a sum of Rs. 15,781,118,709 as loans obtained from the General Treasury. According to the schedule, the loan balance for the factory modernization project was Rs. 6,632,493,444 and the loan balance for the Badalgama project was Rs. 9,148,369,878. Accordingly, there was an unidentified difference of Rs. 255,386 with the balance of the financial statement. The following were further observed in connection with the above balances.

(i) The Company and the Treasury had entered into a loan repayment Agreement on 09 September 2013 in respect of the Factory Modernization Project. According to the financial statements of the Ministry of Finance as at 31st December of the year under review, the loan balance (excluding foreign exchange variance) under the project amounting to Rs. 2,185,414,618 and according to the Treasury Operations Department of the Ministry of Finance, the Treasury paid the Bank as at 31 December of the year under review but the Company had not repaid to the Treasury a balance of Rs. 3,010,404,156 and an interest balance of Rs. 544,357,013. Accordingly, the Company should have stated Rs. 2,185,414,618 under non-current liabilities in the financial statements and Rs. 3,010,404,156 as current liabilities to be repaid to the General Treasury on that day, As a result of ,. Rs.632,493,444 had been shown as long term loan in financial statements of the company in respect of that project, the loan balance had been overstated by Rs. 1,436,674,670 and the interest payable at Rs. 544,357,013 had not been taken into account.

(ii) According to the above refund agreement, the company will have to pay an additional 2% interest to the Treasury if the company fails to repay the loan installment and interest due to the Treasury in time. Accordingly, the amount due to the Treasury as at 31st December 2017 is Rs. 3,010.4 million loan installments and Rs. 544.36 million for interest No provision had been made in the financial statements as at 31 December 2017 for Rs. 137.2 million, which is 2% interest payable from 2013 to 31 December 2017.

(iii) According to paragraph 2.04 of the Agreement between the Company and the Department of External Resources for the Factory Modernization Project, the Company shall bear all costs and exchange variations incurred by the Department of External Resources for the project. Accordingly, the loan balance to be paid as at 31st December 2017 in relation to the above project should be valued and accounted at using year end foreign exchange rate as at the end of the year in terms of paragraph 23 of Sri Lanka Accounting Standards 21. Due to non-accounting for the adverse effect of the foreign exchange rate variance of Rs.753,021,056 from 2013 to 2017, the company's liabilities were understated and the accumulated profit was overstated at the same rate.

(iv) According to Cabinet Decisions No. 15/0205/631/012 dated 08th April 2015 for the Badalgama Project, the Company and the Treasury of Sri Lanka were required to enter into a Repayment Agreement but the relevant Agreement was not entered into until 31st December 2019. According to the 814 Report of the External Resources Department of the Ministry of Finance, the contractor for this project had been paid Rs. 8,072,223,622. According to the financial statements of the Company as at 31st December of the year under review, The long-term debt balance of Rs. 9,148,369,878 was found to be Rs. 1,076,146,256 more than the 814-report balance of the External Resources Department. According to the financial statements of the Ministry of Finance on that day, the loan balance to be paid under the project was Rs. 7,842,369,066.

(e) Bidding by the tender board of the company on 27th June 2011 as per the approval of the Board of Directors dated 31st January 2012 the head office had purchased an ice cream machine on 17 January 2013 at a cost of Rs. 12,685,478. Although the machine was handed over to the Digana Dairy factory in April 2014, this machine had not been used by the date of the audit on 31 December 2019. However, the machine had not been impaired according to the Sri Lanka Accounting Standards 36.

(f) Company were prepared Financial Statements by amalgamating 04 factories Accounts, An accounts of cattle feed project and head office accounts. And final stock has been valued based on varied method Instead of less value of the cost or net realizable value In accordance with Sri Lanka Accounting Standard 02 of chapter 9. As per the sample test it was observed that the final stock balance has understand by Rs. 133,273,441 and the Consolidated profit also overstated by that amount.

(g) According to the financial statements, the advance of Rs. 4,699,558 paid to the Board of Directors as at 31st December 2017 have not been paid even after 5 to 10 years and according to the schedule the balance was Rs. 4,661,019. A difference of Rs. 38,539 was observed between the financial statements and the schedule. Also, the information regarding the advance balance was not submitted for audit and was not disclosed in the financial statement as per Sri Lanka Accounting Standards No. 24.

(h) Evidence related to the following items could not be submitted to the audit and could not be satisfactorily monitored and verified during the audit.

(i) Vouchers and receipts for pre payments of Rs. 3,407,812 and delivery slips for Rs. 4,676,233 in advance (Milk Can).

(ii) Detailed Schedule, Age Analysis, Sales Invoices, Delivery slips pertaining to trade debtors amounting to Rs. 3,099,816 and Delivery Slips and Sales Invoices for various debtors amounting to Rs. 1,458,589.

(iii) Guaranteed Deposit Certificates for Guaranteed Deposits of Rs. 4,228,888 and Receipts and warranties pertaining to secured deposits of the Ceylon Electricity Board amounting to Rs. 1,603,212.

(iv) Invoices and receipts for creditors amounting to Rs. 5,695,377 and Detailed Schedule for interim advances amounting to Rs. 3,940,651.

(v) Balance confirmations related to balances due from government institutions amounting to Rs. 6,809,759.

(vi) Age analysis and detailed schedules relating to accrued expenses amounting to Rs.314,423,452 under current liabilities.

(i) Unused 17,750 kg of packaging material and 31,000 bags of fertilizer owned by Ambewela factory worth around Rs. 15,699,277 is been stored at the Polonnaruwa factory stores from 7 May 2016 without adjusting as outdated stock and added to the inventory as at 31 December 2017 and stated in the accounts.

(j) As at 31 December 2017, it was observed that the net profit had been overstated due to the non-adjusted of the unused packaging materials stock of amounting to Rs. 3,164,057 in the financial statements.

(k) The balance of creditors amounting to Rs.231,428,134 as at 31st December 2017 and the balance conformation letters have been sent to 48 creditors amounting to 199,658,396. 39 creditors had not provided balance conformations and only 9 creditors had given balance confirmations, among those, 3 creditors did not agree with the balance in the schedule. Although it was observed that it should have increased by 17,368,327 and the reasons for the difference were not presented to the audit.

(l) Out of the Rs. 18,048,474 received from a non-governmental organization for the implementation of a project from 2007 to 2011, Rs. 1,497,000 was paid in cash and a balance of Rs.4,545,630 was credited and debited. However, the audit was informed that no evidence or schedules related to the above cash receipts, payments and journal entries was produced.

(m) Cattle feed worth Rs. 2,979,204 had been purchased from a private company and provided to the dairy farmers on a recurring basis when paying for milk. Accounts had not been maintained regarding the issues of cattle feed to dairy farmers and the recovery value from it to the farmers. As a result, it was not established that the amount due from the farmers had been recovered, and the creditors had also erroneously stated that the total value of the cattle feed purchased in the financial statements for the year under review had been misrepresented in the name of the above private institution as a debit balance under other creditors.

2. Financial statements

2.1 Disclaimer of opinion

I was unable to obtain sufficient and appropriate audit evidence to provide a basis for an audit opinion due to the facts set out in the paragraph on the basis for misrepresentation of this report. For that reason, I do not comment on these financial statements

2.1.1 Report on other legal and regulatory requirements

As stated in Section 163 (2) of the Companies Act No. 07 of 2007, I make the following statement.

(a) The basis for the opinion, and scope limitations of the audit are as stated above.

(b) I have not obtained all the information and explanations required for the audit and the Company has not maintained proper accounting records as shown by my investigation;

I am of the view that the financial statements of the Company are in accordance with the requirements of Section 151 of the Companies Act No. 07 of 2007.

2.1.2 Presentation of financial statements

According to Section 6.5.1 of the Public Enterprise Department Circular No. PED / 12 dated June 02, 2003, the Financial Statements and Drafts of Annual Report must be submitted to the Auditor General within 60 days after the end of the financial year, but the Financial Statements for the year 2017 were submitted to the Auditor General on 06 January 2020. The draft annual report had not been submitted until 15 May 2020.

3 . Financial Review

3.1 Financial results

According to the financial statements submitted, the company had a financial deficit of Rs.434,933,130 for the year ended 31 December 2017, correspondingly, last year's surplus was Rs. 339,331,549 and compared to the previous year, the financial results of the year under review were decline by Rs. 774,264,679. The decline was mainly due to the decrease in gross profit of Rs. 490,902,443 over the previous year and an increase of Rs. 340,730,771 in administrative, distribution and other expenses.

3.2 Analytical Financial Review

Due to loans obtained for the factory modernization project and the Badalgama project, the company's gearing ratio increased from 0.64 to 10.12 in 2012 to 2017.

4. Operational review

4.1 Performance

4.1.1 Planning

The following observations are made.

(a) In terms of Section 5.1.2 of the Public Enterprises Circular No. PED / 12 of 02 June 2003, Although the action plan should incorporate in the corporate plan the technical knowledge of the institute, markets and suppliers that the organization currently has, the organizational structure and the goals and objectives to be achieved within the planning period It was not included in the consolidated plan for 2015-2017.

(b) Only capital expenditure was included in the annual budget for the year under review and budgeted operating expenses were not included.

(c) Although the Company had allocated Rs. 660.42 million and Rs. 207.95 million respectively for the purchase of capital assets and repair of capital assets during the year under review, no procurement plan has been prepared in terms of paragraph 4.2 of the 2006 Government Procurement Guidelines.

4.1.2 **Activity and Review**

Sterilized milk production increased by 47 percent in 2016 compared to 2015 and decreased by 36 percent in the year under review compared to 2016. Also, cheese production fell by 59 percent in 2016 and 29 percent in the year under review compared to 2015. In the year under review, butter production increased by 32 percent and milk powder production increased by 69 percent compared to 2015.

4.2 **Management activities**

The following observations are made.

(a) Ambewela factory

According to the stock verification conducted at the Ambewela factory from 26 to 30 December 2017, it was observed that 13 million stocks of milk powder had been damaged and the details are as follows.

(i) Rain water had leaked through the holes in the roof of the main warehouse where the milk powder was stored and filled the warehouse with water to a height of about 3 inches. 178 containers each with 25 kg of milk powder containing 4,450 kilograms that the market value of 3 million milk powder had leaked out of the packages, causing various damages such as getting wet by the rain, cracks on the bags and damages caused by stuck on pallets had occurred.

(ii) The stocks of milk powder had not been stored systematically and safely in the stores in accordance with code numbers, batch numbers, and dates of expiry. Furthermore, at the time of issue of stocks the stocks received first by the stores had not been issued first and the reason was due to the difficulties to access to the stock.

There was 3,900 kilograms of milk powder worth of Rs. 2.6 million, expiring as at 1 February 2018, and 10,750 kilograms of expired milk powder classified in the store as animal feed with market value of Rs. 7.4 million.

(b) Polonnaruwa Factory

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(i) It was observed that diesel stocks were included in the stock records without physical verification.

(ii) The stock of chemicals valued at Rs. 174,420 as at 31 December 2017. There are 26 types of chemicals that expired and were not currently in use between 2007 and 2017, and most chemicals did not have even a production or expiration date which valued at Rs. 3,164,057 was also included in the stock as at 31st December 2017.

(iii) There are 12 acres of land where the Polonnaruwa Dairy Factory is located and two other 37 acres of land with staff quarters, playground, dairy and circuit bungalow but the company did not have the relevant deeds and plans for those lands till the end of 2019. And the audit observed that the dairy shop, sports club and cattle shed built on one of the lands were not in use at present and more than 15 acres of that land was lying idle without being used for any cultivation or construction.

4.3 **Operational inefficiencies**

The following observations are made.

(a) Milco had paid excess of Rs. 73,343,796 more in 2017 due to paying more liters of milk than the amount actual received by the factories during milk collection. This was mainly due to the non-operation of the milk collection centers under proper supervision and the non-construction of new milk collection centers under the factory modernization project so that the data could be transmitted to the head office and monitored automatically.

(b) According to the performance report for the year 2017, the Ambewela factory had an extraordinary stock damage of 1,813,226 liters worth Rs. 124,587,211 and It was observed that the average waste which was 2 per cent till July 2017 has increased to 4 per cent by August 2017.

(c) Prior to the year 2016, UHT milk packets were sold directly from the Polonnaruwa factory to 08 Army camps in Sri Lanka. Due to selling through two agents of the company instead of selling directly to the Sri Lanka Army after 2016 the company had incurred losses of Rs.11,172,336, Rs.19,768,291 and Rs.17,485,394 in 2016, 2017 and 2018 respectively.

(d) Even if the maximum loan period that the company gives to an agent is 50 days, It was observed that the loan periods ranging from 40 days to 180 days were given to the two agents who supplied to the Sri Lanka Army as above in 2017 and 2018 for supplies of Rs. 14,298,178 and Rs. 24,595,873 respectively.

e) The approved loan period had expired but the product had been sold to one of the above two agents in 2017 and 2018 in excess of the value of the bank guarantee of Rs.30 million obtained by the Company with regard to the sale of milk packets made by the Polonnaruwa Dairy Factory, the bank guarantee value for the years 2017 and 2018 was Rs. 10.6 million and Rs. 49.7 million., Respectively. Accordingly, it was observed that the company had arrears of Rs. 34 Mn. For the year 2018 even before the audit date of 21st January 2019.

(f) It was observed that receivable advances less than 1 year Rs. 4,954,294 and Between 1-3 years Rs. 316,750, Between 3-5 years Rs. 252,117 between 5-10 years Rs. 646,030 and More than 10 years was Rs.22,000.

(g) It was observed that the total advance balance of Rs. 26,237,597 Issued to 49 external agencies and outsiders was still unsettled as on 31st December 2017. According to the age analysis of the balance, Rs. 4,564,820 less than 1 year, Rs. 4,634,510 between 1-3 years, Rs. 12,380,390 between 3-5 years, and Rs. 4,517,543 between 5-10 years and Rs. 140,285 over 10 years.

(h) According to the agreement entered Milco with the Pelawatta Pvt. company, Payment should be made within 15 days from the date of delivery of milk. But out of the balance of Rs.122,646,142 due on 31st December 2017, Rs. 41,841,560 over 2 years and Rs.80,804,581 for a period of 4 months to 1 year. Out of the above balance, the balance due by 30 September, 2019 was Rs. 58,065,577. It was observed that no charges had been made in accordance with the agreement.

(i) For the Badalgama project of the company, the relevant custom duties should be paid on the due date on the request of the company to release the equipment imported by the contractor from the port, Although the payment of customs duty should be made by the relevant Ministry through provisions. But due to non-payment of customs duties on the due date, During the year 2017, as an additional cost Rs. 6,439,218 had to be borne as late fees and as a result, loss of the company has increased by that amount.

(j) Advance payments to the Ceylon Petroleum Corporation are Rs. 2,902,662 out of which Rs. 1,996,420 is between 3 to 5 years and Rs. 1,086,636 were observed to be between 5- and 10-years duration.

4.4 **Staff Administration**

(a) The relevant approval for staff recruitment had not requested according to Management Services Circular No. 30 dated 25 October, 2018. There were 1420 carder provisions were approved by the Department of Management Services on 7 November 2008 and actual staff 1471. The actual staff had 45 executive grade and 352 primary level vacancies and a surplus of 363 secondary and primary level employees and a total of 51 employees were in surplus.

(b) According to the Circular 9.14.1 of the above, the Company had not prepared a manual on human resource management with the approval of the Board of Directors and with the concurrence of the Secretary to the Treasury. Furthermore, for the executive officers in addition to the 1/20 allowance compensation leave have been granted for week end duties while other officers (non-executive) have been paid overtime allowance providing lieu leave.

(c) As per Public Finance Circular No. 03/2015 dated 14th July 2015, the maximum value that can be given by the Actual sub imprest is limited to Rs. 100,000. If the limit is exceeded, the Chief Accounting Officer should obtain the prior approval of the Treasury. Accordingly, the Chairman and the Vice-Chairman have been paid once Rs. 314,160 & Rs. 1,000,000, respectively. The Acting Director have been paid on 10 occasions ranging from Rs.115,000 to Rs619,016 as to a total of Rs. 2,739,303.

(d) According to the Public Enterprise Circular No: PED 3/2015 issued by the Secretary to the Treasury dated 17th June 2015, in addition to the allowances mentioned in Chapter 2.8 of Circular No. PED 3/2015no allowances can be paid to the Chairman, Executive and Non Excecutive Directors of the govenrment owned buisness enterprises, unles having the consent of the Minister of Finance on recomendations of the Secretary of the line Ministry. However, it was observed that a monthly allowance of Rs. 45,000 had been paid to the Chairman and Rs. 35,000 to the Deputy Chairman and the Acting Director from 2007 to December 2019 without obtaining such approval.

5. **Sustainable development**

5.1 **Achieving Sustainable Development Goals**
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Although the United Nations has introduced the Sustainable Development Agenda based on the promise of economic growth, social development and environmental protection in all its member countries by 2030, the company's goals and indicators have not been identified accordingly, and accurate data and physical resources Methods of management were also not identified.

6. Accountability and good governance

6.1 Procurement

The following observations are made.

(a) **Factory modernization project**

(i) A foreign company named Desmi have forwarded a proposal to the Finance Ministry to renovate 4 factories and 80 milk collection centres and construct 20 new centres. Cabinet have appointed a Technical Evaluation Committee. According to their report on 31 December 2009 the company and the above company had signed a contract for 39.1 Euro million. However, on 24, June 2011, the Chairman of the MILCO submitted a letter to the above company removing renovation of 80 milk collection centers and the construction of 20 centers, which had been allocated 2.37 Euro million, and signed a new agreement for Rs. 33.78 million on 12 January 2012. However, the Technical Evaluation Committee had initially evaluated the project on the basis that the machines would be operating at maximum capacity, while considering the increase milk collection through renovations to existing centres and the planned new centres to be built. Therefore, the audit observed that the new contract agreement would adversely affect the productivity of the project by eliminating proposed activities at the beginning without alternatives.

(ii) For the factory modernization project in Polonnaruwa, Digana and Ambewela, the MILCO had entered in to a agreement with a Selected Foreign Contractor under Turnkey Scheme without Bidding for a contract value of Rs. 5,854,450,856 or Euro. 33,779,210. According to the agreement, the contract period of the project should have ended on 12 July 2014, but the modernization of the Digana and Ambewela dairy factories had not been completed by 31 July 2017, no action had been taken to extend the contract period and as of July 2017, and no action had been taken to recover the due late fees amount to Euro 1,688,961 as per the agreement.

(b) **Badalgama Project**

The above-mentioned project to relocate the company's Narahenpita factory to Badalgama was implemented with an estimated cost of Rs. 9,932,709,286 received on the agreement between HSBC Bank and the External Resources Department of the Treasury at a non-commercial interest rate of 1.90% and a commercial interest rate of 5% + LIBOR's .and the following were observed pertaining to the project.

(i) As per the Cabinet Memorandum submitted on 04th March 2015;

- Inability of Milco to repay the loan.

- The company is in a severe financial crisis due to the reduction in the cash flow due to the increase in the price of milk and the non-increase in the price of dairy products in line with the government policy has further worsening by obtaining a loan.

- The proposed factory modernization will require about 600,000 litres of milk per day for production and it will face a severe crisis in milk supply once it is established.

Therefore, the Cabinet had decided to reject the project on 7, March 2015 due to the above reasons. However, the Cabinet approved to implement the project on 23rd April 2015 considering the Cabinet Memorandum which was resubmitted on 08th April 2015 subject to a grace period of three years for the relevant loans to refund by MiLCO. However, until 19 October 2018, the company and the Treasury had not reached a refund agreement.

(ii) The Ministry Evaluation Committee dated 05 June 2013 evaluated bids submitted by Desmie Contracting Agencies and Bockcard Food Pharma for the aforesaid project and recommended Boccard Food Pharma as the most advantageous company. However, as per the Cabinet decision dated 23rd April 2015, the contract have been awarded to the Desmie Contracting Agencies on a standalone and unsolicited basis for the project without any bidding and on a Turnkey basis.and they singned the agreements on 19th May 2015. The following were observed.

- As per the proposal of the Ministry Evaluation Committee dated 5 June, 2013, it was observed that the price of Desmi Contracting Agencies is 10 million Euros or Rs. 1750 million more than that of Bockard Food Pharma.

- According to the report of the Cabinet Appointed Committee dated 20, August 2014 on the above project, the value of the construction expected to be carried out by Desmi Contracting Agencies is around Euro 4,000,000 or Rs. 596,952,800, which is above the justifiable value.

- According to the report, the daily milk collection is a limiting factor as the expected daily production capacity of Milco after completion of the modernization is 650,000 liters of milk. As the daily milk collection of the company on 31st December 2017 was 263,567 liters, the daily milk collection should be increased by 146.62 percent to increase to achieve the daily milk requirement to 650,000 liters and as on 31st December 2017 the daily milk production in Sri Lanka was 898,630 liters. Of this, 72.33 per cent was confirmed as having to be bought by the company.

7. Systems and controls

Systems and control deficiencies observed during the audit were periodically referred to the Chairman of the Board. Special attention should be paid to the following areas of control.

	Management field	Observations
(a)	Cooperate and Action plan	The cooperate plan had not been prepared.
(b)	Budgetary Control	The budget had not been prepared.
(c)	Collection and management of liquid milk	Milk wastage due to improper monitoring of milk collection canters and non-construction of adequate milk collection centers

(d)	Stock Management	Stock destruction, expiration and irregular counting of stocks due to improper storage of stocks.
(e)	Bond security	Failure to keep the security securities secure and up to date.
(f)	Immediate Interim Agrima	Issuance of immediate interim injunction without an approved limit.
(g)	Vehicle control	Failure to maintain vehicle log books and monthly driving records.
(h)	Fixed assets	Failure to physically verify fixed assets annually and maintain an updated fixed asset register.