

State Mortgage and Investment Bank - 2019

1.1 Opinion

The audit of the financial statements of the State Mortgage and Investment Bank (“Bank”) for the year ended 31 December 2019 comprising the statement of financial position as at 31 December 2019 and the statement of income and the statement of comprehensive income, statement of changes in equity and statement of cash flow for the year then ended, and notes to the financial statements, including a summary of significant accounting policies, 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 provisions of the National Audit Act No. 19 of 2018 and Finance Act No. 38 of 1971. My comments and observations which I consider should be report to Parliament appear in this report.

In my opinion, the accompanying financial statements of the Bank give a true and fair view of the financial position of the Bank as at 31 December 2019, and of their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basis for Opinion

I conducted my audit in accordance with Sri Lanka Auditing Standards (SLAuSs).

My responsibilities, under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of my report. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with Sri Lanka Accounting Standards, and for such internal control as management determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Bank’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intend to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank’s financial reporting process.

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Bank is required to maintain proper books and records of all its income, expenditure, assets and liabilities, to enable annual and periodic financial statements to be prepared of the Bank.

1.4 Auditor's Responsibilities for the Audit of the Financial Statements.

My objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Sri Lanka Auditing Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Sri Lanka Auditing Standards, I exercise professional judgment and maintain professional skepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the management.
- Conclude on the appropriateness of the management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in my auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

The scope of the audit also extended to examine as far as possible and as far as necessary the following;

- Whether the organization, systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of the presentation of information to enable a continuous evaluation of the activities of the Bank, and whether such systems, procedures, books, records and other documents are in effective operation;

- Whether the Bank has complied with applicable written law, or other general or special directions issued by the governing body of the Bank;
- Whether the Bank has performed according to its powers, functions and duties; and
- Whether the resources of the Bank had been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws.

1.5 Financial Statements

1.5.1 Un reconciled Control Accounts or Records

	Audit Issue	Management Comment	Recommendation
i.	There is an un reconcile credit amount recorded in the “slip control account” amounting to Rs 2,022,797 as at 31 December 2019	Relevant branch managers were advised to clear such long outstanding un reconciled balances in the slip control accounts.	Take necessary actions to reconcile the un reconciled balance.
ii.	Suspense account balance amounting to Rs 2,895,111 is recorded under the other liability as at 31 December 2019	These suspense balances are now cleared by the respective branches except suspense balance in the Kurunegala Branch.	Take actions to clear all suspense balances in the Bank.

1.6 Accounts Receivable and Payable

1.6.1 Receivable

	Audit Issue	Management Comment	Recommendation
i.	The balance amounting to Rs.2, 400,000 recorded in frauds account had been disclosed under other assets in the Financial Statements. The balance reflects the amount relating to two frauds occurred in 1999. The recoverability of this balance is doubtful.	Approval of the Board of Directors has been obtained to write-off this amount from the books of accounts during the year 2020.	Take necessary action to clear the fraud account

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|--|-------------|-------------|-------|-------------|--------|-------------|---|--|-------|-------------|---|---|
| <p>ii. Rent in advance as at 31 December 2019 amounting to Rs 2,406,460 recorded in the other assets were not recovered from the previous owners until 22 June 2020</p> <p>Details are as follows.</p> <table border="0"> <tr><td>Gampaha</td><td>1,049,600</td></tr> <tr><td>Kandy</td><td>825,000</td></tr> <tr><td>Horana</td><td>531,860</td></tr> </table> | Gampaha | 1,049,600 | Kandy | 825,000 | Horana | 531,860 | <p>Legal actions have been initiated to recover these receivables from the respective owners of the building.</p> | <p>Take necessary actions to recover these receivables from the respective owners of the building.</p> | | | | |
| Gampaha | 1,049,600 | | | | | | | | | | | |
| Kandy | 825,000 | | | | | | | | | | | |
| Horana | 531,860 | | | | | | | | | | | |
| | | | | | | | | | | | | |
| <p>iii. An amount totaling to Rs 617,374,536 as at 31 December 2019 with related to interest receivable for senior citizens deposits was due from the General Treasury. Details are as follows.</p> <table border="0"> <tr><td>2017</td><td>192,529,105</td></tr> <tr><td>2018</td><td>249,193,681</td></tr> <tr><td>2019</td><td>131,694,637</td></tr> <tr><td>Accrued interest</td><td>43,957,113</td></tr> <tr><td>Total</td><td>617,374,536</td></tr> </table> | 2017 | 192,529,105 | 2018 | 249,193,681 | 2019 | 131,694,637 | Accrued interest | 43,957,113 | Total | 617,374,536 | <p>A sum of Rs. 192,529,105 has been paid by the General Treasury on 29.08.2020 in respect of senior citizen interest subsidy receivable for the year 2017.</p> | <p>Communicate with the General Treasury in respect of senior citizen interest receivable for the year 2018 and 2019 as well.</p> |
| 2017 | 192,529,105 | | | | | | | | | | | |
| 2018 | 249,193,681 | | | | | | | | | | | |
| 2019 | 131,694,637 | | | | | | | | | | | |
| Accrued interest | 43,957,113 | | | | | | | | | | | |
| Total | 617,374,536 | | | | | | | | | | | |

1.6.2 Advances

----- Audit Issue -----	----- Management Comment -----	----- Recommendation -----																																																						
<p>i. There is a long outstanding advance balance amounting to Rs 1,563,966 as at 31 December 2019 without recovered.</p>	<p>Except long outstanding balance mention below all the advances have been cleared now.</p> <table border="0"> <tr> <td>G/L – 2/22/4703 -</td> <td></td> <td></td> </tr> <tr> <td>Before 2007</td> <td style="text-align: right;">Rs.</td> <td>Information</td> </tr> <tr> <td></td> <td style="text-align: right;">1,386,771.10</td> <td>are not</td> </tr> <tr> <td></td> <td></td> <td>available to</td> </tr> <tr> <td></td> <td></td> <td>clear this</td> </tr> <tr> <td></td> <td></td> <td>balance.</td> </tr> <tr><td colspan="3"> </td></tr> <tr> <td></td> <td style="text-align: right;">In 2012</td> <td style="text-align: right;">Rs.</td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">40,0000</td> </tr> <tr> <td></td> <td></td> <td>Already</td> </tr> <tr> <td></td> <td></td> <td>informed</td> </tr> <tr> <td></td> <td></td> <td>to relevant</td> </tr> <tr> <td></td> <td></td> <td>officers</td> </tr> <tr><td colspan="3"> </td></tr> <tr> <td></td> <td>Unidentified</td> <td></td> </tr> <tr> <td></td> <td>Settlements</td> <td style="text-align: right;">(120,186.80)</td> </tr> <tr> <td></td> <td>Balance</td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">1,306,584.20</td> </tr> </table>	G/L – 2/22/4703 -			Before 2007	Rs.	Information		1,386,771.10	are not			available to			clear this			balance.					In 2012	Rs.			40,0000			Already			informed			to relevant			officers					Unidentified			Settlements	(120,186.80)		Balance				1,306,584.20	<p>Take necessary actions to clear long outstanding balances as well.</p>
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- ii. Gross non-performing loan advances including EPF loan was 21.21 and Gross non-performing loan advances excluding EPF loan was 7.73 for the year 2019. This is higher than the industry ratios of 5.5 and 3.9 respectively.
- Gross NPL ratio and NPL ratio excluding EPF have been slightly increased during the year 2019 due to adverse economic condition have been incurred due to Easter Sunday attack.
- Implement recovery actions to reduce the non-performing loan ratio of the bank.

1.7 Non-compliance with Laws, Rules, Regulations and Management Decisions etc.

Reference to Laws, Rules Regulations etc.	Non-compliance	Management Comment	Recommendation
Public Enterprises Circular No. PED 03/2016 dated 29 April 2016.	Bank had paid Pay as You Earn (PAYE) tax amounting to Rs.20,770,371 for the year 2019 out of its own funds on behalf of its employees instead of being deducted from the salary.	PAYE liability of the employee of the bank have been paid by the bank as per the condition in the collective agreement.	Should adhere to "Public Enterprises Circular No. PED 03/2016 dated 29 April 2016" in relation to PAYE Tax of the bank.
Compliance Requirements as per the Banking Act Direction No 12 of 2007 Section 3 (2) (i) the board's composition, the no of Directors of the Board less than shall not be less than 7 and no more than 13.	The board consists only 06 directors as at 31 December 2019	As per the provisions in the SMIB Law, The board comprised of nine (9) fit and proper persons appointed by the Minister. There is no provision about the availability of a minimum number of board members appointed other than the requirement about the minimum number of three board members for a quorum in the provisions in the SMIB Law.	Should comply with the regulation of the minimum number of directors.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs. 419,073,514 and the corresponding profit in the preceding year amounted to Rs. 244,472,029. Therefore an improvement amounting to Rs.174,601,515 of the financial result was observed. The reason for the improvement is increase of interest income and decrease of income tax expense by Rs 154,680,405 when compared to the previous year.

2.2 Trend Analysis of major Income and Expenditure items

The interest income of the Bank had increased by Rs.456 million or 8.26 per cent as compared with the previous year. This is mainly due to increase in loans and advances by Rs.1.6 billion or 4.8 per cent compared to the previous year. Interest expense has also increased by Rs.373 million or 10 per cent which is mainly due to increase of customer deposits by Rs.4.5 billion or 13.4 per cent when compared with the previous year. Personal expense has increased by 58 million or 7 per cent due to annual salary increment in 2019.

2.3 Ratio Analysis

Following observations are made on some important accounting ratios of the Bank for the year under review as compared with Licensed Specialized Banking Sector ratios.

Description	Sector	Bank		
	Ratio	2019	2018	2017
<u>Profitability Ratio</u>				
Return on Average Equity (ROE) (Percentage)	6.8	7.73	4.82	3.62
Return on Average Assets (ROA) (Percentage)	0.8	1.11	1.13	0.98
Net Interest Margin (Percentage)	3.4	4.52	4.72	4.66
<u>Capital Adequacy</u>				
Total Tier 1 Capital Ratio	12.3	21.04	21.69	23.74
Total Capital Ratio	15.6	21.77	22.23	24.29
<u>Asset Quality</u>				
Gross Non- Performing Advance (Including EPF Loans)	5.5	21.21	22	19.37
Gross Non- Performing Advance (Excluding EPF Loans)	3.9	7.73	7.0	4.5
<u>Liquidity Ratios</u>				
Liquidity Coverage Ratio (Percentage)	53.1	121.05	83.91	86.88

- (i) Return on Equity (ROE) had been increased by 2.91 per cent as at 31 December 2019 when compared with the preceding year mainly due to increased profitability in 2019.
- (ii) The net interest margin of 4.52 per cent for the year 2019 is observed which is slightly higher than the Licensed Specialized Bank ratio of 3.4 per cent.

- (iii) Gross non performing ratio of the Bank including EPF loans is very much higher than the sector ratio of 5.5 per cent. This is due to high NPL ratio in EPF loan category. However EPF loans are cash back loans and can be recovered through Central Bank. Gross non-performing loan ratio without EPF loans is 7.73 per cent in 2019 which is higher than the sector ratio by 3.83 per cent.

3. Operational Review

3.1 Identified Losses

Audit Issue	Management Comment	Recommendation
The credit division of the Bank during the period from 01 September 2016 to 31 March 2017 had granted loans amounting to Rs.66.34 million to forty seven (47) applicants who were presenting themselves as the employees of two fake private organizations. It was revealed that the applicants presenting themselves as employees of the two fake organizations had submitted forge documents in applying for respective loans. Out of the above loan Rs 61,528,617 was recorded as the balance payment outstanding as at 31 December 2019.	Bank has filed the case in the CID to recover the above loans from relevant culprits.	Take necessary actions against culprits to recover the said amount and identify the responsible employees and take necessary actions.

3.2 Operational Inefficiencies

Audit Issue	Management Comment	Recommendation
The management has paid Rs 12,609,581 as the final payment of the VAT on financial services for the year of 2019 on 30 June 2020 without considering excess payment already made for the year 2019 amounting to Rs 12,450,865	Bank has paid Rs. 12,609,581 as final VAT on Financial services for the period 2019/2020 as per the technical advice given by the our tax consultant, this computation included the non-financial VAT income on Dividend income, Faire value gain and investment income on placement with financial institution and also they have advised us to exclude income on above sources from the Final VAT return for the Y/A	Pay the final payments with the confirmed information.

2019/2020 on the ground the appeal court case is still being in progress on the case file by the challenging of considering the above sources under Financial VAT . In case judgment would issue in favor of the plaintiff bank can claim such benefit, nevertheless bank would not incur any penalty on nonpayment of Financial VAT on aforesaid sources of income in the event of the judgment would issue against the plaintiff.

3.3 Procurement Management

<p style="text-align: center;">-----</p> <p style="text-align: center;">Audit Issue</p> <p style="text-align: center;">-----</p>	<p style="text-align: center;">-----</p> <p style="text-align: center;">Management Comment</p> <p style="text-align: center;">-----</p>	<p style="text-align: center;">-----</p> <p style="text-align: center;">Recommendation</p> <p style="text-align: center;">-----</p>
<p>Though the process for purchasing a core banking solution begins in June 2016, the Bank was unable to purchase the new core banking solution up to the date of audit.</p>	<p>Bank has opened the Bids on the 16-July-2020 and received 5 bid proposals . Thereafter, Technical Evaluation Committee has started Evaluation on Technical Evaluation (Phase I) and completed the Technical Evaluation Report and submitted to Ministry Procurement Committee (“State Ministry of Money and Capital Market and State Enterprise Reforms”) on the 02-Dec-2020.</p> <p>This report is an interim report to MPC to report progress of the evaluation process after completion of Technical evaluation phases and requested approval to Open financial and hardware proposals to continue with Financial Evaluation. Once TEC committee receives MPC approval , TEC will arrange to open financial bids and continue with the Financial Evaluation which is the final phase of the evaluation.</p>	<p>Take necessary actions to purchase the core banking solution for the bank as soon as possible.</p>

3.4 Human Resources Management

Audit Issue	Management Comment	Recommendation																																	
<p>According to the cadre position of the Bank, approved cadre and actual cadre was 467 and 372 respectively resulting 95 vacancies as at 31 July 2020. It was further revealed that following key managerial positions are vacant as at 31 December 2019 which affect for the smooth operation of the Bank.</p> <table border="1"> <thead> <tr> <th style="text-align: center;">Description</th> <th style="text-align: center;">No. of Vacancy</th> <th style="text-align: center;">From when the vacancy is exist</th> </tr> </thead> <tbody> <tr> <td>DGM (Credit)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">5/10/19</td> </tr> <tr> <td>DGM (Finance and Planning)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">23/4/16</td> </tr> <tr> <td>DGM(HR Development & Management)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">13/3/12</td> </tr> <tr> <td>AGM (Risk Management)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">2/5/17</td> </tr> <tr> <td>AGM (Loan administration)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">1/3/17</td> </tr> <tr> <td>AGM (Valuation)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">5/9/19</td> </tr> <tr> <td>Chief Internal Auditor</td> <td style="text-align: center;">1</td> <td style="text-align: center;">14/8/14</td> </tr> <tr> <td>Chief Manager IT</td> <td style="text-align: center;">1</td> <td style="text-align: center;">2/9/11</td> </tr> <tr> <td>Chief Manager (Recoveries)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">20/9/17</td> </tr> <tr> <td>Chief Manager (Credit)</td> <td style="text-align: center;">1</td> <td style="text-align: center;">1/1/14</td> </tr> </tbody> </table>	Description	No. of Vacancy	From when the vacancy is exist	DGM (Credit)	1	5/10/19	DGM (Finance and Planning)	1	23/4/16	DGM(HR Development & Management)	1	13/3/12	AGM (Risk Management)	1	2/5/17	AGM (Loan administration)	1	1/3/17	AGM (Valuation)	1	5/9/19	Chief Internal Auditor	1	14/8/14	Chief Manager IT	1	2/9/11	Chief Manager (Recoveries)	1	20/9/17	Chief Manager (Credit)	1	1/1/14	<p>DGM- Credit</p> <p>Mr L.I.Ranasinghe was recruited to the post of DGM – Credit on 26.10.2020</p> <p>DGM –Finance & Planning /DGM – HRD & Management</p> <p>Vacancies of DGM – Finance and Planning & DGM – HRD & management were advised on 31.05.2020 and interviews were conducted. The selected candidate for the position of DGM- Finance and Planning had not accepted the offer due to her personal reasons no candidate was selected for the post of DGM – HRD & Management , DGM – Finance & planning have been re advertised on 18th October 2020 and the interviews are to be held on 14th December 2020.</p> <p>AGM (Risk Management)</p> <p>The vacancy was advertised, interview was held & recruitment is ongoing.</p> <p>AGM (Loan Administration)</p> <p>It is proposed to amend the cadre of this position based on the present operational requirement of the bank and the proposal is submitted to the Board of Directors. As per the decision of Board of Directors , recruitments will be carried out.</p>	<p>Take necessary actions to fill the vacancies in approved cadre to ensure the operations of the bank are smoothly.</p>
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AGM – Valuation

Mr I Edirisuriya has been promoted as CM – Valuation on 30.04.2020. Based on the operational requirement of the Bank, this position will be filled in the future.

Chief Internal Auditor

Ms N.A.R. Niroshani De Silva has been recruited to the post of CIA on 04.12.2020.

Chief Manager IT

This vacancy will be filled based on the operational requirement of the Bank. Presently IT structure is under review of an IT consultant and recruitments will be carried out accordingly.

Chief Manager – Recoveries

This vacancy will be filled based on the operational requirement of the Bank.

Chief Manager – Credit

This vacancy will be filled based on the operational requirement of the Bank.