

## **State Mortgage and Investment Bank**

### **1 Financial Statements**

#### **1.1 Qualified Opinion**

In my opinion, except for the effects 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 the State Mortgage and Investment Bank as at 31 December 2011 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

#### **1.2 Comments on Financial Statements**

##### **1.2.1 Sri Lanka Accounting Standards (SLAS)**

In terms of paragraph 57 of SLAS 16, Gratuity Formula Method should be adopted for the measurement of all post employment benefit obligations. However it had not been applied in measuring the gratuity liability.

##### **1.2.2 Accounting Deficiencies**

The following accounting deficiencies were observed.

- (a) Withholding Tax deduction on the upfront interest income on commercial papers in a private bank had been credited to the Investment Income Account twice in year under review and as such income had been overstated by Rs.3,512,268.
- (b) General provision for loan losses on mortgage loans had been overstated by Rs.87,182.
- (c) The value of stocks in hand at the bank branches as at the balance sheet date had been omitted in the financial statements.
- (d) The gratuity provision shown in the Profit and Loss Account had been understated by Rs: 4,297,426 due to erroneous calculation.
- (e) Although fixed assets should be depreciated since the date of purchase in terms of SLAS 18, the assets purchased during the year under review had not been complied with it and as such the profit had been overstated by Rs.5,245,781.

##### **1.2.3 Reconciliation of Control Accounts**

Balances amounting to Rs. 8,561,853 and Rs .4,874,419 shown under the current assets and current liabilities respectively had remained without being reconciled since 2004.

##### **1.2.4 Accounts Receivable and Payable**

The following observations are made.

- (a) Out of the entire accounts receivable balances aggregating Rs.3,930,045,060 shown in the Balance Sheet as at 31 December 2011, only a sum of Rs.800,625,000 or 20.42 per cent had been confirmed by the respective customers up to 31 March 2012.
- (b) Out of the entire accounts payable balances aggregating to Rs.4,217,183,260 shown in the Balance Sheet as at 31 December 2011, only a sum of Rs.1,834,246,525 or 43.35 per cent had been confirmed by the parties concerned up to 31 March 2012.
- (c) Accrued interest amounting to Rs.134,321,918 payable to the Government, had remained without being settled for over a long period.
- (d) Advances paid aggregating Rs. 412,080 to various institutions and to the officers of the Bank from 2009 to 2011, had not been settled even by 8 May 2012.

### **1.2.5 Non-compliance with Laws, Rules, Regulations, and Management Decisions**

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

<b><u>Reference to Laws, Rules, Regulations etc.</u></b>	<b><u>Non-compliance</u></b>
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- |   |  |
|---|--|
| (a) Section iv of Inland Revenue Department direction No BFSU/2011/01 | The Bank had not adjusted the estimated Financial Value Added Tax semi-annually.   |
| (b) Section 133 of Inland Revenue Act No.10 of 2006                   | There were several instances of failure to obtain income declaration and to pay the Withholding Tax on due dates.  |
| (c) Treasury Circular No: IAI/2002/02 of 28 November 2002             | A Register of Computer Equipment and Software had not been maintained.   |
| (d) Public Enterprise Circular No.PED 57 of 11 February 2011          | Approval of the Minister of Finance and Planning had not been obtained for the payment of Rs.2,200,000. in respect of the construction of ‘Badalkumbura hospital’. |
| (e) Financial Regulation 395(c)                                       | Kandy Branch had not prepared the Bank Reconciliation Statements for the months of June, July and August 2011.   |

### **1.2.6 Unauthorized Transactions**

Following observations are made

- (a) Pay As You Earn tax amounting to Rs.10,867,064 which should be borne by the employees had been paid by the Bank without obtaining proper approvals from the General Treasury.

(b) Approval had been granted by Board Decision No.10/06/80 to reimburse the Chairman's Credit Card bills and to fix the Credit limit at Rs.250,000. It was observed that a sum of Rs.525,125 had been reimbursed during the year under review without obtaining proper approvals from the General Treasury. However, the reimbursement of the Credit Card bills was open to question due to bills and invoices had not been supported by the vouchers.

### 1.2.7 Unidentified Transactions

The following observations are made.

- (a) No effective action had been taken to settle the unappropriated balances of Loan Accounts aggregating Rs. 236,278,296 as at the end of the year under review .
- (b) A sum of Rs. 2,947,793 had been shown as unidentified deposits as at the end of the year under review.

### 1.2.9 Frauds

The following observations are made.

- (a) The balance of Rs. 2,400,000 had been shown in Fraud Account under the other debtors in the financial statements for the year under review. This represents loans amounting to Rs.800,000 and Rs.1,600,000 relevant to loan Nos ,1/27279 and loan No 6/33376 respectively.
- (b) Two Loans had been granted to a customer without obtaining confirmation of the ownership of the property pledged as security. Another Bank had auctioned the property to recover the outstanding of loans on same property pledge as security. The total outstanding of this loans were Rs 3,787,337 and these two loans had been settled on 24 May 2012 and a concession of Rs.87,337 had been given.

## 2. Financial Review

### 2.1 Financial Results

According to the information made available the following table gives a summary of financial results at various stages for the year under review and the preceding year.

Item	Current Year (2011)	Previous Year (2010)	Percentage of Change over previous year
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	Rs.(000)	Rs.(000)	%
Interest Income	2,307,130	2,362,259	(2.3)
Interest Expenditure	<u>1,213,932</u>	<u>1,368,229</u>	(11.3)
Net Interest Income	1,093,198	994,030	10

Other Operating Income	<u>362,747</u>	<u>387,121</u>	(6.3)
Gross Operating Profit	1,455,945	1,381,151	5.4
Total Recurrent Expenditure	<u>761,133</u>	<u>747,776</u>	1.8
Profit from Operating activities	694,812	633,375	9.7
Provisions for Loan Loss	26,693	4,260	526.6
Other Income	<u>9,582</u>	<u>829</u>	1,055.9
Net Profit before Tax	731,087	638,464	14.5
Taxation	<u>176,111</u>	<u>178,737</u>	1.47
Net Profit after Tax	554,976	459,727	20.72
Opening Retained Earnings previously reported	930,678	674,022	38.1
Closing Retained Earnings	1,139,528	930,678	22.44

According to the financial statements presented, the operations of the Bank during the year under review had resulted in a pre-tax net profit of Rs.694.81 Million as compared with the corresponding pre-tax net profit of Rs.633.37 Million in the preceding year thus showing an increase of Rs 61.44 Million in the financial results. Further total profit before tax for the year under review amounted to Rs.731.08 million compared with the corresponding total profit before tax of Rs.638.46 Million in the preceding year thus showing an increase of Rs 92.62 million. The following reasons were mainly affected to the above results.

- Interest expenditure had decreased by 11.3 per cent against the 2.3 per cent decrease of interest income for year under review as compared with the corresponding figures of the preceding year.
- Other income had increased by Rs.9.58 million or 1055.9 per cent as compared with the preceding year due to disposal of fixed assets and increase of sundry income.
- Provision for loan losses had decreased by Rs.22.43 million or 526.6 per cent as compared with the preceding year.

## 2.2

### Analytical Financial Review

According to the information made available, the operating results of the Bank had decreased during the last 03 years except the years 2009 , 2010 and 2011. Details are as follows.

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
	Rs.(Mn)	Rs.(Mn)	Rs.(Mn)	Rs.(Mn)	Rs.(Mn)	Rs.(Mn)
(a) Interest Income	2,307	2,362	2,165	1,956	1,399	1,307
(b) Interest Expenses	1,214	1,368	1,939	1,636	1,002	608
(c) Net Interest Income	1,093	994	226	320	397	699
(d) Other Operating Income	363	387	505	261	170	117
(e) Other Income	9	1	2	5	2	1
(f) Total Income	1,465	1,382	733	586	569	817

(g)	Total Recurrent Expenses	734	743	613	535	445	499
(h)	Pre-tax Net Profit	731	639	120	51	124	318
(i)	Taxation	176	179	46	30	41	105
(j)	Net Profit after Tax	555	460	74	21	83	213

The following observations are made in this connection.

- a) The interest income had increased from Rs.1,307 Million to Rs. 2,362 Million or 80.72 per cent during the period 2006- 2010 and decreased by Rs. 55 Million or 2.33 per cent during the year under review compared with previous year and interest expenses had increased by higher proportion from Rs.608 Million to Rs. 1,939 Million or 218.91 per cent during the period 2006 - 2009 and gradually decreased to Rs.1,214 Million in 2011.
- b) The pre-tax net profit had decreased from Rs.318 Million to Rs.51 Million or 83.96 per cent during the period 2006- 2008 and thereafter it had gradually increased from Rs.120 million by the year 2009 to Rs. 731 million or 509.17 per cent by the year 2011. The net profit after tax had decreased from Rs.213 million in the year 2006 to Rs.21 million or 90.14 per cent by the year 2008. Thereafter it has gradually increased from Rs.74 million in the year 2009 to Rs.555 million or 650 per cent by the year 2011.

### 2.3 Ratios and Percentages

According to the information made available, some of the important ratios of the Bank for the year under review and previous 06 years were as follows.

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
	%	%	%	%	%	%	%
(a) <u>Profitability Level</u>							
i. Net Interest Margin	5.63	7.58	4.41	4.16	4.85	7.98	7.3
ii. Return on Equity	18.3	17.02	3.48	1.76	3.3	8.56	14
iii. Return on Average Assets	3.76	3.46	0.80	0.38	1.1	3.11	4
(b) <u>Capital adequacy</u>							
i. Equity / Total Assets	14.60	14.57	13.41	16.01	19.9	23.5	26
ii. Equity / Loans	19.46	19	18	19	23	26	28
iii. Tier I	29.59	26.15	25.29	27.81	56.95	76.15	87
iv. Tier II	29.92	26.89	25.29	28.47	57.98	77.38	89
(c) <u>Liquidity</u>							
i. Liquid Assets/ Deposits (Liabilities)	20.04	21	26	12	10	10	12
ii. Deposits / Loans and	87.55	85	85	71	61	51	54

Advances

iii. Borrowings/ Loans and Advances 3.44 4 5 5 10 13 13

## 2.4 Working Capital Management

The following observations are made.

- (a) It was observed that the Bank had invested excess funds in short term REPO (mostly for One or Two days ) at an average rate of 7 percent in two companies. It was also observed that in 13 instances, investments aggregating Rs.4,770,566,077 had remained more than one month in the company at the same rate . It was revealed that if the Bank had Invested the excess funds in Call Deposits or short term FD's at that time, the Bank could have earned additional minimum interest of 2 per cent equal to Rs.17,905,404 as interest income.
- (b) It was also observed that the Bank had invested Rs.27,834 Million in 33 instances in a Company as short term investment ( REPO) during the year under review. This investment had been made at an average rate of 7 percent and the investments had remained with the company during the period ranged between Rs.400 million and Rs.1,500 million. It was observed that the Bank could have earned an additional 2 percent as interest equal to Rs.16 Million, if the investment had been made in Call Deposits or short term Fixed Deposits.

## 3 Operating Review

### 3.1 Perfomance

#### 3.1.1 Loan Administration

The following observations are made.

According to the information furnished, the following statement shows the position of total Loans, non – performing Loans and Defaulted Loans of Mortgage Loans, EPF Loans and Estate Sector EPF Loans as at 31 December 2011.

	Outstanding balance as at 31 December2011 Rs.Million	Non – Performing balance Rs.Million	Defaulted balance Rs.Million	Percentage of Non performing Loans (NPL) %	Percentage of Defaulted Loans %
Mortgage Loans	6,652	537	2,167	8.07	32.58
EPF Loans	6,873	4,051	850	58.94	12.37
Estate Sector EPF Loans	956	691	26	72.28	2.72

The following observations are made in this connection.

- (a) Non – Performing Loans Ratio in respect of Mortgage, EPF and Estate Sector EPF loans had been 8.07 , 58.94 , and 72.28 respectively and as compared with 9.93, 65.98 and 76.93 respectively for the preceding year indicated a decreasing trend.
- (b) Recovery position in respect of EPF and Estate Sector EPF loans was unsatisfactory.

### 3.1.2 Age Analysis of Loans

According to the information furnished, the following statement shows the age analysis of Mortgage, EPF and Estate Sector EPF loans as at 31 December 2011.

Period of arrears	<u>Outstanding balance as at 31 December</u>		
	Mortgage Loans	EPF Loans	Estate Sector
_____	Rs.Millions	Rs.Millions	Rs.Millions
Months			
0	3,947	1,972	239
1 - 2	2,168	850	26
3 - 5	358	474	196
6 - 11	91	737	166
12 - 17	33	2,744	325
18 and Over	<u>55</u>	<u>96</u>	<u>4</u>
Total	<u>6,652</u>	<u>6,873</u>	<u>956</u>

The following observations are made in this connection

- (a) Out of the total outstanding balances of Rs.6,873 million in respect of EPF Loans, a sum of Rs.2,840 million had been in arrears for over one year.
- (b) Out of the total outstanding Estate Sector loan balances amounting to Rs. 956 million, a sum of Rs.329 million had been in arrears for over one year.
- (c) There was no evidence to indicate that meaningful action had been taken to recover long outstanding balances of EPF loans and Estate Sector EPF Loans.
- (d) Loan repayment period had been lapsed as at the balance sheet date in respect of 737 mortgage loans with an net arrears amount of Rs.59.7 million.
- (e) Loan repayment period had been lapsed as at the balance sheet date in respect of 1,655 EPF loans with an net arrears amount of Rs. 19.5 million.

### 3.1.3 Total Loans, Non-performing Loans (NPL) and NPL Ratios

According to the information made available total loans (balance principal outstanding) , non-performing loans and NPL Ratio for the year ended 31 December 2011 as compared with preceding four years are given below.

(a) **Total Loans (balance principal outstanding)**

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
	Rs.	Rs.	Rs.	Rs.	Rs.
	millions	millions	millions	millions	millions
Mortgage	6,652	6,577	7,016	7,192	6,194
EPF	6,873	5,814	5,225	4,931	3,984
Estate Sector EPF	<u>956</u>	<u>841</u>	<u>798</u>	<u>715</u>	<u>663</u>
Total	<u>14,481</u>	<u>13,232</u>	<u>13,039</u>	<u>12,838</u>	<u>10,841</u>

(b) **Non-performing Loans**

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
	Rs.	Rs.	Rs.	Rs.	Rs.
	millions	millions	millions	millions	millions
Mortgage	537	653	1,278	917	866
EPF	4,051	3,836	3,714	2,898	2,235
Estate Sector EPF	<u>691</u>	<u>647</u>	<u>618</u>	<u>456</u>	<u>471</u>
Total	<u>5,279</u>	<u>5,136</u>	<u>5,610</u>	<u>4,271</u>	<u>3,572</u>

(c) **Non-performing Loans**

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
	%	%	%	%	%
Mortgage	8.07	9.93	18.21	12.75	13.98
EPF	58.94	65.98	71.08	58.77	56.10
Estate Sector EPF	<u>72.28</u>	<u>76.93</u>	<u>77.44</u>	<u>63.78</u>	<u>71.04</u>
Total	<u>36.47</u>	<u>38.81</u>	<u>43.02</u>	<u>33.27</u>	<u>32.95</u>

The following observations are made in this connection.

- (i) The NPL Ratio of EPF loans had increased from 56.10 per cent to 71.08 per cent during the period of 2007-2009 and decreased to 65.98 per cent and 58.94 per cent in the year 2010 and 2011 respectively and increased from 71.04 per cent to 72.2 per cent in respect of Estate Sector EPF Loans from 2007 to 2011.
- (ii) The total Non-performing loans had indicated an increasing trend from the year 2007 onwards except the year 2010
- (iii) The Non-Performing EPF Loans indicated gradual increase annually.

### 3.1.4 **Position of loan disbursement in respect of Mortgage, EPF, Estate Sector EPF Loans**

According to the information made available the position of Mortgage, EPF and Estate Sector EPF loans granted during the year ended 31 December 2011 as compared with the preceding year is given below.



	<u>2011</u>		<u>2010</u>		<u>Variance</u>	
	<u>Number of</u>	<u>Value</u>	<u>Number of</u>	<u>Value</u>	<u>Value</u>	<u>Percentage</u>
	<u>Accounts</u>	<u>Rs. Million</u>	<u>Account</u>	<u>Rs. Million</u>	<u>Rs. Million</u>	
Mortgage Loans	1,883	1,105	1,164	499	606	121.44
EPF Loans	7,155	1,868	5,082	1,124	744	66.19
Estate Sector EPF						
Loans	<u>2,117</u>	<u>193</u>	<u>1,771</u>	<u>96</u>	<u>97</u>	<u>101.04</u>
Total	<u>11,155</u>	<u>3,166</u>	<u>8,017</u>	<u>1,719</u>	<u>1,447</u>	<u>84.18</u>

All categories of loans disbursed in the year 2011 indicated sharp increase as compared with the year 2010.

### 3.1.5 Loan Portfolio

According to the information furnished the purpose wise analysis of loans granted during the year under review and preceding 4 years is given below.

<u>Purpose of the Loans</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
(a) Purchase of Houses and building sites					
➤ Numbers	1,194	1,285	488	567	715
➤ Value in Rs.Millions	575	637	155	205	435
(b) Construction of Houses and Extensions, Renovations etc.					
➤ Numbers	8,631	9,493	6,779	7,416	9,946
➤ Value in Rs.Millions	2,066	2,501	1,180	1,504	3,120
(c) Redemption of Debts					
➤ Numbers	68	73	29	33	66
➤ Value in Rs. Millions	23	41	9	11	57
(d) Purchase of vehicles					
➤ Numbers	-	-	-	01	00
➤ Value in Rs. Millions	-	-	-	0.08	00
(e) Purchase of Land for Agriculture					
➤ Numbers	-	-	-	-	04
➤ Value in Rs. Millions	-	-	-	-	10
(f) Others					
➤ Numbers	-	-	-	-	41
➤ Value in Rs. Millions	-	-	-	-	14
(g) Total					
➤ Number	9,893	10,851	7,296	8,017	10,772
➤ Value in Rs. Millions	2,664	3,179	1,344	1,720	3,636
➤ Percentage	-	119	42	127	211

- All the above loans had categories indicated an annual increasing trend from year 2009 to year 2011.

### 3.2 **Operating Inefficiencies**

#### (a) **Mortgage Loans**

According to the test checks carried out during the audit the following major weaknesses were observed in the management of Mortgage Loans.

- (i) Long delays in instituting legal actions against defaulters.
- (ii) Long delay of auctioning or sale of Mortgaged properties.
- (iii) Grant of loans exceeding the real market value of the mortgage properties.
- (iv) Loans granted to customers without establishing the free hold title of the property mortgaged.
- (v) Lack of regular communications with the customers specially the defaulters.
- (vi) Grant of further loans without paying attention to the arrears of the previous loans.
- (vii) Failure to comply with instructions on recoveries such as non-recovery of interest, delay charges ect.

#### (b) **Vested Properties of the Mortgage Loans**

According to the information made available a sum of Rs.55,920,500 inclusive of principal amounting to Rs.29,537,145 remained receivable by the Bank as at 31 December 2011 on 115 vested properties. The following observations are made in this regard.

- (i). Prompt action had not been taken to auction the properties.
- (ii). Out of the 115 properties only 15 properties valued at Rs.6,400,000 had been disposed by the end of 2011.
- (iii). Inadequacy of value of 8 properties by a sum of Rs.3,224,865 to cover the accounts receivable due to improper valuation of properties
- (iv). Lack of vacant possession.

#### (c) **Estate Sector EPF loans**

The total outstanding loan amounting to Rs. 4,806,085 which was categorized as loss had not been recovered from the Central Bank over the periods ranging from 2 to 12 years.

### 3.3 **Uneconomic Transactions**

The following observations are made

- (a) The software purchased at a cost of Rs.341,550 during year under review had not been used for the intended purpose of Inventory Management.

- (b) Overdraft facilities had been obtained and overdraft interest of Rs.788,009 had been incurred during the year under review due to poor cash management.

### **3.4 Identified Losses**

#### **(a) Write off of Outstanding Balances of Vested Properties**

The following observations are made

According to the information furnished, outstanding balances of 35 vested properties aggregating Rs 6,952,332 had been written off during the year under review.

#### **(b) Disposal Losses of Vested Properties**

According to the information furnished, the losses arising from the disposal of vested properties amounted to Rs.501,929.

#### **(c) Other Losses**

According to the financial statements for the year ended 2011, bad debtors amounting to Rs.192,886 had been written off.

### 3.5 Human Resources Management

According to the information made available, the approved cadre, the actual

Category of the Staff	Approved Cadre			Actual Cadre			Vacant Cadre		
	2009.12.31	2010.12.31	2011.12.31	2009.12.31	2010.12.31	2011.12.31	2009.12.31	2010.12.31	2011.12.31
Executives	183	183	183	167	159	157	16	24	26
Non - Executives	150	150	150	116	114	107	34	36	43
Management Trainees	15	15	15	-	-	-	15	15	15
Minor Employees	53	53	53	35	34	35	18	19	18
Casual	-	-	-	02	01	3	(02)Excess	(01)Excess	(03)Excess
Total	401	401	401	320	308	302	81	93	99

cadre and vacancies for the three years ended 31 December 2011 are given below.

It was observed that the number of vacancies had gradually increased, and effective action had not been taken since the year 2009 to fill the vacancies.

### 3.6 Gratuity Fund

A Gratuity Fund had not been established by the Bank up to the date of this report.

### 3.7 Computerized Banking System of the Bank

The following drawbacks in the computer system of the Bank were observed.

- Duplication of transactions had been occurred due to the failure in the system to avoid generation of similar ledger folios that had already been existed in the system.
- The system had erroneously brought forward previous year income and expenditure balances that had already been charged to the income statement in the previous year.

## 4. Accountability and Good Governance

### 4.1 Corporate Plan

Although Corporate Plan had been prepared for the period of 2010-2012 it had not been updated. Certain targets set out in the Corporate Plan for the period 2010- 2012 had not been achieved. Details are given below.

- Grant of agricultural loans equivalent to 10 per cent of the loans portfolio.

- (b) Identification of new business/ product areas.
- (c) Improvement of the existing IT infrastructure.

#### **4.2 Action Plan**

The following targets of the Action Plan set for the year 2011 had not been achieved.

- (a) Reducing the Non-performing loans of the mortgage loans and the EPF loans to 5 per cent and 30 per cent respectively.
- (b) Achievement of an annual growth rate of 22 per cent in loans and diversification of loan portfolio to the agricultural and industrial sectors.
- (c) Establishment of a fully automated computerized environment.

#### **4.3 Procurement plan**

A Procurement Plan for the year 2011 had not been prepared .

#### **4.4 Budgetary Control**

The Budget for the year under review had not been prepared completely and only a summarized Profit and Loss Account had been prepared without estimating the detailed income and expenses.

According to the incomplete Budget favorable variances ranging from 07 per cent to 67 per cent and adverse variances ranging from 17 per cent to 145 per cent were observed between the estimates and the actuals. Therefore it was observed that the Bank had not made use of the budget as an instrument of management control.

#### **5. Systems and Controls**

Deficiencies observed in systems and controls during the course of audit were brought to the notice of the Chairman of the Bank from time to time. Special attention is needed in respect of the following areas of control.

- (a) Vested Properties
- (b) Loan Balances
- (c) Interest Income and Tax Liabilities
- (d) Control Accounts
- (e) Advances
- (f) Accounts Receivable and Payable
- (g) Computerized Information System
- (h) Financial Value Added Tax and Withholding Tax
- (i) Bank Reconciliations