

State Mortgage and Investment Bank -2014

The audit of financial statements of the State Mortgage and Investment Bank for the year ended 31 December 2014 comprising the statement of financial position as at 31 December 2014 and the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory 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 read in conjunction with Section 13(1) of the Finance Act, No.38 of 1971 and Section 65(2) of the State Mortgage and Investment Bank Law No.13 of 1975. My comments and observations which I consider should be published with the Annual Report of the Bank in terms of Section 14 (2) (c) of the Finance Act appear in this report.

1.2 Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards and for such internal control as the management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

1.3 Auditor’s Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with Sri Lanka Auditing Standards consistent with International Standards of Supreme Audit Institutions (ISSAI 1000-1810). Those Standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s 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 Bank’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 Bank’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Sub-sections (3) and (4) of Section 13 of the Finance Act, No 38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the Audit.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified opinion.

1.4 Basis for Qualified Opinion

My opinion is qualified based on the matters described in paragraph 2.2 of this report.

2 Financial Statements

2.1 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 2014 and its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Financial Statements

2.2.1 Accounting Deficiencies

The following accounting deficiencies were observed.

- (a) Although the financial statements had been prepared in terms of Sri Lanka Accounting Standards (SLFRS and LKAS), the general ledger accounts had not been updated in order to reflect the balances shown in the financial statements.
- (b) A loan from Government amounting to Rs. 250,000,000 at an interest rate of 9 per cent had been received in 2001. Nevertheless, repayment of capital or interest had not been made to Treasury up to 31 December 2014. Even though interest aggregating Rs.134,321,918 had been provided up to end of the year 2006, no provision for interest aggregating Rs.180,000,000 had been made in the accounts for the period from 2007 to 2014 .
- (c) Sums aggregating Rs.7,063,376 deposited by the customers during the period from 01 July 2013 to 31 December 2014 in the Gampaha Branch had been omitted from the accounts.
- (d) Loan installment (Estate) recovered from the Central Bank of Sri Lanka by the Kandy Branch amounting to Rs. 13,731,140 had not been transferred to relevant account. As such the income and loan balances had been understated and overstated by Rs. 5,574,509 and Rs. 6,157,031 respectively.
- (e) There was a debit balance in cheque on realization account as at 31 December 2014 due to an error in posting. Thus the other debtors shown in the financial statements had been overstated by Rs.22,810,493.
- (f) Long due balances in un-presented cheques account amounting to Rs. 2,841,347 had been carried forward since 2006 without being cleared.
- (g) Even though the Bank had reconciled a balance of Rs. 1,122,255 remained in the cheque on realization account- 004/1/09/1607 of the Gampaha Branch as at 31 December 2013, the entries thereon had not been made in the accounts up to 31 December 2014.

2.2.2 Un-reconciled Control Accounts

An unreconciled opening difference of Rs.18,580,615 was observed between the current account with the Branches and the current account with the Head Office held in Branches.

2.2.3 Unexplained Differences

The following unexplained differences were observed.

- (a) A difference of Rs. 69,963,530 had been observed between the amount shown in the financial statements and the balances generated by the computerized systems with regard to the fixed deposits, savings accounts, unappropriate accounts, loans against fixed deposits etc. as at 31 December 2014.
- (b) Differences of Rs. 648,772 and Rs. 326,282 had been observed between the ledger balances and the balances in the fixed asset register relating to the cost of assets and accumulated depreciation respectively.

2.2.4 Unidentified Transactions

The following observations are made in this connection.

- (a) Deposits aggregating Rs. 1,137,732 had remained unidentified even up to end of the year under review.
- (b) A balance of Rs.4,209,582 had been shown in the advance account without being identified and adjusted in the accounts.
- (c) Unidentified amount of Rs. 2,165,961 shown in the financial statements as other liabilities relating to the encashment of Head Office cheque accounts had been remained in the accounts without being identified and reconciled for more than one year.

2.2.5 Lack of Evidence for Audit

The detail schedules and reconciliations in respect of cheque sent for collection, cheque receivable on collection, fixed deposits receivable, Branch advice accounts-other assets and Branch advice accounts-other liabilities aggregating Rs.21,056,587 had not been submitted to audit although they were called for.

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

The following instances of non-compliance were observed in audit

Reference to Laws, Rules, Regulation etc.

Non-compliance

(a) Financial Transactions Reporting Act, No.06 of 2006

Seventeen “Know Your Customer” forms valued at Rs.3,800,000 relating to Kiribathgoda and Kegalle Branches had not been duly completed.

(b) Section 213 of the Inland Revenue Act, No. 10 of 2006

Kiribathgoda and Kegalle Branches had failed to submit withholding tax return on due dates to the Department of Inland Revenue.

(c) Financial Regulations of the Government of the Democratic Socialist Republic of Sri Lanka

(i). Financial Regulation 396(d)

The Bank had not taken action to cancel the following long outstanding un-presented cheques and an age analysis thereon is shown below.

Bank Account Number	06 to 12 Months	01 to 02 Years	02 to 03 Years
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	Rs.	Rs.	Rs.
A	80,000	447,041	-
B	2,930	17,150	-
C	67,300	261,112	62,975

(ii) Financial Regulation 507

The physical verification of inventory items for the year 2014 had not been done.

(iii). Financial Regulation 754

Even though the Bank had purchased the fixed assets valued at Rs.67,544,820 during the year under review, movement of inventory had not properly updated

(d) Internal Circulars

(i) Circular No.559 dated 14 November 2014 issued by Acting General Manager

The Branches had not sent certified copies of running charts relating to 15 motor bicycles to the Transport Division within one week after the end of the following month as requested by the Circular.

(ii) The letter dated 25 March 2014 issued by the Chief Manager (Branch Operation)

The Branches had not maintained any register for Dormant Accounts.

3. Financial Review

3.1 Financial Results

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.412.71 million as compared with the corresponding pre-tax net profit of Rs.342.74 million in the preceding year, thus showing an improvement of Rs 69.97 million in the financial results.

The decrease of interest expenditure and impairment losses by 10 per cent and 38 per cent respectively during the year under review as compared with corresponding figures of the preceding year while increase of other operating income by 10 per cent during the year under review as compared with the previous year were the main reasons attributed for these improvements.

3.2 Analytical Financial Review

3.2.1 Profitability of the Bank

(a) According to the information made available, the profitability of the Bank for the year under review and for the previous 05 years period are given below.

	2014	2013	2012	2011	2010	2009
	Rs. Mn	Rs. Mn	Rs. Mn	Rs. Mn	Rs. Mn	Rs. Mn
(i) Interest Income	3,633	3,635	2,879	2,611	2,362	2,165
(ii) Interest Expenses	2,214	2,459	1,725	1,214	1,368	1,939
(iii) Net Interest Income	1,419	1,176	1,153	1,397	994	226
(iv) Other Operating Income	103	97	73	76	387	505
(v) Other Income Gain/(Loss)	(23)	(48)	7	-	1	2
(vi) Net Operating Income	1,499	1,225	1,233	1,473	1,382	733
(vii) Total Recurrent Expenses	(1,086)	(882)	803	785	743	613
(viii) Net Profit Before Tax	413	343	430	688	639	120
(ix) Taxation	(140)	(110)	158	178	179	46
(x) Net Profit After Tax	273	233	272	510	460	74
(xi) Loss on Financial Assets Available for Sale	3	1	2	3	-	-
(xii) Actuarial Gains/(Losses) on Defined Benefit Plans (+/-)	(102)	-	-	-	-	-
Total Comprehensive Income	174	234	270	507	-	-

The following observations are made in this connection.

- ❖ The interest income had increased from Rs. 2,165 million to Rs. 3,635 million or 68 per cent during the period of 2009- 2013 while it had decreased to 3,633 million

during the year under review. Interest expenses had decreased from Rs. 1,939 million to Rs.1,214 million from 2009 to 2012. At the meantime it had increased to Rs. 2,459 million in 2013 while it had been decreased to Rs. 2,214 million or 10 per cent during the year under review as compared with the previous year.

- ❖ The pre-tax net profit had increased from Rs.120 million to Rs.688 million or 473 per cent during the period of 2009- 2011. After that it had decreased from Rs.430 million to Rs 343 million or 20 per cent during the period of 2012 -2013 while it had increased from Rs.343 million to Rs 413 million or 20 per cent during the year under review as compared with the year 2013.
- ❖ The net profit after tax had increased from Rs.74 million to Rs.510 million or 589 per cent during the period of 2009 - 2011 and thereafter it had decreased from Rs.272 million to Rs.232 million or 15 per cent per during the period 2012-2013. At the meantime it had increased from Rs.233 million to Rs.273 million or 17.16 per cent as compared with the previous year.
- ❖ The total comprehensive income had decreased from Rs.507 million to Rs. 174 million or 66 per cent during the period of 2011 to 2014.

3.2.2 Significant Accounting Ratios

According to the information made available, some of the important accounting ratios of the Bank for the year under review and for the preceding 06 years are given below.

	2014	2013	2012	2011	2010	2009	2008
	%	%	%	%	%	%	%
<u>Profitability Ratios</u>							
i. Net Interest Margin	4.97	4.76	5.39	7.26	7.87	4.45	3.48
ii. Return on Equity	6.87	6.00	7.31	14.67	18.46	3.06	0.88
iii. Return on Average Assets	1.44	1.39	2.01	3.58	3.77	0.77	0.38
<u>Capital Adequacy Ratios</u>							
i. Equity / Total Assets	13.26	14.65	17.04	17.76	15.40	14.06	16.51
ii. Equity / Loans	16.56	18.38	20.66	22.34	19.35	17.53	18.13
iii. Tier I	25.32	28.09	33.22	39.94	26.09	24.18	27.81
iv. Tier II	25.32	28.09	33.22	39.94	26.83	24.82	28.47
<u>Liquidity Ratios</u>							
i. Liquid Assets/ Deposits(Liabilities)	22.79	21.24	21.98	20.04	21.14	26.04	12.84
ii. Deposits / Loans and Advances	99.52	99.18	93.40	92.51	90.99	91.41	76.96
iii. Borrowings/Loans and Advances	4.61	4.21	3.98	4.10	4.25	5.18	5.84

Even though the Bank is well ahead of the maintaining the minimum limit of the capital adequacy ratio in Tier 1 and Tier 11 of 5 per cent and 10 per cent as prescribed by the Central Bank of Sri Lanka, both ratios had been decreased as at the end of the year under review as compared with the preceding year and recorded the lowest ratio for the last six years.

4. Operating Review

4.1 Performance

The following observations are made.

(a) Non- Performing Loans (NPL)

According to the information made available to audit, the position of the total outstanding loan and the non-performing loans thereon as at 31 December 2014 are shown in the following table.

Types of Loan	Total outstanding loan balance as at 31 December 2014 Rs. Millions	Non-performing loan balance Rs. Millions	Non- performing loans as a percentage of total outstanding
Mortgage Loans	8,126	914	11.25
EPF Loans	9,958	5,439	54.62
Estate Sector EPF Loans	955	691	72.36
Personal Loans	2,059	322	15.64
Motor Vehicle Loans	78	7	8.97
Investment Fund	155	11	7.09
Refinance Loans	503	29	5.76
Total	21,834	7,413	33.95

The following observation is made in this connection:

The percentages of NPL mortgage loans, EPF loans, estate sector EPF loans, personal loans, motor vehicle loans for the previous year were 12.69, 57.4, 73.9, 18.83 and 4.27 per cent respectively and thus indicating an decreasing trend.

(b) **Age Analysis of Outstanding Loans**

According to the information furnished to audit, the following statement shows the age analysis of mortgage, EPF, estate sector EPF, personal and motor vehicle loans as at 31 December 2014.

Period of Outstanding	Mortgage Loans	EPF Loans	Estate Sector	Personal Loans	Vehicle Loans	Total
Months	Rs. millions	Rs. millions	Rs. millions	Rs. millions	Rs. Millions	Rs. millions
Less than 01 month	5,155	3,372	55.88	1,451	60.5	10,094.38
1-2	2,298	1,320	43.3	368	11.3	4,040.60
3-5	391	615	257.75	114	2	1,379.75
6-11	120.3	1,394	242.82	74	2.5	1,833.62
12 – 17	71.3	3,198	353.84	41.5	2.4	3,667.04
18 and over	90.4	59	2.22	11	-	162.62
Total	8,126	9,958	955.81	2,059.50	78.7	21,178.01

The following observation is made in this connection.

Out of total EPF loans and Estate Sector EPF Loans, sums of Rs.3,257 million or 33 per cent and Rs.356 million or 37.25 per cent respectively were in arrears for over one year.

(c) **Position of Loan Disbursement in respect of Mortgage, EPF and Estate Sector EPF Loans**

According to the information made available, the position of mortgage, EPF, estate sector EPF loans, personal loans, motor vehicle loans and refinance loans granted during the year 2014 as compared with the preceding year are given below.

Types of Loans	2014		2013		Variance	
	Number of Loans granted	Value	Number of Loans granted	Value	Value Increase/ (Decrease)	Percentage
		Rs.Millions		Rs.Millions	Rs.Millions	
Mortgage	1,603	1,393	1,330	1,218	175	14

Loans						
EPF Loans	7,975	2,875	6,011	2,140	735	34
Estate Sector						
EPF Loans	2,422	292	1,537	157	135	86
Personnel						
Loans	2,452	1,149	1,599	747	402	54
Motor Vehicle						
loans	7	33	9	27	6	22
Refinance	585	197	1,774	277	(80)	(29)
Total	15,044	5,939	12,260	4,566	1,373	30

Number of loans granted and total value of the loans granted during the year under review is increased by 23 per cent and 30 per cent respectively as compared with the previous year.

4.2 Operating Inefficiencies

4.2.1 Mortgage Loans

The following major weaknesses were observed with regard to the granting the mortgage loans.

- (a) In the following instances, the Bank had not taken necessary action to recover the arrears amount in terms of provision in the Credit Manual.

Loan Number	Date of loan granted	Amount of loan granted	Total outstanding as at 31 December 2014
		Rs.	Rs.
51/651/04/477	13/12/2012	850,000	421,475
1/700/01/325	22/10/2007	125,000	82,885
04/003/02/5353	09/11/2007	250,000	51,758

- (c) Instances of loans granted without considering the arrears positions of the previous loans were observed. Certain such instances are given below.

Loan Number	Date of loan granted	Amount of loan granted	Total outstanding as at 31 December 2014
		Rs.	Rs.
HF 3484	12/07/2010	620,000	124,282
10/001/02/00135/BTA 041	04/05/2011	1,948,000	545,995

- (d) A loan amounting to Rs. 620,000 had been granted without considering the letter send by another Bank regarding the loan defaulted by the customer
- (c) The following instances, the Bank had not informed to the customers about the interest rate revision and extension of the credit period.

Loan Number	Date	Amount of loan granted	Total Outstanding As at 31 December 2014
		Rs.	Rs.
01-700-01-325	22.10.2007	125,000	82,885
04/003/02/5353	09.11.2007	250,000	51,759

- (f) It was revealed that the value of the properties vested for mortgage loans in some instances were not adequate to cover the outstanding balances of the respective loans. Some of such instances are given below.

Loan Number	Principle amount outstanding	Total amount due as at 31 December 2014	Estimated value of the property	Established loss as at 31 December 2014
	Rs.	Rs.	Rs.	Rs.
6/31940/T6/869	262,500	1,098,018	850,000	248,018
18/58484/Y18/129	127,748	568,633	500,000	68,633
18/62583/Y18/383	176,248	710,640	300,000	410,640
7/62516/D7/435	150,000	555,862	350,000	205,862
12/61050/D12/210	132,841	500,879	407,200	93,679
K4/2929/KY2/813	598,404	598,404	275,000	323,404
10/54419/D10/213	99,455	547,799	300,000	247,799
1/32533/CD2/358	79,999	306,489	300,000	6,489
18/72739/Y18/923	50,834	226,985	200,000	26,985
6/45094/F6/137	299,997	719,201	200,000	519,201
K/4/3186/KY3/289	138,409	415,325	250,000	165,325
5/43545/H6/524	255,030	551,886	300,000	251,886
61/KIA/26	8,919,111	19,677,458	13,000,000	6,677,458
2/01758/K2/427	252,659	675,433	500,000	175,433
2/643/PO1/147	1,802,789	3,125,622	2,400,000	725,622
05/001/08/1773	507,058	1,212,692	800,000	412,692
Total	13,853,082	31,491,326	20,932,200	10,559,126

4.3 Transactions of Contentious Nature

The following observations are made.

- (a) An approval had been granted by the Board of Directors without getting concurrence of the General Treasury to reimburse entertainment expenses made out by the Credit Card provided to the Chairman. Accordingly, it was observed that the bills aggregating Rs.564,772 had been reimbursed by the Bank during the year under review.
- (b) Pay As You Earn (PAYE) tax amounting to Rs. 12,885,149 had been paid by the Bank on behalf of its employees contrary to the Public Enterprises Department Circular No.PED 02/2013 of 11 September 2013.
- (c) A sum of Rs.1.5 million had been donated to a Non-government Organization to repair and construct the partly buildup houses of identified poor families in the Gampaha District during the year under review without obtaining the approval from the Cabinet of Ministers as per Paragraph 8.3.8 of Chapter 8 of the Public Enterprises Guideline for Good Governance.

4.4 Identified Losses

The following identified losses were observed in audit.

- (a) Losses amounting to Rs.984,312 had been incurred during the year under review on disposal of vested properties.
- (b) Loan interest and other charges amounting to Rs.584,757 had been written off during the year under review with the approval of the Board. Further, an un reconciled balance of Rs. 8,561,853 brought forward from 2004 under the current assets had been written off during the year under review without being obtained proper approval from the Treasury.
- (c) Software purchased at a cost of Rs.341,550 in 2011 for inventory management had not been utilized for the intended purpose due to unusable condition of the software.

4.5 Human Resources Management

It was observed that 91 posts or 35 per cent of the approved cadre of the Non-executives level and 05 posts in the Executive level had been vacant by the end of the year under review, which adversely affected to the smooth operation of the Bank, while 05 posts in other categories were excess as at the end of the year under review.

5. Accountability and Good Governance

5.1 Action Plan

The following targets set out in the Action Plan for the year 2014 either completely or partly not achieved during the year under review. Details are shown below.

Action Code	Target	Position of Achievement
Goal 1	Increase of loan portfolio to Rs.30 billion.	Loan portfolio as at 31 December 2014 was only Rs. 24.27 billion.
	Increase of deposits by Rs.1,020 million per month.	The net increase of deposit per month was only 245 million or 24 per cent of the target.
	Establishment of Service Centre.	No any Service Centre had been established up to 31 December 2014.
Goal 2	Open/Upgrade the existing Branches to model Branches	No any Branch was upgrade or opened.
	Upgrade 4 existing Branches as super grade Branches	No any Branch was upgraded as super grade Branch.
Goal 4	Improving the cost to income ratio from 25 per cent to 20 per cent.	Ratio was 30 per cent during the year under review.
	Increasing the profit before taxes to Rs.660 million.	Profit before tax for the year ended 31 December 2014 was Rs. 412.71 million or 62.53 per cent of the target.
Goal 5	Reducing 1-2 arrears installments Mortgage Loan exposures from 28 per cent to 5 per cent by 2014.	1-2 arrears installments Mortgage Loans exposure as at 31 December 2014 was 28 per cent.
	Maintaining Zero non-performing loan ratios and no arrears position in respect of personal and vehicle loans.	Non-performing loan ratios of personal and Vehicle loans were 15.63 per cent and 8.65 per cent respectively.
Goal 6	Increasing the total loan portfolio by Rs.8.4 billion in 2014.	Loans and receivable growth for 2014 was only 13.5 per cent and increase of total loan portfolio was only 2.85 billion.
Goal 7	Integrating entire branch network with a new core banking solutions.	No core banking solution was introduced in 2014.
	Implementing ATM network for all the Branches.	ATM units were not newly introduced during the year 2014.

Goal 10	Organize a national workshop on customer feedback survey findings.	No such workshop was conducted.
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5.2 Internal Control

It was unable to verify the steps taken to strengthen the process of financial reporting which are mentioned in the directors' statement due to lack of documentation. Hence, the opinion on the directors' statement on internal controls for last three years had been issued by me with the emphasis of matter paragraphs.

5.3 Budgetary Control

The Comprehensive Budget for the year under review had not been prepared and instead only a summarized profit and loss account had been prepared without considering detailed categories of income and expenses. According to the incomplete budget, significant variations were observed, between the budgeted and actual figures, thus indicating that the budget had not been made use of an effective instrument of internal control.

5.4 Internal Audit

Internal audit had not been covered most of the areas as scheduled in the internal audit programme to ensure the effective performance of the Bank. Hence, the Internal Audit Division had not effectively discharged their duties and responsibilities to achieve the objectives of Internal Audit as per the Financial Regulation 133. Further, the post of Chief Internal Auditor and Internal Auditor had not been filled by the Bank even up to end of the year under review.

6. Systems and Controls

Deficiencies in systems and controls observed 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) Accounting
- (b) Accounts Receivable and Payable
- (c) Computerized Information System
- (d) Compliance with Laws, Rules and Regulations
- (e) Budgetary Control