

State Mortgage and Investment Bank – 2018

1.1 Qualified Opinion

The audit of the financial statements of the State Mortgage and Investment Bank (“Bank”) for the year ended 31 December 2018 comprising the statement of financial position as at 31 December 2018 and the statement of comprehensive income, statement of changes in equity and cash flow statement 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, except for the effects of the matters described in paragraph 1.5 of this report, the accompanying financial statements give a true and fair view of the financial position of the Bank as at 31 December 2018, and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basis for Qualified Opinion

My opinion is qualified on the matters described in paragraph 1.5 of this report.

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 qualified 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 Company'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 Company 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 Accounting Deficiencies

Audit Issue	Management Comment	Recommendation
(i) An abnormal credit balance of Rs.13,651,821 had been carried forward in the claim voucher account without being corrected since more than 03 years. The reasons for this abnormal credit balance had not been identified. As well the debit balances of Rs.1,996,000 and Rs.1,030,374 had been remained in claim vouchers account in Chillaw Branch and Kurunagala Branch respectively since more than 02 years without being reconciled.	Unreconciled Differences in the Chillaw branch and Kurunagala branch are now cleared, balances in the Kandy branch is being reconciled.	Take necessary actions to reconcile the balances in the Kandy branch as well.
(ii) A difference of Rs.8,088,496 was observed between the balance as per general ledger and balance as per the loan schedule as at 31 December 2018 in relation to interest receivable on estate provident fund loan balance.	Action will be taken to clear above difference before end of 2019.	Take necessary actions to clear the differences in between general ledger and the loan schedule.
(iii) An abnormal debit balance of Rs.8,137,376 had been carried forward in the Cheques on Realization account without being corrected for a considerable period of time. Out of the above debit balance Rs.7,885,705 had been remained in the account since more than 05 years. The reasons for the debit balance had not been identified.	Action will be taken to clear above difference before end of 2019.	Take necessary actions to clear the said difference.

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| (iv) | The abnormal debit balance of cheques on realization account in Kandy Branch had been understated by Rs.2,702,521 due to erroneous entries posted to the same account in order to correct the abnormal debit balance during the year 2018. | Action will be taken to clear above difference before end of 2019. | Take necessary actions to clear the said difference. |
| (v) | The cash out flow on VAT, NBT, DRL and income tax recorded in the cash flow statement was higher than the actual cash out flow by Rs.24,652,323. As well the cash inflow on dividend income had been recorded in the cash flow statement without deducting the withholding tax of Rs.3,090,360 on dividend income. | There were no any over or under payment of the taxes for the year ended 2018, reason for the above differences were the non-adjusting of accrued taxes for the year ended December 2019. | Take necessary actions to adjust accrued taxes for the year ended December 2019. |
| (vi) | A difference of Rs.4,296,607 was observed between inter branch accounts of the Bank as at 31 December 2018. | These differences are now cleared. | |
| (vii) | An unreconciled balance of Rs.3,008,166 had been carried forward in EPF and ETF payable accounts since more than 12 years. | Action will be taken to clear above difference before end of 2019. | Take necessary actions to clear the said amount. |
| (viii) | An abnormal debit balance of Rs.2,499,034 and Rs.303,814 had been recorded in loan installment for estate sector account in Kandy Branch and Hatton Branch respectively due to error posting. | Hatton Branch - error debit amounting to Rs 303,814 corrected now.
Kandy - Action will be taken to clear above difference before end of 2019. | Take necessary actions to clear the abnormal debit balance in Kandy Branch as well. |
| (ix) | There was an abnormal debit balance of Rs.2,508,640 in branch advice account without being corrected for a considerable period of time. Out of the above debit balance Rs.2, 489,500 had been remained in the accounts since more than 03 years. The reasons for the debit balance had not been identified. | Action will be taken to clear above difference before end of 2019. | Take necessary actions to clear the abnormal debit balance of Rs 2,508, 640 in branch advice account. |

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| (x) | An amount of Rs.2,400,000 was recorded in frauds account and disclosed under other assets in the Financial Statements. The balance reflects the amount relating to two frauds occurred in 1999. However the recoverability of this balance is doubtful. | Recoverability of the above frauds is very remote; action will be taken to write off before end of December 2019. | Take necessary actions to write off the said amount after confirming the non-recoverability from the legal division of the bank. |
| (xi) | A credit balance of Rs.1,615,152 had been carried forward in rent advance account in head office. The reason for the credit balance had not been identified. | Action will be taken to clear above difference before end of 2019. | Take necessary actions to clear the said amount. |
| (xii) | An irrecoverable debit balance of Rs.1,512,882 had been recorded in accrued assistant to provident fund account since more than 02 years and disclosed under other debtors in the financial statements. | Action will be taken to clear above difference before end of 2019. | Take necessary actions to clear the said amount. |
| (xiii) | The Bank had erroneously recognized the interest payable amount higher than the correct amount by Rs.818,630 on National Savings Bank loan for the period of 26 December 2018 to 31 December 2018. | Corrected now | |
| (xiv) | The Bank had disclosed all of its fixed assets under vehicles and furniture and equipment without properly grouping those according to their nature. | Note to comply for future reporting. | Disclose and group the Property Plant & Equipment according to LKAS 16. |

1.5.2 Unreconciled Control Accounts or Records

Audit Issue

A debit balance of Rs.12,772,657 had been carried forward in un-reconciled control account disclosed under other assets in the Financial Statements. The balance arose due to transfer of un-reconciled differences from particular general ledger accounts to un-reconciled control account during the period from 2016 to 2018 for which supporting documents were not available.

Management Comment

Action will be taken to clear above differences before year end 2019.

Recommendation

Take necessary actions to clear the said amount.

1.6 Accounts Receivable and Payable

1.6.1 Advances

Audit Issue	Management Comment	Recommendation
(i) Out of total non-performing personal loan balance of Rs. 889,881,994 as at 31 December 2018, 12 loans aggregating to Rs.19,598,126 represents the major non performing customers. Though legal actions had been taken against the defaulters and Bank was unable to recover even a single installment during the year 2018.	Even though the NPL of the EPF loan was 65% as at 31.12.2018, EPF loans are treated as fully cash back assets provided that all arrears in the EPF loans are claimed from the CBSL annually, hence there is no any impact in high NPL of the EPF loans.	Take necessary actions to recover the non-performing loans and do follow up procedures with the customers.
(ii) Personal loans, mortgage loans and EPF loans are contributed by 42 per cent, 24 per cent and 18 per cent respectively to the total loan portfolio of the Bank. The non-performing loan ratios of above three main categories are recorded as 6 per cent, 9 per cent and 65 per cent respectively as at 31 December 2018. It was observed that EPF loan has the highest NPL ratio compared to NPL ratios of other loan categories.		

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.20,159,760 for the year 2018 out of its own funds on behalf of its employees instead of being deducted from the salary.	PAYE taxes of the employees have been borne by the bank as per the provision 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.

National Procurement
Guideline – 2006

Section 5.1.1	The Bank was unable to draft the bidding documents including technical specifications, drawing and etc. in a proper manner.	This has been corrected now.	
Section 6.3.3	The Bid opening committee had not appointed and bid opening procedure had not been followed properly.	Bid opening committee is being in operation since 26.06.2019	Should adhere to National Procurement Guideline 2006 for procurement activities of the bank.
Section 7.1	The Technical Evaluation Committee had not been evaluated the received bids as per Section 7.1 of National Procurement Guideline.	This has been done under shopping as the value of partition work was not material.	Should adhere to National Procurement Guideline 2006 for procurement activities.
Section 8.9.1	A formal letter of acceptance followed by the execution of a formal contract had not been entered between the bank and bidders.	Bank use preprinted serial numbered purchased order as formal awarding letter to selected bidder. However bidder consent is being obtained in the awarding letter now.	When execution of a formal contract in between bank and the bidder prepare a formal letter of acceptance according to National Procurement Guideline 2006.
Section 8.12.1	Evidences were not available to ensure whether the execution of works are adequately supervised and assessed for the purpose of making interim and final payments.	Having considered to value of the contract it is not practical to hire external expert for supervision work. Therefore as effective cost measure valuation officers of the bank and officer of the H.R. division had been closely monitored such	Take necessary actions to make evidence available in terms of execution of works are adequately supervised and assessed for the purpose of making interim and final payments.

partition work which is evident by the certification work done by the officers.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs. 244,472,029 and the corresponding profit in the preceding year amounted to Rs 178,524,309. Therefore an improvement amounting to Rs.65,947,720 of the financial result was observed. The reason for the improvement is increase of interest income by a greater amount than the increase of interest expense and personal expense.

2.2 Trend Analysis of major Income and Expenditure items

The interest income of the Bank had increased by Rs.780 million or 16 per cent as compared with the previous year. This is mainly due to increase in loans and advances by Rs.1.5 billion or 4 per cent compared to the previous year. Interest expense has also increased by Rs.476 million or 15 per cent which is mainly due to increase of customer deposits by Rs.652 million or 1.9 per cent when compared with the previous year. A personal expense has increased by Rs.99 million or 14 per cent due to granting salary increments to employees as per the provision in the new collective agreement.

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.

Name of the Ratio	Bank Sector Ratio 2018 (%)	2018 (%)	2017 (%)
Return on Equity	7.7	4.82	3.62
Return on Assets	0.8	1.13	0.98
Net Interest Margin	3.2	4.72	4.66

- (i) Return on Equity (ROE) and Return on Assets (ROA) had been increased by 1.2 per cent and 0.15 per cent respectively as at 31 December 2018 when compared with the preceding year mainly due to increased profitability in 2018.
- (ii) The net interest margin of 4.72 per cent for the year 2018 is observed which is slightly higher than the Licensed Specialized Bank ratio of 3.2 per cent.
- (iii) Gross non performing ratio of the Bank including EPF loans is very much higher than the sector ratio of 4.8 per cent. This is due to high NPL ratio of 65 percent in EPF loan category. Gross non-performing loan ratio without EPF loans is 7 per cent in 2018 which is higher than the industry average ratio of 2.2 per cent.

3. Operational Review

3.1 Uneconomic Transactions

Audit Issue	Management Comment	Recommendation
Bank had spent Rs.1.16 million for the partition and construction works of the Kiribathgoda branch in March 2017. However the branch has shifted into new premises in January 2018 just nine months after the completion of the partition work. Therefore the expense incurred for the partition became a fruitless expenditure.	Bank had incurred above cost for DR center of the IT division. After completion of the work building owner of the property has informed the bank that he has sold the property and issue a notice to vacant the building within 3 month.	Include necessary clauses in the agreement and communicate properly with the relevant parties.

3.2 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.68.34 million to forty seven (47) applicants who were presenting themselves as the employees of two fake private organizations. It was further revealed that the aforesaid applicants had submitted forge documents in applying for respective loans. Total amount of above loan was included in the non-performing loan balance at 31 December 2018.	Bank has filed the case in the CID to recover the above loans from relevant culprits.	Take necessary legal actions against culprits to recover the said amount.

3.3 Management Inefficiencies

Audit Issue	Management Comment	Recommendation
Even though a sum of Rs.38,312,700 had been paid as rental of the head office building for the year under review, most of the facilities such as office and parking space, wash room, lunch room, stores, wiring systems etc. of the building are not in a satisfactory level as the building is very old. Further, the Bank had failed to obtain an insurance coverage as per provisions in the rent agreement. Hence, the staff, assets and customers' safety is at a risk.	On request of the Bank, Ministry of Finance has appointed Cabinet appointed procurement committee and TEC to purchase new building, even though the procurement committee has selected a building and furnished their recommendation to Ministry on October 2018, however so far we have not receive the cabinet decision for new building.	Take necessary actions to purchase new building after receiving the cabinet decision.

3.4 Procurement Management

Audit Issue	Management Comment	Recommendation
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 date of audit. Still the process is at the beginning stage.	To Purchas of new system Ministry of Finance has appointed Mistrial TEC on 01.03.2019; TEC has furnished the FRS and RFP and paper advertisement to the Ministry on 23.09.2019 for approval.	Take necessary actions after obtaining the approval for purchasing a core banking solution of the bank.

3.5 Human Resources Management

Audit Issue	Management Comment	Recommendation
The approved cadre of the Bank for the year under review was 467 and the Bank had deployed 389 employees as at the end of the year 2018. Accordingly, 78 vacancies remained as at 31 December 2018. It was further observed that 09 key managerial positions are vacant which affect for the smooth operation of the bank.	Out of the vacant posts, DMG credit, AGM recoveries, AGM(HR&L) and Senior Accountant have been filled during the year 2019, and advertised to fill the vacancies in the post of Chief Internal Auditor.	Take necessary actions to fill the vacancies in approved cadre to ensure the operations of the bank are smoothly.

4. Accountability and Good Governance

4.1 Internal Audit

Audit Issue	Management Comment	Recommendation
It was observed that the chief internal auditor position is vacant since more than five years.	Bank has advertised the vacancy in the national newspapers in several time during the year and last year however, received the applications does not satisfy with the IT qualification required as directed by CBSL. Bank has inform the CBSL about the position and obtained consent of the CBSL to call application as per SOR of the bank.	After obtaining the consent of the CBSL, take necessary actions to fill the vacancy of the Chief Internal Auditor for maintain the good governance of the bank.