

1.1 Opinion

The audit of the Financial Statements of the Merchant Bank of Sri Lanka and Finance PLC (“Company”) 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 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 directions 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. My comments and observations which I consider should be report to parliament appear in this report. To carry out this audit I was assisted by a firm of Chartered Accountants in public practice.

In my opinion, the accompanying Financial Statements of the Company and the Group give a true and fair view of the financial position of the Company and the Group as at 31 December 2018 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 Group’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 Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company’s and the Group’s financial reporting process.

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Company 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 Company

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 internal control of the Company and the Group.
- 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 Group'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 Group 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 Company and whether such systems, procedures, books, records and other documents are in effective operation;
- Whether the Company has complied with applicable written law, or other general or special directions issued by the governing body of the Company.

- Whether the Company has performed according to its powers, functions and duties; and
- Whether the resources of the Company 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 Internal Control over the Preparation of Financial Statements

Audit Issue	Management Comment	Recommendation
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a (i) Maintenance of Fixed Assets Register

A sub module for all Property, Plant and Equipment has not been maintained in the ERP system with adequate details, proper control and monitoring process. An excel version register is being maintained, even though there was no formal process with reasonable documentation for review of estimated useful lives of assets and there were fully depreciated assets which are still in use by the Company.

Asset (Fully Depreciated)	Amount at Cost (Rs. 000 ³)
Motor Vehicle	52,694
Computer Accessories	275,947
Office Equipment	44,248
Office Furniture	99,377
Telephone	11,119
Total	483,385

We are in the process of evaluating option of procuring the solution or developing in-house solution. In the event the company decides to develop the system in-house, the project tentatively would be completed by March 2020.

Noted. Audit committee paper including Estimated life of Fixed Assets categories will be forwarded at the end of December 2019. All Fixed assets categories has been recognized under the cost model as per LKAS 16 sec 79(b)

Maintain a proper sub ledger for property, plant and equipment within the ERP system each with the identification number for each asset in the fixed assets register thereby enabling the tracking and identification of the relevant asset.

- Perform a detailed exercise in a structured manner and re-assess the useful economic lives of the plant and equipment with adequate documentation, obtain approval from the Board of Directors and Audit Committee (whenever required) and accordingly, if required, adjust the depreciation rates to ensure that all plant and equipment are depreciated over their remaining economic useful lives.

(ii) By the time of receiving a Fixed Asset to the company's premises a Goods Received Note (GRN) is not being raised.

Noted. This will be implemented by 30 September 2019.

It is advisable that the company should implement proper internal controls over the acquisition of fixed assets to avoid any inaccurate information in the Financial Statements.

1.5.2 Documentary Evidences not made available for Audit.

Item	Amount (Rs.)	Evidence not Available	Management Comment	Recommendation
Suspense	40,279,985	Any Documentary Evidence	Management is in the process of clearing balances in Suspense accounts and can be finalized by end of October 2019.	It is recommended that the management should further enhance its systems in the preparation of monthly and year-end reconciliations and emphasis should be placed on in-depth review of the reconciliations and approving of the adjusted entries. Management should ensure that there aren't any long outstanding balances which may distort the figures in the statement of the Financial Statements.

1.6 Accounts Receivable and Payable

1.6.1 Receivables

Audit Issue	Management Comment	Recommendation
a Out of the total insurance agency commission receivable of Rs. 15,240,723, there was a balance of Rs. 14,262,404 outstanding for more than a year.	In past MBSL had a decentralized insurance commission collection process. Accordingly every branch receipted the monthly insurance commission collected at branch level. VAT invoices issued by the relevant branch against the receipted commission cheque and send to the insurer for VAT Collection. However branches were unable to manage the VAT outstanding collections from Insurance Companies and this caused the reason for outstanding VAT amount of LKR 14,262,404. However, we have centralized the insurance commission collection process at Central Credit Division. As a result most of the insurance companies are now settling the commission to the bank including	It is recommended management to assess the recoverability of the above long outstanding debts and to provide for impairment, if necessary. Further, it is required to maintain detailed records in a manner to be able to trace with the ledger balances at any given time.

the VAT amount as well. But in some cases VAT invoices are collected subsequently after issuing the commission cheques to the bank directly. However we closely monitoring the VAT outstanding against the insurance commission income at CCD and there is no VAT outstanding at present.

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| <p>b A periodical review in respect of the 24 facilities totaling to Rs. 390,507,498 had not been carried out in order to assess the credit worthiness of the customers and to check the validity of the securities. Further, we observed that the bill discounting facility details had not been properly transferred to the new system such as payment history, older facility details, granted date of the facilities etc. (Annexure 1)</p> | <p>Observation noted. Periodical reviews are being carried out. All the required information with regard to facilities are already available in the system (i.e. Payment history, older facility details, granted date of the facilities, etc.)</p> | <p>Management should establish appropriate credit policies to reduce the credit risk.</p> |
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1.6.2 Payables

Audit Issue

As at the end of the year under review, There was a long outstanding balance of Rs. 10,994,432 in the Creditors' balance for more than a year. That includes unidentified direct deposits and unrepresented payments.

Management Comment

The identified portfolio will be reconciled and required adjustments will be made before December 2019, except court cases and personal loans paid in excess.

Recommendation

It is recommended that management should further enhance its systems in the preparation of monthly and year-end reconciliations and emphasis should be placed on in-depth review of the reconciliations and approving of the adjusted entries and ensure that there aren't any long outstanding balances which may distort the figures in the Financial Statements.

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

Reference to Laws, Rules Regulations etc.	Non-compliance	Management Comment	Recommendation																																			
(a) Finance Business Act Direction No. 04 of 2018	<p>It was noted that valuation of the property of Land and Building situated at No 385/1, Kotte Road, Pitakotte had not been carried out during the last three years even though it is required by the Finance Business Act under “valuation of immovable properties”.</p> <p>Date Of Latest Available Valuation Report Valid up to Carrying Value as at 31.12.2018(Rs.)</p> <table border="1"> <tr> <td>25/11/1996</td> <td>25/11/2001</td> <td>4,082,533</td> </tr> </table>	25/11/1996	25/11/2001	4,082,533	<p><u>Pitakotte - Land and Building</u></p> <p>Even though, the MBSL is the lawful owner of the property, there are illegal occupants in the premises and we are unable to obtain a valuation, because of the threats from the illegal occupants.</p> <p>Legal Action will be Initiated for declaration of title and ejection.</p>	<p>It is recommended to obtain the latest valuation report from a professional Valuer to fulfill the disclosure requirement at least once in every three years according to the Finance Business Act.</p>																																
25/11/1996	25/11/2001	4,082,533																																				
(b) CBSL Direction Number 3 of 2018	<p>From 1 July 2018 onwards the company should maintain their Tier 1 capital above 6 per cent and total capital above 10 per cent. However, the Company has failed to comply with the aforesaid requirement.</p> <p>Further, currently the Company does not have a comprehensive plan to explain the remedial actions against this non-compliance. Details are given below.</p> <table border="1"> <thead> <tr> <th>Nar rati on Tier</th> <th>Jul-18</th> <th>Aug -18</th> <th>Sep -18</th> <th>Oct -18</th> <th>Nov-18</th> <th>Dec-18</th> </tr> </thead> <tbody> <tr> <td>1</td> <td>5.11</td> <td>4.99</td> <td>5.14</td> <td>4.99</td> <td>5.27</td> <td>5.42</td> </tr> <tr> <td>capit al</td> <td>%</td> <td>%</td> <td>%</td> <td>%</td> <td>%</td> <td>%</td> </tr> <tr> <td>Total capit al</td> <td>9.38</td> <td>9.25</td> <td>9.48</td> <td>9.27</td> <td>9.69</td> <td>9.88</td> </tr> <tr> <td></td> <td>%</td> <td>%</td> <td>%</td> <td>%</td> <td>%</td> <td>%</td> </tr> </tbody> </table>	Nar rati on Tier	Jul-18	Aug -18	Sep -18	Oct -18	Nov-18	Dec-18	1	5.11	4.99	5.14	4.99	5.27	5.42	capit al	%	%	%	%	%	%	Total capit al	9.38	9.25	9.48	9.27	9.69	9.88		%	%	%	%	%	%	<p>A comprehensive plan has been presented and discussed with Board of Directors. The same procedure has been presented to BOC as the parent company for advice and approval. Meanwhile CBSL has indicated in writing the possibility of allowing recognition of IFRS 9 day 1 impact over a period of 4 years.</p>	<p>It is recommended that the Company’s management should take remedial action to overcome this situation.</p>
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1.8 IT General Controls

Audit Issue	Management Comment	Recommendation
<p>a Network and firewall</p> <p>It was noted that the entity is using Check point 5200 HA firewall for MBSL. All the Company’s machines</p>	<p>a) The IT department has planned & initiated a comprehensive VAPT</p>	<p>It is recommended to ensure logging of unauthorized access attempts. It is vital that</p>

are covered under this firewall. However, the following deficiencies were identified while utilizing this firewall.

- a) It was observed that network and firewall penetration testing had not been carried out by the entity.
- b) Regular monitoring of firewall activities is not performed.
- c) Company's change management procedure has not been adopted for firewall related parameter changes.
- d) Firewall rule cleanup is not performed regularly.

assessment including a firewall review. The project has already been started for this year and is expected to complete before the end of this year.

- b) Comment noted, regular firewall review has been started.
 - c) Change management procedures have been streamlined from the 1st of June 2019 and those cover all the changes including changes made on the firewall.
 - d) This is part of firewall review as stated in b) above.
- Further, it is recommended to perform the following, but not limit it to,
- (a) Perform periodic penetration testing.
 - (b) Perform regular monitoring of firewall activities.
 - (c) Adapt Company's change management procedure for firewall parameter changes including proper authorization.
 - (d) Perform regular firewall rule clean up.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs. 181,285,000 and the corresponding profit in the preceding year amounted to Rs. 100,851,000. Therefore, improvement amounting to Rs. 80,434,000 of the financial result was observed. The reasons for the improvement are increase of operating income, decrease in impairment charges for loans and other losses and impairment reversal of investment in subsidiary.

Year	2018	2017	2016	2015
Net operating Income (Rs.)	2,660,870,000	2,389,822,000	2,154,312,000	1,621,515,000
Profit for the Year (Rs.)	181,285,000	100,851,000	85,624,000	(78,306,000)

2.3 Ratio Analysis

According to the Financial Statements and information made available to audit, some important ratios for the year under review as compared with the preceding year are given below.

Ratio	2018	2017
	(%)	(%)
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Profitability Ratio	40.62	37.32
Net Profit Ratio	2.77	1.58
Return on Total Assets	0.50	0.30
Return on Equity	6.30	3.18
Liquidity Assets Ratio	10.20	11.49
Net Interest Margin	7.83	7.64
Cost to Income Ratio	71.07	73.10

3. Operational Review

3.1 Operational Inefficiencies

Audit Issue

During the period, the Company has disposed one of their properties at Wattala for Rs. 94,297,500. As per the Valuation done by the Mr. S.A.M.A. Perera dated 7 August 2018, forced sale value of the above property was Rs. 98,250,000. It is noted that the valuation is greater than the Rs. 3,952,500 than the actual sold price.

This property has been sold to one of the existing customer of MBSL by granting a new loan amounting to Rs. 64,297,500. Subsequently the same property has been rented out by the customer to MBSL. The Company had recognized a disposal profit of Rs. 83,199,014 in the Statement of Profit or Loss which leads to the suspicion that the transaction took place in order to boost the bottom line of the Company.

Management Comment

The said property was acquired due to non-payment of loan facility from a customer. The company disposed the said property due to following reasons.

1. To recover the loan given to the customer.
2. To liquidate the non-yielding asset.

The said property was not taken on rent after selling.

The loan was granted to the buyer after proper credit evaluation and also due to providing credit is our core business. This generates the main income to the company. However, the loan has been settled by the customer in full before the granted period. This is a normal business activity of a Finance Company.

Recommendation

It is recommended to evaluate these transactions properly, before executing them.

3.3 Procurement Management

Audit Issue	Management Comment	Recommendation
<p>a. The Procurement Manual has not been prepared by the Company. Further, the Company does not follow the Government Procurement Manual too.</p>	<p>Board approved Procurement procedure manual is available and which has been forwarded to the National Procurement Commission on 28/03/2019 and waiting for their response.</p>	<p>It is recommended to follow an approved procurement manual.</p>
<p>b. When obtaining Heiyanthuduwa vehicle yard, the Company has not followed the Government procurement guidelines-2006 including Paper Advertisement published on Newspaper. Even though the Board has advised regarding conditions of the rent agreement at their meeting held on 08 January 2019, the Company has not entered in to the agreement with the owner until the audited date 21 June 2019.</p>	<p>Yard selection and procurement are not the frequent activity and general procedure of the procurement that has been proceeding for all existing yard at that time was followed. As per decision made by the management, Ja-Ela yard and Ekala yard are to be disposed by on or before the end of the month, Dec 2018. Due to the urgency of the matter, board approval has been obtained to use the Heiyanthuduwa land as the vehicle yard on temporary basis for LKR 300,000 monthly payment until the formal board approval for the lease terms is approved. However, the board subsequently instructed to withhold the execution of the said rent agreement with the yard owner of the Heiyanthuduwa land and further instructed to start fresh procurement process according to procurement guideline. Board decision has been taken on 12 March 2019 (Board Paper No RC /2019/566/006).</p>	<p>It is recommended to follow an approved procurement manual. In the absence of relevant guideline in the approved procurement manual the company should follow the government procurement guideline.</p>
<p>c. It was observed that the Company has purchased a Toyota Prado vehicle for the use of Chairman of MBSL at a total cost of Rs. 18,650,000.00 (including taxes and transfer fees) on 13 September 2016 from Woodland Company (according to the board paper No. HO/SS/2016), MBSL has not followed the PED 12 procedures of getting approval of appropriate Ministry and concurrence of the Department Of Public Enterprises, General Treasury.</p>	<p>Purchasing of Toyota Land Cruiser Prado Vehicle (Jeep) was carried out as per the guidelines of the company for capital item purchases mentioned in the delegation of authority and approval given by the board of directors for the board paper No HO/SS/2016/502/006. Under the present circumstances, we are following the PED 12 circular issued by the Department of Public Enterprise to obtain the approval for the capital item purchases as stated in the circular from the appropriate ministry and the concurrence of the Department of Public Enterprise.</p>	<p>The company should comply with guidelines in the Hand Book on Public Enterprises Guideline for Good Governance issued under PED Circular no 12 dated 02 June 2003.</p>

3.4 Human Resources Management

Audit Issue	Management Comment	Recommendation
a Section 9.2 of the Hand Book on Public Enterprises Guideline for Good Governance issued under Public Enterprises Circular No. PED 12 dated 02 June 2003, the organization chart and the approved cadre should be registered with the Department of Public Enterprises, General Treasury. However, the Company had not complied with the above requirement.	It is not required to obtain approval from the Dept. of Public Enterprise, General Treasury for cadre position and organization chart as the Company has board approved policies and procedures for the same. However, we have kept informed the Department of Management Service, General Treasury regarding the approved cadre position of the company for 2019/20.	The company should comply with guidelines in the Hand Book on Public Enterprises Guideline for Good Governance issued under PED Circular no 12 dated 02 June 2003.
b Section 9.3.1 of the Hand Book on Public Enterprises Guideline for Good Governance issued under Public Enterprises Circular No. PED 12 dated 02 June 2003, Schemes of recruitment and promotion should be approved by the board and the appropriate ministry, with the concurrence of the Department Of Public Enterprises, General Treasury. However, the Company had not complied with the above requirement.	It is not required to obtain approval from the Dept. of Public Enterprise, General Treasury for schemes of recruitment and promotion etc. as the company has board approved policies and procedures for the same.	The company should comply with Hand Book on Public Enterprises Guideline for Good Governance issued under Public Enterprises Circular No. PED 12 dated 02 June 2003.