

State Mortgage and Investment Bank - 2020

1.1 Opinion

The audit of the financial statements of the State Mortgage and Investment Bank (“Bank”) for the year ended 31 December 2020 comprising the statement of financial position as at 31 December 2020 and the statement of income and the statement of comprehensive income, statement of changes in equity and statement of cash flow for the year then ended, and notes to the financial statements, including a summary of significant accounting policies, was carried out under my direction in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with provisions of the National Audit Act No. 19 of 2018 and Finance Act No. 38 of 1971. My comments and observations which I consider should be report to Parliament appear in this report.

In my opinion, the accompanying financial statements of the Bank give a true and fair view of the financial position of the Bank as at 31 December 2020, and of their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basis for Opinion

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

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

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

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

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

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

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

My objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Sri Lanka Auditing

Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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

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

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

- Whether the organization, systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of the presentation of information to enable a continuous evaluation of the activities of the Bank, and whether such systems, procedures, books, records and other documents are in effective operation;
- Whether the Bank has complied with applicable written law, or other general or special directions issued by the governing body of the Bank;
- Whether the Bank has performed according to its powers, functions and duties; and
- Whether the resources of the Bank had been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws.

1.5 Financial Statements

1.5.1 Un reconciled Control Accounts or Records

Audit Issue	Management Comment	Recommendation
i. There is an un reconcile credit amount recorded in the “slip control account” amounting to Rs 1,871,997 as at 31 December 2020.	This balance to be write of due to unavailability of documentary evidence.	Take necessary actions to reconcile the unreconciled balance or do the necessary adjustment in the accounts.
ii. There were three suspense accounts which were disclosed under other assets as at 31 December 2020 Details are as follows	1/06/1102 – 4,309,124 this balance represent customer despot to our collection accounts on 31.12.2020, and temporary recorded in the suspense accounts in order to update the Bank (G/L) accounts, after receiving to detail bank statement this balance was cleared on first week of the January 2021. 1/06/1104 - 54,509- this balance has been cleared during the year 2021 1/09/1618 - to be cleared	Take actions to clear all suspense balances in the Bank at the year end.

GL Account	Balance
1/06/1102	4,309,124
1/06/1104	54,509
1/09/1618	15,783
Total	4,379,416

1.6 Accounts Receivable and Payable

1.6.1 Advance

Audit Issue	Management Comment	Recommendation
i. There are two long outstanding advance balances amounting to Rs 1,563,966 and Rs 1,233,723 respectively as at 31 December 2020 reference to the ledger account 2/22/4703 and 2/22/4702.	These balances are to be write off due unavailability of supporting documents	Take necessary actions to recover long outstanding advance balance as soon as possible.

1.6.2 Loans and Advances

Audit Issue	Management Comment	Recommendation
i. Gross non-performing loan advances including EFP loan was 22.94 percent and Gross non-	Gross NPL ratio as at 31.12.2021 was 19.85% Net NPL - 16.55%	Implement recovery actions to reduce the non-performing loan ratio of the bank.

performing loan advances Gross NPL excluding EPF - 9.19% excluding EPF loan was 10.71 percent for the year 2020. This is higher than the industry ratios of 6.8 percent and 4.9 percent respectively.

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

Reference to Laws, Rules Regulations etc.	Non-compliance	Management Comment	Recommendation
i. Public Enterprises Circular No. PED 03/2016 dated 29 April 2016.	Bank had paid Pay as You Earn (PAYE) tax amounting to Rs.1, 756,213 for the year 2020 out of its own funds on behalf of its employees instead of being deducted from the salary.	PAYE(APT) are paid as per condition in the collective agreement	Should adhere to “Public Enterprises Circular No. PED 03/2016 dated 29 April 2016” in relation to PAYE Tax of the bank.
ii. The Banking Act Direction No 12 of 2007 section 3.1.i.c the board should Identify the principal risks and ensure implementation of appropriate systems to manage the risks prudently in the Bank.	The Bank has not performed BCPDR for the year 2020 and poor documentation in the BIRMC minutes in 2020 were observed.	Noted for Future Compliance	Should comply with the regulation of the Banking Act Direction No 12 of 2007 Section 3.1.i.c
iii. The Banking Act Direction No 12 of 2007 Section 3.1.i.e the Board should review the adequacy and the integrity of the Bank’s internal control systems and management information systems.	AS 400 does not facilitate the industry requirement in terms of generating information and reports.	Bank has made arrangement to purchase New Core Banking system. Paper Advertisement published for Invitation of Bids on 16.12.2021 and bids closing on 03.02.2022.	Should comply with the regulation of the Banking Act Direction No 12 of 2007 Section 3.1.i.c
iv. The Banking Act Direction No 12 of 2007 Section 3.1.i.l the Board should	The Bank was unable to achieve the deadlines of reporting with	Noted for future compliance	Should comply with the regulation of the Banking Act Direction No 12 of 2007 Section 3.1.i.l

	understand the regulatory environment and ensure that the bank maintains an effective relationship with regulators.	the relevant regulators. Ex Annual Report of the Bank in 2019 and 2020.	
v.	The Banking Act Direction No 12 of 2007 Section 3.1.iii the Board shall meet regularly, and board meetings shall be held at least twelve times a year at approximately monthly intervals.	Board meetings were started on April 2020 onwards and only met 11 times for the year 2020.	A new Board of Directors had been appointed in January 2020, but due to the delay in receiving CBSL clearance for Fitness and Propriety of Directors Board meetings could not be held until 20th April 2020. Subsequent to receiving CBSL approval the Board has met regularly for board meetings and managed to conduct 11 meetings during the year 2020.
vi.	The Banking Act Direction No 12 of 2007 Section 3.2.i the board's composition, the no of Directors of the Board shall not be less than 7 and no more than 13.	As per the Banking Act, minimum no of directors should be seven (7). However actual no of directors in the board were five (5) as at 31 December 2020.	Noted, Now complied
vii.	The Banking Act Direction No 12 of 2007 Section 3.5.ix The chairman, shall not engage in activities involving direct supervision of key management personnel or any other executive duties whatsoever	It was observed that Appointment letters of the CIA, Assistant Manager (Credit) and Assistant Internal Auditor have been signed by the Chairman in 2020	Noted. We have requested clarification from the GA on this matter by the letter dated 31 st December 2021
viii.	The Banking Act Direction No 12 of 2007 Section 3.6.iii.c	It was observed that the Bank has not considered goals and	Noted for future actions. The Board has decided
			Should comply with the regulation of the Banking Act Direction No 12 of 2007 Section 3.1.iii
			Should comply with the regulation of the Banking Act Direction No 12 of 2007 Section 3.2.i
			The Chairman should not be exercised executive duties of the Bank.
			Should comply with the regulation of the Banking Act Direction No 12 of 2007

the Human Resources target set at the to monitor the Section 3.2.i and Remuneration beginning for the performance of the Committee shall performance KMPs by monitoring evaluate the evaluation of the their performance performance of the CEO and KMPs. against the agreed KPIs CEO and key management personnel against the set targets and goals periodically in future.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs. 355,834,458 and the corresponding profit in the preceding year amounted to Rs. 419,073,544. Therefore, a decrease amounting to Rs.63,239,086 of the financial result was observed. The reason for the decrease is increase of income tax expense and impairment charge in 2020 when compared to the previous year.

2.2 Trend Analysis of major Income and Expenditure items

The interest income of the Bank had increased by Rs.95.2 million or 1.6 per cent as compared with the previous year. This is mainly due to increase in loans and advances by Rs.1.2 billion or 3.6 per cent compared to the previous year. Interest expense has also increased by Rs.9.1 million or 0.23 per cent which is mainly due to interest rate decrease in the market when compared with the previous year. Impairment charges had been increased by 138.7Mn due to loan product wise impairment calculation done by the bank when compared to the previous year.

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 and last four years.

Description	Secto	Bank				
		2020	2020	2019	2018	2017
Year						
Profitability Ratio						
Return on Average Equity (ROE) (Percentage)	10.59	6.09	7.73	4.82	3.62	
Return on Average Assets (ROA) (Percentage)	0.94	1.15	1.11	1.13	0.98	
Net Interest Margin (Percentage)	3.2	4.24	4.52	4.72	4.66	
Capital Adequacy						
Total Tier 1 Capital Ratio	12.05	21.5	21.04	21.69	23.7	
Total Capital Ratio	15.36	22.6	21.77	22.23	24.2	
Asset Quality						
Gross Non- Performing Advance (Including EPF)	6.8	22.9	21.21	22	19.3	
Gross Non- Performing Advance (Excluding EPF)	4.9	10.7	7.73	7.0	4.5	

Liquidity Ratios

Liquidity Coverage Ratio (Percentage) 59.52 116 121.0 83.91 86.8

- i. Return on Equity (ROE) had been decreased by 1.64 percent as at 31 December 2020 when compared with the preceding year mainly due to decreased in profitability in 2020.
- ii. The net interest margin of 4.24 percent for the year 2020 is observed which is slightly higher than the Licensed Specialized Bank ratio of 3.2 percent.
- iii. Gross nonperforming ratio of the Bank including EPF loans is very much higher than the sector ratio of 6.8 percent. This is due to high NPL ratio in EPF loan category. However EPF loans are cash back loans and can be recovered through Central Bank. Gross non-performing loan ratio without EPF loans is 10.71 percent in 2020 which is higher than the sector ratio by 4.9 percent.

3. Operational Review

3.1 Identified Losses

Audit Issue	Management Comment	Recommendation
The credit division of the Bank during the period from 01 September 2016 to 31 March 2017 had granted loans amounting to Rs.66.34 million to forty seven (47) applicants who were presenting themselves as the employees of two fake private organizations. It was revealed that the applicants presenting themselves as employees of the two fake organizations had submitted forge documents in applying for respective loans. Out of the above loan Rs 61,506,617 was recorded as the balance payment outstanding as at 31 December 2020.	Case has been filed in the criminal investigation division against relevant suspects and disciplinary actions were taken against relevant employees those involved in granting of such loans.	Take necessary actions against culprits to recover the said amount and identify the responsible employees and take necessary actions.

3.2 Operational Inefficiencies

Audit Issue	Management Comment	Recommendation
i. Temporary closed status in the UR account amounting to Rs 38,378,330 was not settled yet.	These balances have been cleared during the year 2021	Loan administration should be cleared this kind of balances to smooth the operations of the Bank.
ii. Long outstanding customer refund balances amounting to Rs 72,103,281 were observed as at 31 December 2020	As at 31.12.2021 balance of this account was reduced to Rs. 50,739,909.	Long outstanding customer refund balances should be settled as soon as possible.

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| <p>iii. Updated maturity dates of the loans and advances under the moratorium granted were not available in the system.</p> | <p>Current system is designed to recover the loans based on number of instalments and does not based on the maturity date. Bank will modify the system to calculate the lapsed date with the moratorium period.</p> | <p>Updated maturity dates of the loans and advances should be available in the system.</p> |
| <p>iv. PL and NPL classification in the loan portfolio as at 31 December 2020 were not identified properly.</p> | <p>PL & NPL classification is based on arrears status of the customer.</p> | <p>PL and NPL classification in the loan portfolio should be accurate and it should be checked by Finance Division.</p> |
| <p>v. It was observed that there was no data validation control point in the IT data extraction in the IT Department or in the Finance Department of the Bank.</p> | <p>IT Division does validations where possible.</p> | <p>The Bank should introduce data validation control point in the IT data extraction in the IT Department or in the Finance Department and it should be confirmed by the relevant officer.</p> |

3.3 Fixed Asset Register

----- Audit Issue -----	----- Management Comment -----	----- Recommendation -----
<p>i. Following information are not included in the Fixed Asset Register.</p> <ul style="list-style-type: none"> - Inventory numbers - Seller of the Asset - List of Disposed Assets - Existing Location of the Asset 	<p>Inventory number in the fixed assets register are now updated – Separate list of disposal assets will be provide along with financial Statements.</p>	<p>Details of Inventory numbers, Seller of the Asset, List of disposed assets and existing location of the asset should be maintained in the Fixed Asset Register.</p>
<p>ii. Reconciliation Report of the Asset Verification as at 31 December 2020 and fixed Asset Register were not furnished to the Audit.</p>	<p>Will be provided along with assets verification report.</p>	<p>Reconciliation Report of the Asset Verification and fixed Asset Register as at 31.12.2020 should be furnished to the audit along with accounts of the Bank.</p>

3.4 Information System of the Bank

----- Audit Issue -----	----- Management Comment -----	----- Recommendation -----
<p>i. The bank does not maintain the change request form and since there was change request into systems for moratorium. Further no supporting evidence was available for UAT Testing in 2020</p>	<p>Although bank had a mechanism for testing, documentation process was started only in October 2021.</p>	<p>The Bank should maintain the change request form and UAT testing form and it should be properly documented.</p>

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| ii. | The Bank does not maintain change log in physically or system itself for the year 2020 | Procurement process for Core-Banking solution has not been approved by the Ministerial Procurement Committee.
By the CBSL letter (Ref: 02/19/306/0001/006) dated 23-April-2021, has given instructions not to spend capital expenditure to purchase core banking solution due to proposed merger of SMIB, and to take mitigative actions. As per Board directions, a basic core banking solution will be implemented. Accordingly, a fresh tender process has been started to procure a basic CBS | The Bank should maintain change log in physically or system |
| iii. | Access Matrix for AS 400 is not available | Will be submitted | The Bank should develop Access Matrix for AS 400 |

3.5 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 the date of audit.	Procurement process for Core-Banking solution has not been approved by the Ministerial Procurement Committee. By the CBSL letter (Ref: 02/19/306/0001/006) dated 23-April-2021, has given instructions not to spend capital expenditure to purchase core banking solution due to proposed merger of SMIB, and to take mitigative actions. As per Board directions, a basic core banking solution will be implemented. Accordingly, a fresh tender process have been started to procure a basic CBS	Take necessary actions to purchase the core banking solution for the bank as soon as possible.

3.6 Human Resources Management

Audit Issue	Management Comment	Recommendation
According to the cadre position of the Bank, approved cadre and actual cadre was 467 and 369 respectively	Carder of the bank originally designed in	Take necessary actions to fill the vacancies in

resulting 98 vacancies as at 31.12.2020 It was further revealed that following key managerial positions are vacant as at 31 December 2020 which affect for the smooth operation of the Bank.

Job position	Approved posts	Filled posts	Vacancies
General Manager	1	1	0
Deputy General Manager(credit)	3	1	0
Deputy General Manager (Finance and planning)		0	2
Deputy General Manager (HR Development and Management)		0	
Assistant General Manager (Credit)	10	0	5
Assistant General Manager (finance)		1	
Assistant General Manager (legal)		1	
Assistant General Manager (IT)		1	
Assistant General Manager (Recoveries)		1	
Assistant General Manager (HR & L)		1	
Assistant General Manager (Risk Management)		0	
Assistant General Manager (Branch operation)		0	
Assistant General Manager (Valuation)		0	
Assistant General Manager (credit-Disbursement and Monitoring)		0	
Chief internal auditor	1	1	0
Chief Manager(credit)	12	2	5
Chief Manager (Branch operation)		1	
Chief Manager (HR&		1	

line with proposed approved cadre to ensure branches expansion of the smooth operations of the bank, However CBSI has withheld granting permission to opening of new branches until meeting with minimum regulatory capital of the bank, filling of the vacancies has been deferred.

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Chief Manager (Risk Management)		1	
Chief Manager (Legal)		0	
Chief Manager(compliance)		1	
Chief Manager (Valuation)		1	
Chief Manager (IT)		0	
Chief Manager9Recoveries)		0	
Senior Accountant	2	0	2
Senior Manager - Marketing	1	0	1
Senior Branch Manager	24	10	1
Branch Manager		13	
Senior Manager-Valuation	12	3	0
Manger- Valuation		2	
Assistant Manager-Valuation		7	
Senior Manager-Legal	18	0	2
Manger- legal		5	
Assistant Manager-Legal		11	
Senior Manager-IT	4	1	3
Manger- IT		0	
Assistant Manager-IT		0	
Senior Manager-Credit	35	2	5
Manger- Credit		4	
Assistant Manager - Credit		24	
Personal Manger	1	0	1
Senior Manager - HRD			