

# **State Mortgage and Investment Bank - 2010**

## **1 Financial Statements**

### **1.1 Opinion**

So far as appears from my examination and to the best of information and according to the explanations given to me, I am of opinion that the State Mortgage and Investment Bank had maintained proper accounting records for the year ended 31 December 2010 and except for the effects on the financial statements of the matters referred to in paragraph 1.2 of this report, the financial statements have been prepared in accordance with the Sri Lanka Accounting Standards, give a true and fair view of the state of affairs of the State Mortgage and Investment Bank as at 31 December 2010 and the financial results of its operation and cash flows for the year then ended.

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

#### **1.2.1 Accounting Deficiencies**

Following accounting deficiencies are observed.

- (a) Disclosure for compensation amounting to Rs.508,648 had not been made in the financial statements for the year under review in terms of SLAS 36.
- (b) The value of Rs.379,500 for the Software for Stock System which was shown as advance payment had not been capitalized and amortized in terms of SLAS 37 .

#### **1.2.2 Accounts Receivable and Payable**

Following observations are made.

- (a) Out of the total receivable accounts balances aggregating Rs.3,165,993,388, only a sum of Rs. 1,458,670,864 or 46.07 % had been confirmed by the respective customers up to 21 April 2011.
- (b) Out of the total payable accounts balances aggregating Rs. 2,837,653,204 , only a sum of Rs. 1,646,232,961 or 58 % had been confirmed by the parties concerned up to 21 April 2011.
- (c) Advances aggregating Rs.50,000 paid to various Institutions and to the officers of the Bank from January to November 2010,had not been settled even as at 25 April 2011.
- (d) Accrued interest amounting to Rs.134,321,918 payable to the Government had remained unsettle for a long period.

### 1.2.3 Unreconciled Differences

Following observations are made.

- (a) Balances amounting to Rs. 8,561,853 and Rs. 4,874,419 under the current assets and current liabilities respectively had been remained without being reconciled since 2004.
- (b) According to the schedule attached to the Financial Statements, the balance of vested properties as at 31 December 2010 was Rs. 23,685,030 but according to the schedule provided by Recovery Division of the bank it was shown as Rs. 26,667,062 (BPO) and the difference was Rs. 2,982,032
- (c) Following difference was observed in respect of the depreciation charges for Differed tax calculation for the year under review.

<u>Fixed Assets Depreciation</u>	Rs.
As per the Financial Statements for 2010	12,109,631
As per Differed Tax calculation	<u>9,788,170</u>
Difference	<u>2,321,461</u>

### 1.2.4 Lack of Evidence for Audit

The following items of accounts could not be satisfactorily vouched in audit in the absence of evidence indicated against each.

<u>Item</u>	<u>Value</u> Rs	<u>Evidence not available</u>
(i) Expenditure for a conference held at Galadari Hotel	164,600	List of participants and details of programme.
(ii) Advertisement expenditure through Advertising Agencies.	1,400,364	Agreements with relevant Advertising Agencies
(iii) Expenditure relating 06 vouchers	1,172,298	Acknowledgements
(iv) Payments for the “Wyawasayakathwa Pubuduwa” programme for the District Secretary, Matara	500,000	Details of programme and invoices

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

Following instances of non-compliance were observed in audit .

<b><u>Reference to Laws, Rules, Regulation etc.</u></b>	<b><u>Non-Compliance</u></b>
(a) Government Procurement Guidelines Circular No.8 dated 25 January 2006 as amended by Circular No.06 dated 5 October 2006.	<p>(i) A sum of Rs. 2,642,104 had been paid for Advertisement expenses without calling for competitive quotations and obtaining Tender Board approval.</p> <p>(ii) A sum of Rs. 4,317,765 had been paid for purchasing of various goods without calling for quotations and obtaining Tender Board approval.</p> <p>(iii) Although vehicle repairing cost over Rs.100,000 should only be made with the approval of the Secretary to the Ministry, such approval had not been obtained in respect of vehicle repairs amounting to Rs.303,257 made by the Bank.</p>
(b) Financial Regulations	
(i) F.R. – 341	A register of counterfoil books had not been maintained by Ambalantota branch of the bank.
(ii) F.R.395(c)	Bank Reconciliation statements had not been prepared since June 2010 by the Matara branch of the bank.
(iii) F.R. 454 and 751	Inventory registers had not been maintained by Ambalantota and Matara branches .
(iv) F.R.R 756 and 757	Copies of the board of survey reports had not been forwarded to the Auditor General for the year under review as required

## 2. **Financial and Operating Review**

### 2.1 **Financial Results**

- (a) According to the financial statements presented, the operations of the Bank for the year under review had resulted in a pre-tax net profit of Rs.642.24 Million as compared with the corresponding pre-tax net profit of Rs.119.93 Million in the preceding year thus showing an increase of Rs 522.31 Million in the financial results.
- (b) According to the information made available, the operating results of the Bank had increased for the year under review and preceding year. Other 04 preceding years it was shown declining trend. Details are as follows.

	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
	<b><u>Rs.(Mn)</u></b>	<b><u>Rs.(Mn)</u></b>	<b><u>Rs.(Mn)</u></b>	<b><u>Rs.(Mn)</u></b>	<b><u>Rs.(Mn)</u></b>	<b><u>Rs.(Mn)</u></b>
(i) Interest Income	2,362	2,165	1,956	1,399	1,307	1,168
(ii) Interest Expenses	1,368	1,939	1,636	1,002	608	468
(iii) Net Interest Income	994	226	320	397	699	700
(iv) Other Operating Income	387	505	261	170	117	71
(v) Other Income	1	2	5	2	1	1
(vi) Total Income	1,382	733	586	569	817	773
(vii) Total Recurrent Expenses	740	613	535	445	499	358
(viii) Pre-tax net profit	642	120	51	124	318	415
(ix) Taxation	178	46	30	41	105	102
(x) Net Profit after tax	463	74	21	83	213	312

The following observations are made in this connection

- a) The interest income had increased from Rs.1,168 Million to Rs. 2,362 Million or 102.23 per cent and interest expenses had increased by higher proportion from Rs.468 Million to Rs. 1,939 Million or 314.32 per cent during the period 2005 - 2009 and decreased to Rs. 1,368 Million or 29.7 per cent in the year 2010.
- b) The pre-tax net profit had increased from Rs.415 Million to Rs. 642 Million or 54.7 per cent and the net profit after tax had increased from Rs. 312 Million to Rs. 463 Million or 48.4 per cent during the said period

## 2.2 Ratios and Percentages

According to the information made available, some of the important ratios of the Bank for the preceding 06 years were as follows.

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
(a) <u>Profitability Ratios</u>	%	%	%	%	%	%
i. Net Interest margin	7.67	4.41	4.16	4.85	7.98	7.3
ii. Return on Equity	17.47	3.10	1.76	3.3	8.56	14
iii. Return on Average Assets	3.57	0.72	0.38	1.1	3.11	4
(b) <u>Capital adequacy</u>						
i. Equity / Total Assets	14.62	13.28	16.01	19.9	23.5	26
ii. Equity / Loans	19	18	19	23	26	28
iii. Tier I	26.15	25.29	27.81	56.95	76.15	87
iv. Tier II	26.89	25.29	28.47	57.98	77.38	89
(c) <u>Liquid Assets</u>						
i. Liquid assets/ Deposits (Liabilities)	21	26	12	10	10	12
ii. Deposits / Loans and Advances	85	85	71	61	51	54
iii. Borrowings/ Loans and Advances	4	5	5	10	13	13

Ratios and percentages had increased during the year under review when compared with preceding year except liquid assets.

### 2.3 Loan Administration

The following observations are made.

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

According to the information made available the position of Mortgage, EPF and Estate Sector EPF loans granted for the year ended year under review as compared with the preceding year is given below.

	<u>2010</u>		<u>2009</u>		<u>Variance</u>	
	<u>Number of Accounts</u>	<u>Value</u>	<u>Number of Accounts</u>	<u>Value</u>	<u>Rs. Million</u>	<u>Percentage</u>
		Rs. Million		Rs. Million	Rs. Million	Percentage
Mortgage Loans	1,164	499	1,652	523	(24)	(4.6)
EPF Loans	5,082	1,124	3,851	692	432	62.4
Estate Sector EPF Loans	<u>1,771</u>	<u>96</u>	<u>2,511</u>	<u>130</u>	<u>(34)</u>	<u>(26.1)</u>
Total	<u>8,017</u>	<u>1,719</u>	<u>8,014</u>	<u>1,345</u>	<u>374</u>	<u>27.8</u>

The EPF Loans for the year under review was Rs. 1,124 million as compared with Rs. 692 million for the preceding year resulting an increase of Rs. 432 million or 62.4 per cent. It was observed that loan balances had decreased by Rs. 24 million and Rs. 34 million or 4.6 per cent and 26.1 per cent in the year 2010 compared with the preceding year in respect of Mortgage loans and Estate Sector EPF loans respectively.

#### 2.3.2 Age Analysis of Loans

According to the information furnished, the Following Statement shows the age analysis of Mortgage, EPF and Estate Sector EPF loans as at 31 December 2010.

<u>Period in Months</u>	<u>Outstanding Balance as at 31 December 2010</u>		
	<u>Mortgage Loans</u>	<u>EPF Loans</u>	<u>Estate Sector EPF Loans</u>
	Rs.Million	Rs.Million	Rs.Million
0	3,781	1,454	158
1 - 2	2,144	524	36
3 - 5	437	345	152
6 - 11	134	581	163
12 - 17	34	2,802	326
18 and Over	<u>47</u>	<u>108</u>	<u>6</u>
Total	<u>6,577</u>	<u>5,814</u>	<u>841</u>

The following observations are made.

- (i) Out of the total outstanding balances of Rs.5,814 million in respect of EPF Loans, a sum of Rs.2,910 were in arrears over one year.
- (ii) Out of the total outstanding balances of Rs. 841 million in respect of Estate Sector EPF Loans, a sum of Rs.332 million were in arrears over one year.
- (iii) There were no evidence that meaningful action had been taken to recover loan outstanding balances in respect of EPF Loans and Estate Sector EPF Loans.

### **2.3.3 Total Loans ,Non-Performing Loans(NPL) and NPL Ratios**

According to the information made available ,the total loans outstanding , non-performing loans and NPL Ratio for the year under review as compared with preceding four years are given below.

#### **(a) Performing Loans**

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
	Rs. million	Rs. million	Rs. million	Rs. million	Rs. million
Mortgage	6,577	7,016	7,192	6,194	5,407
EPF	5,814	5,225	4,931	3,984	3,389
Estate Sector EPF	841	798	715	663	623
Total	13,232	13,039	12,838	10,841	7,419

#### **(b) Non Performing Loans**

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
	Rs. million	Rs. million	Rs. million	Rs. million	Rs. million
Mortgage	653	1,278	917	866	1,058
EPF	3,836	3,714	2,898	2,235	1,979
Estate Sector EPF	647	618	456	471	356
Total	5,136	5,610	4,271	3,572	3,393

#### **(c) NPL Ratio (%)**

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Mortgage	9.93	18.21	12.75	13.98	19.57
EPF	65.98	71.08	58.77	56.10	58.39
Estate Sector EPF	76.93	77.44	63.78	71.04	57.14
Total	38.81	43.02	33.27	32.95	45.73

The following observations are made in this regard.

- (i) According to the above statement ,Non – Performing Loans (NPL) Ratio in respect of Mortgage, EPF and Estate Sector EPF loans were 9.93% , 65.98% , and 76.93% respectively.
- (ii) NPL Ratio had increased from 58.39% to 65.98 % in respect of EPF Loans and 57.14% to 76.93% in respect of Estate Sector EPF Loans from 2006 to 2010
- (iii) Total Non-performing loans had increased by Rs. 2,217 Million from Rs. 3,393 Million in 2006 to Rs.5,610 in 2009 while Total Non-Performing Loans had reduced by Rs. 474 Million from Rs. 5,610 Million in 2009 to Rs. 5,136 Million in 2010.
- (iv) Non-Performing EPF Loans had increased by Rs.2,157 Million from Rs.1,979 Million in 2006 to Rs.3,836 Million in 2010 and Non-Performing Estate Sector EPF Loans had increased by Rs. 291 Million from Rs.356 Million in 2006 to Rs.647 Million in 2010.
- (v) Major weaknesses were observed in audit test checks in respect of recovery procedure of Mortgage loans.
  - (a) There were long delays in taking legal actions in respect of 04 loans aggregating Rs.552,000 granted from 1984 to 1996. Total outstanding balances as at 31 December 2010 were Rs. 1,732,439.
  - (b) There were long delays in taking actions to auction or sale of mortgage properties in respect of 08 loans aggregating Rs.3,622,000 granted from 1984 to 2008. Total outstanding balances as at 31 December 2010 were Rs. 6,368,574.
  - (c) Valuation of properties were in questionable situation in respect of 03 loans aggregating Rs.10,125,000 granted from 1995 to 2008. Total outstanding balances as at 31 December 2010 were Rs. 15,658,988.
  - (d) Mortgage properties were not in suitable condition in respect of 02 loans aggregating Rs.325,000 granted from 1995 to 1996. Total outstanding balances as at 31 December 2010 were Rs. 1,259,208.
  - (e) There were long delays in taking action to remind the lending parties in respect of 03 loans aggregating Rs.392,000 granted from 1984 to 1996. Total outstanding balances as at 31 December 2010 were Rs. 1,317,197.

#### **2.4 Vested Properties of the Mortgage Loans**

According to the information furnished, a sum of Rs.26,667,062 in respect of Balance Principle Outstanding (BPO) and a sum of Rs.54,807,912 in respect total amount receivable had been shown as receivables to the Bank as at 31 December 2010 in connection with 131 numbers of vested properties.

The following observations are made in this regard.

- (i) There was no evidence that the speedy and meaningful action had been taken to dispose and recover the outstanding balances in respect of some vested properties even by the year 2010. The Bank has disposed only 06 properties valued at Rs. 548,243 (BPO) out of 137 properties during the year under review .



(ii) Most of the vested properties could not be sold due to the following reasons.

- (a) As the outstanding loan balances, accrued interest and other expenses had exceeded the market price of the properties which were kept as a security it was observed in audit that the properties could not be sold out for such higher prices. It was further observed that the net loss sustained from the six vested properties were Rs.1,272,076
- (b) Absence of vacant possession, inadequate protection of properties and improper valuation process are adversely affected for the sale of vested properties .

## 2.5 Human Resource Management

According to the information made available, the approved cadre, the actual cadre and vacant position for the year under review as compared with two preceding years are given below.

Category of Staff	Approved Cadre as at			Actual Cadre as at			Vacant position as at		
	31.12.2008	31.12.2009	31.12.2010	31.12.2008	31.12.2009	31.12.2010	31.12.2008	31.12.2009	31.12.2010
Executives	183	183	183	161	167	159	22	16	24
Non Executives	150	150	150	125	116	114	25	34	36
Management Trainees	15	15	15	-	-	-	15	15	15
Minor Employees	53	53	53	42	35	34	11	18	19
Casuals	-	-	-	-	02	01	-	(02)Excess	(01)Excess
<b>Total</b>	<b>401</b>	<b>401</b>	<b>401</b>	<b>328</b>	<b>320</b>	<b>308</b>	<b>73</b>	<b>81</b>	<b>93</b>

## 2.6 Identified Losses

The following observations are made.

- (a) The amount receivable amounting to Rs. 748,908 had been written off due to the sea erosion of a property which had been pledged for a loan.
- (b) According to the informations furnished, losses aggregating Rs. 245,818 had been sustained when disposed off of the vested properties.

## 2.7 Unidentified Transactions

The following observations are made.

- (a) Unappropriated balances on loan accounts had gradually increased from 2008 as shown below. Details are as follows.

<u>Year ended 31 December</u> -----	<u>Amount shown in the accounts</u> Rs.
2008	140,275,275
2009	163,649,853
2010	227,267,479

- (b) Deposits aggregating Rs. 6,829,468 as at the end of the year under review had not been credited to relevant depositors.

Age analysis of unidentified deposits as at 31 December 2010 are given below.

<u>Year ended 31 December</u> -----	<u>Amount shown in the accounts</u> Rs.
2004	5,767,325
2005	7,654,648
2006	11,022,769
2007	12,339,334
2008	8,189,152
2009	7,262,062
2010	6,829,468

According to the above details unidentified deposits had gradually increased from Rs. 5,767,325 to Rs. 12,339,334 for the four years from 2004 to 2007. However the balance of unidentified deposits as at 31 December 2008, 31 December 2009 and 31 December 2010 had shown a declining trend.

## 2.8 Unauthorized Transactions

Maximum limit of Rs. 2,000,000 in respect of a daily Bank current account balances had been exceeded in several instances as follows in a branch of the bank.

<u>Date</u>	<u>Retained Balance</u> Rs.	<u>Exceeded Amount</u> Rs.
04.05.2010	2,557,776	557,776
01.07.2010	3,141,548	1,141,548
05.07.2010	3,794,493	1,794,493
07.07.2010	2,859,535	859,535
26.07.2010	2,624,846	624,846

## 2.9 Internal Audit

Following observations are made with regard to the establishment and operation of the Internal Audit.

### (a) **Internal Auditing Standards and Code of Ethics**

The Bank had not planned its Internal Audit Charter and annual Internal Audit Programmes according to the Circular No. DMA/ 2009(3) of 07 October 2009 issued by the Department of Management Audit of the Treasury . The following Internal Audit Standards had not been applied when preparing Internal Audit Programmes

- (i) Appendix 2 – Performance Standards – No. 2110 – Risk Management.
- (ii) Appendix 2 – Performance Standards – No. 2201 – Planning Consideration

### (b) **Annual Internal Audit Programme for the year 2010.**

The following co-areas, which are extremely important for the banking activities, were not covered in the Annual Audit Programme for the year under review.

(i) Review and evaluate of the :-

- Quarterly and annual Financial Statements.
- Implementation of Action Plan for the year 2010 and Corporate Plan for the period 2010- 2012.
- Overall Performance of the Bank .
- Risk Management of the Bank.
- Cash Flow Management of the Bank.
- Human Resource Management specially on recruitment promotional progress, matters pertaining to staff Administration progress .
- Advertising Expenses.

- (ii) Verifying the Inventory Register with physical assets.
- (iii) Review of Audit Queries issued by the Auditor General's Department and Management's response to the same.
- (iv) Review of implementation of the recommendations of the Committee on Public Enterprises (COPE).

**(c) The following activities scheduled in the Annual Internal Audit Programme for the year 2010 had not been carried out.**

- (i) Arrears and recovery of outstanding loans.
- (ii) Unreconciled Accounts and Unidentified Deposits at Head Office and Outstation Branches.
- (iii) Procurement.
- (iv) Valuation of properties.
- (v) Overhead Expenses.
- (vi) Internal audit for only one Outstation Branch audit has been performed out of 8 Branches Scheduled to cover up.

**2.10 Corporate Plan, Annual Action Plan and Annual Budget**

Certain targets set out in the Corporate Plan for the period 2010- 2012 and certain targets set out in the Action Plan and the Annual Budget for the year 2010 had not been achieved.

**3. Systems and Controls**

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

- (a) Vested Properties
- (b) Outstanding Loan Balances
- (c) Accounting
- (d) Internal Audit
- (e) Reconciliation of Control Accounts
- (f) Settlement of Advances
- (g) Confirmations of balances
- (h) Compliance with Laws, Rules and Regulations