

## **Small and Medium Enterprises Development Facility Project -2013**

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The audit of financial statements of the Small and Medium Enterprise Development Facility Project for the year ended 31 December 2013 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 II B 3 of Schedule 2 of the Credit Agreement No. 4804-LK dated 08 November 2010 entered into between the Democratic Socialist Republic of Sri Lanka (GOSL) and the International Development Association (IDA).

### **1.2 Implementation, Objectives, Funding and Duration of the Project**

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According to the Credit Agreement of Small and Medium Enterprise Development Facility Project, the Department of Development Finance under the Ministry of Finance and Planning is the Executing Agency and the Implementation Agency of the Project shall be by the Ministry of Finance and Planning. The objective of the Project is the improvement of the accessibility to financing which included short term financing to the Small and Medium Enterprises of Sri Lanka affected by the global financial crisis.

The Project consists of the following parts,

(a) **Financing and Risk Sharing**

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- (i) Carrying out of productive investments for Small and Medium Enterprises through the establishment of Lines of Credit for Participating Financial Institutions (PFIs) for purposes of provision of Sub-project Loans to such enterprises.
- (ii) Expansion of access to and terms of finance for Small and Medium Enterprises, through the establishment of Risk Sharing Facilities in relation to portfolios of Small and Medium Enterprise Sub-project Loans originated and held by PFIs.

(b) **Expansion of the Policies and Capacity of the Small and Medium Scale Banking Businesses**

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- (i) Capacity building of PFIs in relation to the provision of financing to Small and Medium Enterprises, and of such enterprises in relation to the effective utilization of such financing.
- (ii) Strengthening of the enabling environment for Small and Medium Enterprise financing, including the carrying out of a diagnostic for purposes of identification of constraints and measures addressing such constraints.

- (iii) Provision of support to Project management, implementation, and monitoring and evaluation, including administrative and financial management, procurement, and disbursement.

According to the Credit Agreement, the International Development Association (IDA) had agreed to finance the estimated total cost of the Project amounting to SDR 37,800,000 equivalent to Rs. 6,455.77 million. The Project commenced its activities on 01 May 2010 and had been scheduled to be completed by 31 March 2014 later the Project period had been extended by 30 September 2015.

The details of financing according to the components of the Project are given below.

Component -----	Financing -----	
	US\$ Million -----	Rs.Million -----
<b>Component 1</b> -----		
<b>Financing and Risk Sharing Facility</b>		
(a) Line of Credit	28	3,149.16
(b) Risk Sharing Facility	13	1,462.11
<b>Component 2</b> -----		
<b>Policy and Capacity enhancement for SME Banking</b>		
(a) Capacity enhancement for Lending Institutions and SMEs	7	787.29
(b) Support to strengthen the enabling environment for SME's	1	112.47
(c) Support the Project Implementation Unit	4	449.88
Unallocated Fund	4.4	494.86
<b>Total</b>	57.4	6,455.77
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### 1.3 Responsibility of the Management for the Financial Statements

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Management is responsible for the preparation and fair presentation of these financial statements in accordance with Generally Accepted Accounting Principles. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

## 2. Scope of Audit and Basis of Opinion

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My responsibility is to express an opinion on these financial statements based on my audit. Audit opinion, comments and findings in this report are based on a review of the financial statements presented to audit and substantive tests of samples of transactions. The scope and extent of such review and tests were such as to enable as wide an audit coverage as possible within the limitations of staff, other resources and time available to me. The audit was carried out in accordance with Sri Lanka Auditing Standards to obtain reasonable assurance as to whether the financial statements are free from material misstatements. The audit includes the examination on a test basis of evidence supporting the amounts and disclosures in financial statements and assessment of accounting policies used and significant estimates made by the management in the preparation of financial statements as well as evaluating their overall presentation. I have obtained sufficient information and explanations which to the best of my knowledge and belief were necessary for the purpose of my audit. I therefore believe that my audit provides a reasonable basis for my opinion. The examination also included such test of systems and controls, transactions, assets, liabilities and accounting records as deemed necessary to assess the following.

- (a) Whether the systems and controls were adequate from the point of view of internal control so as to ensure a satisfactory control over Project management and the reliability of books, records etc. relating to the operations of the Project.
- (b) Whether adequate accounting records were maintained on a continuing basis to show the expenditure of the Project from the funds of the Government of Sri Lanka and the Lending Agency, the progress of the Project in financial and physical terms, the assets and liabilities arising from the operations of the Project, the identification of purchases made out of the Loan, etc.
- (c) Whether withdrawals under the Loan had been made in accordance with the specifications laid down in the Credit Agreement.
- (d) Whether the funds, materials and equipment supplied under the Loan had been utilized for the purposes of the Project.
- (e) Whether the expenditure had been correctly identified according to the classifications adopted for the implementation of the Project.
- (f) Whether the financial statements had been prepared on the basis of Generally Accepted Accounting Principles.
- (g) Whether the initial deposit, withdrawals from and replenishments to the Special (Dollar) Account had been truly and fairly disclosed in the books and records maintained by the Project and the balance as at 31 December 2013 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka (CBSL) as at that date.

- (h) Whether satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report.
- (i) Whether financial covenants laid down in the Credit Agreement had been complied with.

### **3. Opinion**

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So far as appears from my examination and to the best of information and according to the explanations given to me, except for the effects of the adjustments arising from the matters referred to in paragraph 5 of this report, I am of opinion that,

- (a) the Project had maintained proper accounting records for the year ended 31 December 2013 and the financial statements give a true and fair view of the state of affairs of the Project as at 31 December 2013 in accordance with Generally Accepted Accounting Principles.
- (b) the funds provided had been utilized for the purposes for which they were provided,
- (c) the withdrawals from and replenishments to the Special (Dollar) Account during the year ended 31 December 2013 had been truly and fairly disclosed in the books and records maintained by the Project and the balance as at 31 December 2013 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka as at that date,
- (d) the statements of expenditure (SOEs) submitted could be fairly relied upon to support the applications for reimbursement in accordance with the requirements specified in the Loan Agreement,
- (e) satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report, and
- (f) the financial covenants laid down in the Credit Agreement had been complied with.

### **4. Financial Statements**

#### **4.1 Financial Performance**

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According to the financial statements presented, the expenditure of the Project for the year ended 31 December 2013 amounted to Rs. 637,663,360 and the cumulative expenditure as at 31 December 2013 amounted to Rs. 3,053,472,299. The following statement shows a summary of expenditure for the year under review, the expenditure for the year 2012 and the cumulative expenditure as at 31 December 2013.

Particulars	Expenditure for the year ended 31 December		Cumulative Expenditure as at 31 December 2013
	2013 ----- Rs.	2012 ----- Rs.	----- Rs.
Fixed Assets	303,806	415,416	15,711,564
_Loan Proceeds with PFIs for granting sub loans	612,070,270	1,521,446,408	2,951,978,018
Operating Expenses	13,416,171	11,929,939	52,627,464
Training and Development of officers of PFIs	11,668,557	17,533,657	32,995,697
Training of Small and Medium Enterprises by Project Operating Unit	159,556	-	159,556
	----- 637,663,360 =====	----- 1,551,325,620 =====	----- 3,053,472,299 =====

#### 4.2 Special (Dollar) Account

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According to the books and records maintained by the Project and the information made available a summary of the operations of the Special (Dollar) Account maintained by the Central Bank of Sri Lanka for the year ended 31 December 2013 is given below.

	US\$ -----	Rs. ----
Balance as at 01 January 2013	10,226,827	1,300,451,518
Add		
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Reimbursements	5,403,861	708,731,685
Foreign Exchange Gain	-	20,975,967
	----- 15,630,688	----- 2,030,159,170
Less		
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Withdrawals	4,956,349	634,457,367
	----- 10,674,339 =====	----- 1,395,701,803 =====

## 5. Audit Observations

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### 5.1 Non-compliance with Laws, Rules, Regulations etc

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Even though instructions had been issued through the reports of the Foreign Mission to carry out a complete audit on the impact to the environment from the Small and Medium Enterprises (SMEs) promoted under this Project, such an environmental audit had not been carried out up to 31 December 2013 due to the inability to find a suitable specialist.

## 6 Operational and Financial Review

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### 6.1 Utilization of Funds

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Certain significant statistics relating to the financing, budgetary provision and utilization of funds during the year review and as at 31 December 2013 are shown below.

	Amount agreed to be financed as per Loan Agreement		Budgetary Provision for year 2013	Amount utilized during the year under review	Amount utilized as at 31 December 2013
	US\$ Million	Rs. Millions	Rs. Million	Rs. Million	Rs. Million
IDA	57	6,456	900	638	3,053
GOSL	Nil*	Nil*	8	8	27
	-----	-----	-----	-----	-----
	57	6,456	908	646	3080
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The following observations are made.

- (i) Even though US\$ 13 million equivalent of Rs. 1,462 million or 23 per cent of the amount agreed according to the Loan Agreement had been allocated for risk sharing, that money had not been utilized up to the end of the year under review.
- (ii) Even though US\$ 1 million equivalent of Rs. 112 million had been allocated for the support for creating a capable environment for employing capital in Small and Medium Enterprises, no action whatsoever had been made to achieve the objective for its achievement.

### 6.2 Issues on Loans released by the PFIs

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According to the Progress Reports furnished by the Project, the number of SMEs for loans approved, the amounts approved by the PFIs, the amount of loans released, the average loan

approved per entrepreneur and the loan paid as a percentage of the loan approved are given below.

Name of PFI	Small and Medium Enterprises for which Loans had been approved	Amount of Loans approved by PFI	Amount released up to 31 December 2013	Average Loan approved per Entrepreneur
-----	Nos	Rs. Million	Rs. Million	Rs. Million
Bank of Ceylon	64	493	439	7.7
People's Bank	68	360	323	5.3
Commercial Bank	80	524	504	6.5
DFCC Bank	26	366	364	14.1
National Development Bank	21	352	335	16.8
Pradeshiya Sanwardhana Bank	88	315	245	3.6
Hatton National Bank	18	330	322	18.3
Sampath Bank	49	419	420	8.55
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	414	3,159	2,952	7.63
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The following observations are made in this connection.

- (i) Average loans approved and granted by the private banks was higher than the loans granted by the state owned banks. Thus indicated that the state owned banks had assisted to the SMEs operating in small scale having understood the real sectors of SMEs to be uplifted.
- (ii) According to the information received, The PCIs had conducted training programmes for 7,647 SME Entrepreneurs during the year under review. However, the loans granted only to 3,159 SMEs.
- (iii) According to the information received, it was expected to provide job opportunities for 254 males and 1,396 females in SMEs. However, Project Operations Unit (POU) had not maintained adequate information as enable to ascertain the achievement of expected target.
- (iv) Even through all PFI had agreed to release the first installment of loans within 06 month after the approval of loan, two loans aggregating to Rs 26.5 million had not released as at 31 December 2013 to respective SMEs even though 01 year and 10 months respectively had elapsed after approving of the loans.

### **6.3 Issues on Enhancing the Capacity of the Staff of the PFIs and Entrepreneurs**

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The following observations are made.

- (a) Under the Component -02 of the Project, the PFIs had conducted training programmes for the purpose of capacity enhancement of the lending institutions and SMEs and therefore, 5,580 of the officers of the PEIs and 7,890 Entrepreneur had been participated for such programmes. According to the information collected, the Project had incurred a average cost of Rs 4,188 per officer of the PFIs and only Rs 1,213 per Entrepreneur whilst 414 loans approved only during the year under review.
- (b) A field inspection carried out by the representatives of the IDA on 06 November 2013 had revealed that many of the beneficiaries under this Project need further training on the practices of general administration and technical knowledge on their businesses. Nevertheless, out of the provision of Rs.427 million allocated by the Project for the capacity building of the Entrepreneurs, only a sum of Rs.33 million had been spent up to the end of the year under review.
- (c) It was observed that the cost of training per officer and per entrepreneur had varied significantly. Bank of Ceylon had incurred the lowest cost on training per bank officer amounting to Rs. 1,096 whilst Hatton National Bank had incurred a higher cost of Rs. 19,002 per officer. In addition, Commercial Bank of Ceylon had incurred only Rs.498 per entrepreneur for training whilst Sampath Bank had incurred a highest cost of Rs. 3,032 per entrepreneur, thus indicated that the contents of training and resources used thereon are not similar for all PFIs.

### **6.4 Issues on sharing risks on outstanding balances of loans and interest**

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According to the Section "E" of the Loan Agreement, action should be taken to share the risk with Sri Lank Insurance Corporation (SLIC) to mitigate the risks on recoverability of loans and interest. Even though the loans aggregating Rs. 1,462 million had been released up to 31 December 2013, action had not been taken to share the risk with SLIC.

### **6.5 Issues on interest recovered on the loans granted to SMEs by PFIs and risk sharing**

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According to Clause "J" of the Agreements entered into with the PFIs by the Project, the interest on loans should determined half yearly on average rate of interest on fixed deposits published by the Central Bank (CBSL). Following observations are made.

- (i) Different interest rates on fixed deposits ranging from 8.69 per cent to 15.93 per cent had been charged by the PFIs on loan balances instead of using average rate of interest of the CBSL. It was observed that the project had not been taken action to specify a interest rate which should be applied by all the PFIs.



- (ii) As the risk sharing facilities with SLIC had not been arranged during the year under review, the beneficiaries had to pay interest at higher rates with risk component included therein. Further, it was observed that the interest rate of 14.88 per cent applied during the year under review could have been reduced by half, if the risk sharing facility arranged by the Project timely.