

Small and Medium Enterprises Development Facility Project - 2014

The audit of financial statements of the Small and Medium Enterprise Development Facility Project for the year ended 31 December 2014 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

According to the Credit Agreement of Small and Medium Enterprise Development Facility Project, the Department of Development Finance is the Executing Agency and then Ministry of Finance and Planning and presently, the Ministry of Finance is the Implementation Agency of the Project. The objective of the Project is the improvement of the accessibility to financing including 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**

- (i) Carrying out of productive investments for Small and Medium Enterprises through the establishment of Lines of Credit for Participating Financial Institutions (PFIs) for the 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 Participating Financial Institutions.

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

- (i) Capacity building of Participating Financial Institutions on provision of financing to Small and Medium Enterprises, and effective utilization of such financing.
- (ii) Strengthening and enabling environment for Small and Medium Enterprise financing and carrying out of a diagnostic analysis for the

purpose of identification of constraints and measures addressing such constraints.

- (iii) Providing supports 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 had agreed to finance the estimated total cost of the Project amounting to SDR 57.4 million (US\$ 57 million) equivalent to Rs.7,575.7 million. The Project commenced its activities on 01 May 2010 and scheduled to be completed by 31 March 2014. Subsequently, the period of the Project had been extended up to 30 September 2015

1.3 Responsibility of the Management for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards and for such internal control as the management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

1.4 Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with Sri Lanka Auditing Standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Project's preparation and fair presentation of the financial statements 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 Project's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the management as well as evaluating the overall presentation of the financial statements. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion. The examination also included such tests as deemed necessary to assess the following.

- (a) Whether the systems and controls were adequate from the point of view of internal controls 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 the 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 classification adopted for the implementation of the Project,
- (f) Whether the Financial Statements had been prepared on the basis of Sri Lanka Accounting Standards,
- (g) Whether satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report and,
- (h) Whether financial covenants laid down in the Credit Agreement had been complied with.

2. Financial Statements

2.1 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,

- (a) the Project had maintained proper accounting records for the Period ended 31 December 2014 and the financial statements give a true and fair view of the state of affairs of the Project as at 31 December 2014 in accordance with Sri Lanka Accounting Standards.
- (b) the funds provided had been utilized for the purposes for which they were provided.

- (c) 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 Credit Agreement.
- (e) the 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.

3. Financial and Physical Performance

3.1. Utilization of Funds

Certain significant statistics relating to the financing of funds, budgetary provision for the year under review and the utilization of funds during the year under review and up to 31 December 2014 are shown below.

Source	Amount agreed to be financed by the Loan Agreement		Allocation made in the Budget Estimate for year 2014	Amount utilized		
	US\$ million	Rs. million		Rs. million	US\$ million	Rs. million
IDA	57	7,575.7	1,600	1,345.0	33.6	4,398.0
GOSL	-	-	12	7.5	0.3	34.5
	57	7,575.7	1,612	1,352.5	33.9	4,432.5

Out of the total allocation of US\$ 57 million equivalent to Rs 7,575.7 million for the activities of the Project, only US\$ 33.9 million equivalent to Rs 4,432.5 million had been utilized up to 31 December 2014. Therefore, the possibility of utilizing the sum of US \$ 23.1 million or Rs.3,143.2 representing 41 per cent of the allocation, during the rest of the period of 09 months appears doubtful.

5.2 Progress of the activities of the Project

The following observations are made.

- (a) According to the Progress Reports of the Project, the performance of the Participating Financial Institutions as at 31 December 2014 on lending of Small and Medium Enterprises are given below.

Participating Financial Institution	Loans approved		Loans granted up to 31 December 2014		Loans granted as a percentage of Loans approved
	No of Loans	Amount approved	No of Loans	Amount released	
		Rs. million		Rs million	%
Bank of Ceylon	135	999.9	95	579.0	58
Commercial Bank	85	582.2	83	552.2	95
DFCC Bank	27	368.0	26	363.7	99
Hatton National Bank	55	783.3	44	559.6	71
National Development Bank	32	503.9	31	482.4	96
People's Bank	133	971.1	99	545.9	56
Regional Development Bank	183	743.7	120	386.6	52
Sampath Bank	93	930.0	87	786.1	84
	743	5,882.1	585	4,255.5	
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The Licensed Banks in private sector had maintained high percentages of loans granted on loans approved than the Licensed Banks in public sector and it indicated that the efficiency in loan processing cycle. However, 05 Licensed Banks in private sector had granted 271 loans only to the Small and Medium Industries whilst 03 Licensed Banks in public sector had granted 314 loans. Thus indicated that Bank of Ceylon, People's Bank and Regional Development

Bank had approached the entrepreneurs engaged in Small and Medium Industries successfully.

- (b) The progress on programs conducted for capacity development purposes of the staff of the Participating Financial Institutions and Small and Medium Entrepreneurs as at 31 December 2014 is given below.

Participating Financial Institution	Participants			Total Cost	Cost per Participant
	Small and Medium Entrepreneurs	Participating Financial Institutions	Total	Rs	Rs
Bank of Ceylon	2,630	2,210	4,840	6,972,334	1,440
Commercial Bank	1,282	307	1,589	1,055,864	664
DFCC Bank	2,212	1,809	4,021	11,193,404	2,783
Hatton National Bank	970	159	1,129	3,770,179	3,339
National Development Bank	1,835	1,377	3,212	12,335,251	3,840
People's Bank	1,175	578	1,753	11,482,715	6,550
Regional Development Bank	145	742	887	5,645,227	6,364
Sampath Bank	529	261	790	3,555,186	4,500
Project Monitoring Unit	809		809	2,293,487	2,835
	11,587	7,443	18,990	58,303,647	3,070

The following observations are made in this connection.

- (i) The Project had not determined the maximum level of cost of training per participant and as a result, training cost incurred by Participating Financial Institutions per participant was varied significantly.
- (ii) Even though the training programmes had been conducted for 11,587 entrepreneurs, only 585 loans had been granted by all Participating Financial Institutions as at 31 December 2014.

- (iii) According to the feasibility studies carried out , it was expected to generate job opportunities for 3,414 males 1,997 females in Small and Medium Entrepreneurs. However, Project Operations Unit had not maintained adequate information on new job opportunities generated through the Project activities.

- (c) According to the Clause “J” of the Agreements entered into by the Project with Participating Financial Institutions , the interest on loans should be determined half yearly on average rate of interest on fixed deposits as determined by the Central Bank of Sri Lanka. Different interest rates on fixed deposits ranging from 8.69 per cent to 15.93 per cent had been charged by the Participating Financial Institutions on loan balances instead of using average rate of interest determined by the Central Bank of Sri Lanka. The Social Impact Assessment Survey carried out by the Project in July 2014 had also revealed that different interest rates are being applied by the Participating Financial Institutions of the Project.