State Mortgage and Investment Bank - 2015

The audit of financial statements of the State Mortgage and Investment Bank for the year ended 31 December 2015 comprising the statement of financial position as at 31 December 2015 and the statement of income, statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information, 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 13(1) of the Finance Act, No.38 of 1971 and Section 65(2) of the State Mortgage and Investment Bank Law, No.13 of 1975. My comments and observations which I consider should be published with the Annual Report of the Bank in terms of Section 14 (2) (c) of the Finance Act appear in this report.

1.2 Board's Responsibility for the Financial Statements

The Board of Directors ("Board") 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 Board determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

1.3 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 consistent with International Auditing Standards of Supreme Audit Institutions (ISSAI 1000-1810). 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 Bank'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 Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Sub-sections (3) and (4) of Section 13 of the Finance Act, No 38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the Audit.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

1.4 Basis for Qualified Opinion

My opinion is qualified based on the matters described in paragraph 2.2 of this report.

2. Financial Statements

2.1 Opinion

In my opinion, except for the effects of the matters described in paragraph 2.2 of this report, the financial statements give a true and fair view of the financial position of the State Mortgage and Investment Bank as at 31 December 2015, and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Financial Statements

2.2.1 Compliance with Sri Lanka Accounting Standards (LKAS)

Transactions aggregating Rs.52,659,625 had been entered into key management personnel, and their close family members and entities during the year under review. However, those transactions had not been disclosed in the financial statements as requested by LKAS 24.

2.2.2 Accounting Deficiencies

The following observations are made.

(a) Although the financial statements had been prepared in accordance with the Sri Lanka Accounting Standards (SLFRS and LKAS), the general ledger accounts had not been updated in order to reflect the balances shown in the financial statements.

(b) Interest on Treasury loan of Rs.250,000,000 aggregating Rs.336,821,918 obtained at an interest rate of 9 per cent in 2001 and capital portion of such loan had not been remitted to the General Treasury even up to the end of the year under review. However, interest on this loan aggregating Rs.134,321,918 only had been provided in the accounts up to the end of the year 2006 and no provision for interest aggregating Rs.202,500,000 had been made in the accounts for the rest of the period.

(c) Customers' deposits aggregating Rs.2,033,026 relating to the period from 01 July 2013 to 31 December 2014 deposited in Gampaha Branch had been omitted from the customers' accounts and this amount had been transferred to un-reconciled control accounts maintained in Head Office treated as an unidentified amount.

(d) There was an unusual debit balance of Rs.17,716,837 in cheque on realization account as at 31 December 2015 due to an error in posting, thus the other debtors shown in the financial statements had been overstated by similar amount.

(e) A balance of Rs.3,060,627 in un-presented cheques account had been carried forward from long period without being cleared.

(f) Even though the Bank had reconciled the balances between the current account of the Branches and the Head Office as at 31 December 2015, the entries for Rs.24,646,881 had not been made to adjust the relevant accounts.

2.2.3 Unexplained Differences

The following unexplained differences were observed in audit.

(a) A difference of Rs.50,395,286 which had been raised between the amount shown in the financial statements and the balances generated by the computerized systems with regard to the fixed deposits, savings accounts and loans against fixed deposits had been transferred to un-reconciled control account during the year 2015.

(b) A difference of Rs.13,318,499 was observed between the balances of refinance loans, mortgage loans, personal loans, estate sector EPF loans, EPF loans and un-appropriated accounts shown in the financial statements and the balances generated by the computerized systems as at 31 December 2015.

2.2.4 Unidentified Balances

The following observations are made.

(a) A debit balance of Rs.7,552,584 and credit balance of Rs.2,119,457 had been shown in the advance accounts without being identified and adjusted in the accounts for a long period of time.

(b) Even though the Bank had confirmed the rent advance account balance was Rs.2,900,000, this balance had been shown in the financial statements as credit balance of Rs.5,592,830 as at 31 December 2015.

(c) Other liabilities relating to encashment of Head Office cheques amounting to Rs.2,391,827 had been remained in the accounts without being identified and reconciled for more than one year.

(d) Unidentified debit amount of Rs.856,431 shown in the financial statements as accrued advertising.

(e) Unidentified debits and credits totalled Rs.4,153,957 recorded in the bank accounts maintained in other banks had been transferred to un-reconciled control account without being identified them.

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

The following instances of non-compliance were observed in audit.

Reference to Laws, Rules, Regulations etc.	Non-compliance
(a) Financial Transactions Reporting Act, No.06 of 2006	Eleven “Know Your Customer” forms relating to Kurunegala Branch had not been duly completed.
(b) Financial Regulations of the Government of the Democratic Socialist Republic of Sri Lanka	
(i) Financial Regulation 754	Even though the Bank had purchased the fixed assets valued at Rs.12,195,544 during the year under review, the movement of inventory had not properly updated. Hence, it was unable to obtained verified records of inventory as at the year end.
(ii) Treasury Circular No. IAI/2002/02 dated 28 November 2002	The Bank had not maintained a register for computer equipment and software.
(c) Internal Circulars	
(i) Letter dated 25 March 2014 issued by the Chief Manager (Branch Operation)	The Branches had not maintained any register in respect of Dormant Accounts.
(ii) Office Circular No. BROP/14/07/11 issued by the Chief Manager (Branch Operation)	Gift stock register, fixed deposit certificates stock register, pass books issuing register and fixed deposits refund register had not been properly maintained by some Branches.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank during the year under review had resulted in a pre-tax net profit of Rs.681 million as compared with the corresponding pre-tax net profit of Rs.413 million in the preceding year, thus indicating an improvement of Rs.268 million in the financial results.

The decrease of interest expenditure and other expenses by 7.09 per cent and 24.4 per cent respectively, and increase of interest income by 6.77 per cent during the year under review as compared with the preceding year were the main reasons attributed for this improvement.

Further, the total value addition of the Bank had been decreased by 28.68 per cent in 2013 as compared with the year 2011 while it had increased by 31 per cent during the year under review as compared with the previous year.

3.2 Analytical Financial Review

3.2.1 Profitability of the Bank

(a) According to the information made available, the profitability of the Bank for the year under review and for the previous 05 years period is given below.

	2015	2014	2013	2012	2011	2010
	Rs. Mn	**Rs. Mn**	**Rs. Mn**	**Rs. Mn**	**Rs. Mn**	**Rs. Mn**
(i) Interest Income	3,879	3,633	3,635	2,879	2,611	2,362
(ii) Interest Expenses	(2,057)	(2,214)	(2,459)	(1,725)	(1,214)	(1,368)
(iii) Net Interest Income	1,822	1,419	1,176	1,153	1,397	994
(iv) Other Operating Income	107	103	97	73	76	387
(v) Other Income { Gain/(Loss) }	(95)	(23)	(48)	7	-	1
(vi) Net Operating Income	1,834	1,499	1,225	1,233	1,473	1,382
(vii) Total Recurrent Expenses	(1,154)	(1,086)	(882)	(803)	(785)	(743)
(viii) Net Profit Before Tax	680	413	343	430	688	639
(ix) Taxation	(271)	(140)	(110)	(158)	(178)	(179)
(x) Net Profit After Tax	409	273	233	272	510	460
(xi) Loss on Financial Assets Available for Sale	13	3	1	(2)	(3)	-
(xii) Actuarial Gains/(Loss) on Defined Benefit Plans (+/-)	-	(102)	-	-	-	-
Total Comprehensive Income	**422**	**174**	**234**	**270**	**507**	**-**

The following observations are made in this connection.

- The interest income had gradually increased from Rs.2,362 million to Rs.3,879 million or 64.2 per cent during the period of 2010- 2015. In the meantime, the interest expenses had decreased from Rs.1,368 million to Rs.1,214 million from 2010 to 2011 while it had decreased to Rs. 2,057 million or by 7 per cent during the year under review as compared with the previous year.

- The pre-tax net profit had increased from Rs.639 million to Rs.688 million or 7.6 per cent during the period of 2010- 2011. After that it had decreased from Rs.430 million to Rs 343 million or 20.2 per cent during the period of 2012 -2013 while it had increased from Rs.413 million to Rs.680 million or 64.64 per cent during the year under review as compared with the preceding year.

- The actual pre- tax net profit had exceeded the budgeted profit by 46.28 per cent in the year under review.

3.2.2 Significant Accounting Ratios

According to the information made available, some of the important accounting ratios of the Bank for the year under review and for the preceding 04 years are given below.

	2015 %	2014 %	2013 %	2012 %	2011 %
Profitability Ratios					
i. Net Interest Margin	5.65	4.97	4.76	5.39	7.26
ii. Return on Equity	9.90	6.87	6	7.31	14.67
iii. Return on Average Assets	2.11	1.44	1.39	2.01	3.58
Capital Adequacy Ratios					
i. Equity / Total Assets	12.45	13.26	14.65	17.04	17.76
ii. Equity / Loans	15.61	16.56	18.38	20.66	22.34
iii. Tier I	22.17	25.32	28.09	33.22	39.94
iv. Tier II	22.65	25.32	28.09	33.22	39.94
Liquidity Ratios					
i. Liquid Assets/ Deposits(Liabilities)	20.62	22.79	21.24	21.98	20.04
ii. Deposits / Loans and Advances	104.95	99.52	99.18	93.4	92.51
iii. Borrowings/Loans and Advances	3.62	4.61	4.21	3.98	4.1
Market Share Compared to the Licensed Specialized Banks					
i) Net Loans and Advances	5.88	5.56	6.22	5.93	6.08
ii) Total Assets	3.11	2.79	2.92	3.04	3.04

Even though the Bank is well ahead in maintaining the minimum limit of capital adequacy ratio of Tier I and Tier II as 5 per cent and 10 per cent which prescribed by the Central Bank of Sri Lanka, both ratios had been decreased as at the end of the year under review as compared with the preceding year and recorded the lowest ratio for the last four years.

4. Operating Review

4.1 Performance

(a) Non- Performing Loans (NPL)

--

The following observations are made.

(i) According to the information made available, the total outstanding loans as at 31 December 2015 was Rs. 24,953.1 million and out of that a sum of Rs.7,433.02 million was identified as non-performing loans and in its represent 29.78 per cent of the total outstanding loans.

(ii) The percentages of non-performing loans such as mortgage, estate sector EPF and personal loans in the year under review were 8.21 per cent, 68.20 per cent and 5.84 per cent respectively and the percentage of these non-performing loans in the previous year were 11.25 per cent, 72.36 per cent and 15.64 per cent, as such these loans indicating a decreasing trend as compared with the previous year. However, the non-performing motor vehicle loan is indicating a significant increasing trend of 17.95 per cent as compared with that of 8.97 per cent in the previous year.

(b) **Long Outstanding Loan Balances**

According to the age analysis furnished to audit, the total loans outstanding as at 31 December 2015 were Rs. 24,817.90 million and out of that a sum of Rs. 4,156.40 million had been outstanding for more than one year. It was further observed that out of total EPF loans and estate sector EPF loans amounting to Rs. 9,706 million and Rs. 1,475 million respectively, sums of Rs.3,443 million or 35 per cent and Rs.436 million or 30 per cent respectively were in arrears for over one year

(c) **Loan Disbursement**

According to the information made available, the total number of loans and total value of the loans granted during the year under review is increased by Rs.245 million and Rs. 1,609 million or 1.6 per cent and 27 per cent respectively as compared with the previous year. Further, no motor vehicle loans had been granted during the year under review.

(d) **Achievement of Planed Targets**

The following targets set out in the Action Plan for the year under review either completely or partly not achieved during the year under review. Details are shown below.

Action Code	**Target**	**Position of Achievement**
Goal 1	Net increase of retail deposits by Rs.400 million per month.	The net increase of deposit per month was only Rs.47 million or Rs.11.75 per cent of the target.
	Net increase of deposits by Rs.950 million per month**.**	The net increase of deposit per month was only Rs.307 million or 32 per cent of the target.

Goal 4	Profitability targets be given to the Branch managers to ensure the maintenance of Net Interest Margin	No profitability targets were given to Branches.
	Improve the cost to income ratio from 58 to 50 per cent.	Cost to income ratio was 54 per cent.
	Achieving net increase total deposit base from Rs.18 billion to Rs.23 billion.	Total Deposit base as at 31 December 2015 was Rs.18.96 billion.
Goal 5	Reducing non-performing loans ratio of personal and vehicle loans to 5 per cent.	The non-performing loans ratios of personal and vehicle loans were 5.82 per cent and 10.31 per cent respectively.
Goal 6	Increasing housing loans (Mortgage & EPF) by Rs.7.2 billion.	EPF and Mortgage loans disbursement during the year under review was Rs.4.27 billion and it was Rs. 4.5 billion in the year 2014
	Initiate SME lending in 2013 and achieve growth.	SME lending has not been commenced even in the year under review.
Goal 7	Integrating entire branch network with a new core banking solutions.	No core banking solution was introduced in 2015.
	Implementing ATM network in all Branches.	ATM units were not newly introduced during the year 2015.
	Improving the efficiency of the functions and existing internal controls through business process re-engineering.	No such undertaking had been done.
Goal 08	Develop MIS in existing system.	No such new developments taken place.
	Strengthen the IT Team to promptly cater MIS requirement	No any new blood has come to the IT team and no any training has been given to IT team to strengthen the staff.

4.2 Operating Inefficiencies

4.2.1 Loans Administration

(a) Mortgage Loans

The following major weaknesses were observed with regard to granting the mortgage loans.

(i) A loan amounting to Rs.1,950,000 had been given on 17 April 2012 without considering the temporary nature of the employment and as such no any single installment had been repaid by the lender even up to 31 December 2015.

(ii) Instances of loans granted without considering the arrears positions of the previous loans were observed.

(iii) Details of loan granted under loan number P.O 1594 amounting to Rs.10,400,000 had not been reported to the Credit Information Bureau in terms of Credit Information Bureau Act, No. 18 of 1990. Hence, another commercial bank had offered a loan without considering the value of this loan.

(iv) In nine instances, the Bank had not informed to the customers about the interest rate revision and extension of the credit period.

(v) Three loans to the total value of Rs. 3,975,000 had been disbursed without obtaining the reports from the Credit Information Bureau.

(vi) The outstanding value of two loans as at 31 December 2015 was Rs.5,029,332. However, it had been exceeded their force sale value of Rs.3,650,000 as at that date.

(vii) Five loans worth Rs. 14,615,000 had been given without being properly carried out the income assessments of the customers and amount outstanding thereon as at the end of the year under review was Rs. 11,775,483

(vii) It was revealed that the value of the properties vested for mortgage loans in some instances were not adequate to cover the outstanding balances of the respective loans. Such 22 instances the total value of vested property against the loans were Rs.21,705,000. However, the total loans due as at end of the year under review were amounted to Rs. 35,003,631 and as such the established loss was Rs.13,298,631.

4.3 Transactions of Contentious Nature

Pay As You Earn (PAYE) tax amounting to Rs. 17,120,888 had been paid by the Bank on behalf of its employees contrary to the Public Enterprise Circular No. PED 03/2016 of 29 April 2016.

4.4 Human Resources Management

The following observations are made.

(a) Even though the staff training is very crucial aspect for development of an entity, a Training Committee had not been appointed as requested by Chapter 7 of the Public Enterprises Department Circular No. PED/12 of 02 June 2003 and only 30 per cent out of the total budgeted estimate of Rs.13.8 million had been spent for training and development purposes during the year under review. Further, the Bank had spent an amount less than 53 per cent for training as compared with previous year.

(b) In contrary to Chapter 6.4 of the Human Resource Policy Manual of the Bank, 10 officers are being working on acting basis for more than one year including key positions such as Deputy General Manager (Credit), Assistant General Manager (Human Resources and Legal), Assistant General Manager (Finance) and Assistant General Manager (Legal).

(c) Post of Marketing Manager which is the key position of the Marketing Division had been remained on contract basis since 2010.

4.5 Management Weaknesses

The following observations are made.

(a) Even though a sum of Rs.38,312,700 had been paid as rental for the year under review, most of the facilities such as office and parking space, wash room, lunch room, stores, wiring systems etc. of the Head Office building are not in a satisfactory level as the building is very old. However, the bank had failed to obtain an insurance coverage as per provisions in the rent agreement. Hence, the staff, assets and customers' safety is at a risk.

(b) Even though a sum of Rs.3.3 million had been spent for advertisements, the most of the advertisements had been published in unpopular Medias. Hence, it was in doubt that whether the Bank had obtained maximum benefits from this expenditure. It was further observed that no detailed budget had been prepared for marketing expenses during the year under review.

(c) The information relating to current position of the court case filed against the person who fraudulently taken the money of Rs.2,400,000 from the Bank had not been made available for audit.

5. Accountability and Good Governance

5.1 Budgetary Control

Even though the Bank had revised its budget in September 2015, significant variations ranging from 15 per cent to 84 per cent were observed between the revised budgeted and actual figures, thus indicating that the budget had not been made use of an effective instrument of internal control.

5.2 Internal Audit

In contrary to the paragraphs 1 and 3 of Charter of the Internal Audit of the Bank, the staff of the Internal Audit Division had been transferred to and from another Division regularly. Further, the duties of Assistant General Manager (Finance) had been covered by the Chief Internal Auditor under approval of the Board of Directors since 14 August 2014.

6. Systems and Controls

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

Area	Observation
(i) Accounting	Some accounts balances were not accurate due to posting errors.
(ii) Operation of Bank Accounts	(i) Eleven Bank reconciliation statements had not been certified by the certifying officer. (ii) The unidentified debits and credits amounting to Rs.2,354,487 and Rs.1,908,602 respectively were in the bank reconciliations for a long period of time without being cleared.