Merchant Bank of Sri Lanka & Finance PLC – 2016

The audit of the financial statements of the Merchant Bank of Sri Lanka & Finance PLC ("Company") and the consolidated financial statements of the company and its subsidiary ("Group") for the year ended 31 December 2016 comprising the statement of financial position as at 31 December 2016 and the statement of profit or loss, statement of changes in equity and statement of cash flow 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. To carry out this audit I was assisted by a firm of Chartered Accountants in public practice.

This report is issued in terms of articles 154(6) of the Constitution of the Democratic Socialist Republic of Sri Lanka.

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 the 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. 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 Company'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 Company's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by Board, 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 audit opinion.

2. Financial Statements

2.1 Opinion

In my opinion, the consolidated financial statements give a true and fair view of the financial position of the Group as at 31 December 2016, and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.1.2 Emphasis of Matter

Without qualifying my opinion, I draw your attention to the following notes to the financial statements which relate to the subsidiary company MBSL Insurance Company Limited.

- Note 44 in the financial statements regarding the going concern assumption in the preparation of the financial statements of MBSL Insurance Company Limited.
- Note 47.2.2 which describes the contingent liability related to a performance bond insurance claim intimated during the year. My opinion is not qualified in respect of these matters.

2.1.3 Other Matter

The consolidated financial statements of Merchant Bank of Sri Lanka for the year ended 31 December 2015 were audited by another auditor who expressed an unqualified opinion on those statements on 18 May 2016 with the emphasis of matter regarding the going concern of the subsidiary, MBSL Insurance Company Limited.

2.1.4 Report on Other Legal and Regulatory Requirements

As required by Section 163 (2) of the Companies Act No. 07 of 2007, I state the following:

a) The basis of opinion and scope and limitations of the audit are as stated above.

b) In my opinion:

- I have obtained all the information and explanations that were required for the audit and, as far as appears from our examinations, proper accounting records have been kept by the Company.
- The financial statements of the Company give a true and fair view of its financial position as at 31 December 2016 and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.
- The financial statements of the Company and the Group comply with the requirements of sections 151 and 153 of the Companies Act No.07 of 2007.

However, it should be noted that, the net assets of the subsidiary are less than half of the stated capital and face a serious loss of capital situation in terms of Section 220 of the Companies Act No 07 of 2007.

- As discussed in note 44 to the financial statements, the subsidiary has not segregated the long term insurance business and the general insurance business being carried on by it into two separate companies in accordance with Section 53 of Regulation of Insurance Industry (Amendment) Act No.03 of 2011.

- The non–life business of the subsidiary does not fulfill the minimum required thresholds set for the capital adequacy ratio and total available capital by the regulation of Insurance Industry Act, No.43 of 2000, "the Solvency Margin (Risk Based Capital) Rules 2015, while the life business does not fulfill the minimum required threshold set for total available capital.

2.2 Comments on Group Financial Statements

2.2.1 Group's Financial Statements and Basis of Consolidation

The Group financial statements comprised the consolidation of the financial statements of the Company, its Subsidiary and Associate in compliance with Sri Lanka Accounting Standards (SLFRS/LKAS). The company has 84.12 per cent ownership of the subsidiary, MBSL insurance company Ltd had 29 per cent ownership of the associate company, Lanka Securities (Pvt) Ltd as at end of the year under review. The position of the investments in the above companies as at 31 December 2016 and end of the preceding year was as follows.

Name of the Company	**Position of Investment**	
	2016	**2015**
	Rs.'000	**Rs.'000**
Subsidiary - Unquoted Companies		
MBSL Insurance Company Ltd	516,096	516,096
Less-Provision for Impairment	(438,790)	(205,899)
Net Investments in Subsidiaries	**77,306**	**310,197**
Associate - Unquoted Companies		
Lanka Securities (Pvt) Ltd	81,084	81,084
Less-Provision for Impairment	-	-
Net Investments in Associate	**81,084**	**81,084**
Total Investments	**158,390**	**158,390**

2.3 Comments on Financial Statements of the Company

2.3.1 Compliance with Sri Lanka Accounting Standards (SLFRS and LKAS)

The following observations are made.

(a) LKAS 40 – Investment Properties

(i) Company's policy is to carry out valuation of investment properties once in five years. However, the valuation of properties situated at Pitakotte and Puttalam caring value of which were Rs. 4,255,554 and Rs. 600,000 respectively, had not been carried out during last five years. Hence it was noted non compliance with company's policy as well as LKAS 40.

(ii) Properties situated in Colombo 11 and Kotte had been disposed at a price less than the fair value in the last financial statements of Rs. 75,000,000 and Rs. 14,727,000 respectively. Sales proceeds received for Colombo 11 and kotte properties were Rs.36,500,000 and Rs. 6,500,000 respectively.

(b)LKAS 16 - Property, Plant and Equipment

As per the LKAS 16 - Entity should commence depreciation of property, plant and equipment when the asset is available for use. However, depreciation had been provided by the company for the month of acquisition in full rather than considering date of asset available for use. Hence Current depreciation method is not in line with LKAS 16.

2.3.2 Financial Investment – Held for Trading

Differences have been observed between number of shares recorded in the financial statements and the CDS statements. The total financial impact due to said difference was Rs.2,859,524.

2.3.3 Non-recognition of opening pre-payment as expense for the year

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Pre-payment of Rs. 1,063,307 brought forward from previous year reflected under other assets without recognizing as expenses for the year. Other assets as well as net profit for the year had been overstated due to aforesaid pre-payment.

2.3.4 Long Outstanding Balances and minus balances

(a) There was a line item in the bank reconciliations called "bank error". The reason for the above error was deposits where the company has not passed the related receipt to the system and the cheques returned but not accounted. Long outstanding balances from the year 2015 were available in the bank reconciliations for the month of December 2016 under the sub heading of "bank error".

(b) There were long outstanding balances called Provision for other assets, Provision for bad debts, Debtors and Advance general under other assets amounting to Rs. 2,901,626, Rs.1,239,871, Rs.20,244,936 and Rs.1384,151 respectively. However, recoverability of above balances are doubtful, other asset balance may be overstated in the financial statements.

(c) Long outstanding balances of Rs. 21,103,679 had been observed under other liability which is brought forward from previous years.

(d) Net exposure of some lease and hire purchase facilities amounting to Rs. 6,052,789 were negative as at 31 December 2016.

2.3.5 Property Plant and Equipment

a) Even though fully depreciated assets such as Motor vehicle, Computer accessories, Office equipment, Office furniture, Fixture and fittings, other equipment and telephone system are being used for the business, retrospective adjustments had not been made in the financial statements by reassessing the useful life of those assets. Therefore actual status of the property, plant and equipment may not be reflected in the financial statements. Total book value of above assets was Rs. 236,982,078.

b) As per the financial statements the value of the land situated at No.474, Henadala Road was Rs.9, 961,400 and as per the deed registered with land registry, that value was Rs. 5,906,200. Hence the difference of Rs. 4,055,200 in value was observed. Therefore, the value of property, plant and equipment, may be misstated.

2.3.6 Non – compliance with Laws, Rules and Regulations

The following non-compliance with Laws, Rules and Regulations were observed in audit.

	Laws, Rules and Regulations	Requirement	Non-Compliance
(a)	Section 7(2) of the Finance Companies (Corporate Governance) Direction No. 03 of 2008 for Licensed Finance Companies in Sri Lanka	The Chairman shall be a non-executive director. In case where the chairman is not an independent non-executive director, the Board shall designate an independent non-executive director as the senior director with suitably documented in terms of reference ensures a greater independent element. The designation of the senior director shall be disclosed in the finance company's Annual Report.	The company had not disclosed designation of the senior director in the Annual Report when chairman is not an independent non-executive director.
(b)	Section 8(3)(e) of the	The Integrated Risk Management	Integrated Risk Management Committee

Finance Companies (Corporate Governance) Direction No. 03 of 2008 for Licensed Finance Companies in Sri Lanka	Committee shall meet at least quarterly to assess all aspects of risk management including updated business continuity plans.	had not been held minimum meeting within the financial year.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Group had recorded a pre-tax net profit of Rs. 81.14 million as compared with the corresponding profit after taxpre-tax net profit of Rs. 3.28 million for the preceding year, thus indicating an improvement of Rs.77.86 million or 2,373.78 per cent in the financial results. The operations of the company excluding a Subsidiary during the year under review had resulted in a profit after tax of Rs.85.62 million as compared with the loss after tax of Rs. 78.31 million in the preceding year, thus indicating an improvement of Rs. 163.93 million or 209.34 per cent in the financial results.

The following table gives a summary of the financial results of the Company and the Group at various stages for the year under review and the preceding year.

	Company			Group		
	2016 Rs. 000	**2015 Rs. 000**	**Change (%)**	**2016 Rs. 000**	**2015 Rs. 000**	**Change (%)**
Net interest income	2,028,170	1,939,834	4.55	2,142,450	2,029,708	5.55
Total operating income	2,178,551	2,083,666	4.55	2,478,337	2,579,118	(3.91)
Net operating income	2,154,312	1,621,515	32.86	2,450,378	2,104,500	16.44
Profit before income tax	239,871	(35,428)	777.06	246,800	56,001	340.71
Profit for the year	85,624	(78,306)	209.34	81,142	3,283	2,371.58

3.2 Value Addition Statement

	2016 Rs. Million	**2015 Rs. Million Restated**
Value Added		
Total Income	4,888	4,217
Cost of borrowing & support services	(3,738)	(2,914)
Provision for bad debts & investments	(24)	(462)
	1,126	**841**

Value Allocation

Payments to employees	782	671
Government tax	266	100
Depreciation	78	70
	1,126	**841**

3.3 Analytical Financial Review

3.3.1. Significant Accounting Ratios

Certain significant accounting ratios for the year under review and previous year are given below. The following observations are made in this regard.

i) Profitability of the company is favourable in the year under review when compared with last year. Net profit ratio had been increased to 1.75 from net loss ratio of 1.86 in the last year. Further return on average asset and Return on equity had been increased from minus 0.28 per cent to plus 0.28 per cent.

ii) Capital Adequacy Ratio (Tier 1+2) of 10.69 present is more than central bank accepted ratio of 10 per cent. This has dropped from 11.91 per cent in the year 2015.

iii) Loans to deposit ratio of the company is 146 percent for the year under review and 147 per cent in the year 2015. WACC were 11.56 per cent in 2016 and 9.29 per cent in 2015.

iv) Company has high liquidity ratios of 1.75 per cent in 2016 and 11.35 per cent in 2015 which indicate that the company had not managed working capital properly.

3.4 Maturity Gap Analysis of the Company as at 31 December 2016.

The company has negative maturity gaps amounting Rs. 8,690 million and Rs. 7,681 million for less than three months' period and within one year as at 31 December 2016 respectively.

	On Demand (Rs.000')	**Up to 3 months (Rs.000')**	**3 – 12 months (Rs.000')**	**1-3 years (Rs.000')**	**3-5 years (Rs.000')**	**More than 5 years (Rs.000')**
Total Assets	696,887	3,424,244	9,880,192	12,119,796	4,245,398	1,259,025
Total Equity & Liabilities	2,305,268	10,505,738	8,871,677	5,594,070	1,048,331	3,608,644
Maturity Gap	(1,608,381)	(7,081,494)	1,008,515	6,525,726	3,197,067	(2,349,619)

4. Operating Review

4.1 Loans and Advances

4.1.1 Loan and Advances had been increased by Rs. 3,405 million or 13.77 per cent compared with previous year. Personal loans were the main reason for this increase and comments on this category are as follows. Personal loan scheme had been increased from Rs. 2,376 million in 2015 to Rs. 4,681 million in 2016. It is an increase of Rs. 2,305 million or 97 per cent. Hence the company has taken a high risk by granting personal guarantee loans within this year and it may adversely affect to the future recovery and managing cost of fund of the company.

4.1.2 Actual amount granted under Leasing & Hire Purchase and Loans and Advances were higher than the budgeted amount by 19 per cent and 25 per cent respectively as at 31 December 2016. The bank had disbursed 46 per cent more than the targeted amount under Bills receivables as at 31 December 2016. The budget had not been used as a proper management tool by the bank.

4.1.3 As per the Gold Loan procedures of the company, the gold loan facility should be granted within the limit of 85 per cent of the current gold value. But, if the customer requests more than 85 per cent of its market value it should be approved by the Credit Committee. However, it was observed some instances where loans have been granted by the gold loan manager more than 85 per cent of the market value. Providing of advances more than 85 per cent of market value to customers without obtaining the approval from credit committee will increase the Credit risk of the company.

4.1.4 Following observations are made regarding non-performing Loans and Advances.

a) Non-performing loan ratio of the company had been decreased from 13.26 per cent to 9.27 per cent in the year under review when compared with the previous year. Following observations were made in this regard.

   i. Impairment coverage of non-performing loans were 6.06 percent in 2015 and 3.82 per cent in 2016.
   ii. The main reason for reduction of non-performing ratio was a capital written off amounting to Rs. 445 million during the year 2016.
   iii. The above non performing ratio is still high when compared with the market non performing ratio of 5.3 per cent. It had affected to reduction of market price of shares of the company from Rs. 17.5 in 2014 to Rs.13.60 in 2016.

b) It was observed that fifteen non-performing staff loans amounting to Rs. 7,860,584 were exist as at 31 December 2016. Out of aforesaid amount, amounting Rs. 7,144,638 or 91 per cent of the total receivable and represents from four staff officers granted in the years 2007, 2013 and 2014.

c) Bills Receivable as at 31 December 2016 was Rs. 874 million. A sum of Rs. 199.9 million or 22.87 per cent of total outstanding was in the Non-performing category.

4.1.5 A facility of Rs.14 million had been granted on 1 April 1994 against property mortgage. For the purpose of recovering the above facility, case had been filed against the above customer on 4 September 1996 and court order had been issued stating that property should be sold at a public auction. Accordingly, at the auction held on 16 June 2005, the company had to acquire the property for nominal value of Rs. 3 million due not having buyers. However, above asset had not been treated/ accounted as a company property though it is used as vehicle yard. Further, above mentioned bill had been written off during the year 2016 (after 12 years) without considering the current legal situation of the above property.

4.2 Managerial Deficiencies

The company has not evaluated Marketability, Acceptability, Safety and Transferability of the securities when granting the loans. In the sample examination, the bank had granted total loan amount of Rs.33.25 million under securities of 6 vehicles such as Lorry, Jeep, car etc valued at Rs.28.11 million to a private company.

a) Investment of quoted shares incurred losses of Rs. 31.364 million in 2016 and Rs. 24.07 million in 2015 due to ineffective management of investments and non-monitoring of the share market closely.

b) It is noted that Property and Equipment was 0.99 per cent of total assets of the company as at 31 December 2016. It's only one property included net book value of Rs. 11.3 million. All branches are holding under rented properties with outside parties. Therefore, the company had paid Rs. 60.130 million as rent expense for all branches during the year and even Head office operations are held under rent building in Kollupitiya which incurred cost of Rs. 62.573 million for the year 2016.

c) The Company had invested Rs. 516 million for obtaining 84.12 per cent shareholding of MBSL Insurance Company Ltd. However, the subsidiary company incurred continuous losses from their operations. Therefore, the company had impaired its investment in time to time. The company made impairment provision of Rs. 237.89 million in the year under review and accumulated provision was Rs. 438.79 million and balance of investment was Rs. 77.31 million as at 31 December 2016.

However, the board of directors of the company made a decision to divest the entire shareholding of the subsidiary company. Further transaction has not been concluded as at reporting date to consider this as a discontinued operation.

d) The company branch network consists of 49 branches in island wide. However, the company was not able to open any new branch during the year under review. Out of the above 21 branches or 41 per cent are situated in Western province.

4.3 Human Resource Management

(a) The Approved cadre should be registered with the Department of Public Enterprises, General Treasury as per the clause No 9.2 of the hand book of good governance under the Public Enterprises Circular No.2 dated 3 June 2003. However, the company had not complied with the above requirement and the grade wise approved cadre had not been submitted to the audit.

(b) The staff expenses of the company was 52 per cent in 2016 and 51 per cent in 2015 which represent a significant portion of the total expenses during the last two financial years of the company which is more than fifty per cent of the total expenditure.

4.4 Customer Deposits of the Company

The customer deposits of the company consist following items.

	As at 31/12/2016 (Rs.'000)	As at 31/12/2015 (Rs.'000)	Change (Rs.'000)	(%)
Fixed Deposits	17,790,162	15,153,099	2,637,063	17.40
Saving Deposits	728,257	693,207	35,050	5.06
Total	18,518,419	15,846,306	2,672,113	16.86

(a) Customer deposits had been increased by Rs. 2,672 million or 16.86 per cent as compared with previous year. However, ninety-six per cent of total deposits represent by fixed deposits of the company as at 31 December 2016.

(b) It was observed that 84.29 per cent of total deposits amounting to Rs. 15,608 million will be matured within one-year period. However total financial assets which will be matured within one year amounting to Rs. 14,001 million. Therefore, there was a maturity mismatch amounting to Rs. 1,607 million compared with customer deposits at the end of year.

(c) Further, it is noted that top ten fixed depositors were amounting to Rs. 4,883 million and it was 26.35 per cent of total deposits of the company. There is a high risk to the company by depending on few customer deposit base and when obtain these fixed deposits had borne a high rate of interest for acquired and retain them within the company.

4.5 Net Interest Income of the Company

Loans and Advances had increased amounting to Rs. 3,405 million or 13.77 per cent and interest income increased amounting to Rs. 665 million or 16.32 per cent compared with the previous year. Hence net interest income of the company increased amounting to Rs. 89 million or 4.59 per cent only for the year ended 31 December 2016 with compared to the previous year.

5. Market share of the Company

5.1 Market share of deposits and loans and advances

Company's Market share of the total deposits and the Market share of Loans and advances were 3.49 per cent and 3.22 per cent respectively in the year 2016 and those were 3.29 per cent and 3.42 per cent in the year 2015.

5.2 Fitch ratings of the Company

Fitch local rating is grade A (ICRA Lanka Limited) of the company as at 31 December 2016.

6 Systems and Controls

Deficiencies in systems and controls observed during the course of audit were brought to the notice of the Bank by my detailed reports issued to the Chairman of the Bank. Special attention is needed in respect of the following areas of control.

(a). Loan Administration	- Non Performing Advance Ratio - Highest Non Performing Customers and Branches - Written Off Loans
(b) Human resource managements	- Staff Expenses - Approval for cadre