State Mortgage and Investment Bank – 2016

The audit of financial statements of the State Mortgage and Investment Bank ("the Bank") for the year ended 31 December 2016 comprising the statement of financial position as at 31 December 2016 and the 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

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 management 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 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 qualified 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 Qualified Opinion

In my opinion, except for the effect 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 2016, 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/ SLFRS)

The Bank had made the debit and credit entries amounting to Rs.124,707 and Rs.3,317,349 respectively to the withholding tax on specified fees account as error corrections relating to the year before 2015 without complying with the requirements laid down in LKAS 08 - Accounting Policies, Changes in Accounting Estimates and Errors.

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. Therefore, the Bank had to post 19 entries worth Rs. 484,816,298 to the General Ledger as adjustments after reporting period for the preparation of the financial statements.

(b) An amount of Rs. 8,614,361 was shown as an un-reconciled control account in the financial statements as at 01 January 2016. Though a sum of Rs.58,137,838 and Rs.42,526,685 had been debited and credited to this account respectively during the year under review, most of these debit and credit entries are related to previous years for which adequate information was not made available. Accordingly, the recoverability and accuracy of a debit balance of Rs.24,225,514 shown under other assets in the financial statements is in doubt.

(c) There was an abnormal debit balance of Rs. 12,407,870 in Cheques on Realization Account as at 31 December 2016 without being confirmed. Hence, the other debtors shown in the financial statements had been overstated by that amount.

(d) Adjustments to be made in the bank reconciliation statements relating to the year 2016 and previous years aggregating Rs. 5,020,135 had not been made to the respective bank reconciliation statements and therefore, cash and cash equivalent balance shown in the financial statements for the year under review had been understated by similar amount.

(e) According to the financial statements for the year under review the un-appropriated loan balance was Rs.168,317,332. However, it was shown as Rs.148,743,268 in the age analysis. Hence, other liabilities shown in the financial statements had been overstated by Rs.19,574,064 as at 31 December 2016.

2.2.3 Un-explained Differences

The following observations are made.

(a) A difference of Rs. 3,265,669 was observed between the loan balances shown in the General Ledger and Loan Schedules relating to four loan categories as at 31 December 2016 and reason for this difference was not explained to audit. Further, a difference of Rs. 1,382,385 had been observed between the value of loans as per the financial statements and the total value of loans (after aggregating the loans) considered and not considered for impairment.

(b) A difference of Rs. 2,856,831 was observed between the inter branch accounts which had not been reconciled as at 31 December 2016.

(c) It was observed a difference of Rs. 2,213,095 between the EPF and ETF payables shown in the financial statements and the amounts shown in the remittance forms as at 31 December 2016.

(d) An amount of Rs.1,587,771 shown as employees' security deposit in the schedule to the financial statements was differ from the corresponding amount of Rs.1,729,042 shown in the financial statements as at 31 December 2016 and as such an unexplained difference of Rs. 141,271 was observed in audit.

(e) A difference of Rs. 539,171 was observed between the financial statements and the balances generated by the computerized systems with regard to the deposits as at 31 December 2016.

(f) Though a credit balance and a debit balance should be appeared in the branch advice account and claim voucher account respectively according to the accounting method followed by the Bank, an abnormal debit and credit balance of Rs.6,571,060 and Rs.17, 592,805 respectively were observed in these accounts as at 31 December 2016. However, the reasons for this had not been explained to audit.

(g) Although an amount of Rs. 27,884,783 was appeared in the financial statements as tax effect, it was Rs. 493,558 as per schedules provided to audit. The difference of Rs. 27,391,225 had not been adjusted in the financial statements as at 31 December 2016.

2.2.4 Lack of Evidence for Audit

An amount of Rs. 2,400,000 shown as fraud account under other debtors as at the end of the year under review could not be satisfactorily vouched in audit due to non-submission of detailed schedules, confirmations and other required details to audit.

2.3 Accounts Receivable and Payables

The following observations are made.

(a) An amount of Rs.1,389,087 had been shown as received in advance in the financial statements for more than two years . However, these balances had not been settled even as at the end of the year under review.

(b) The following account balances aggregating Rs. 2,121,389 had been carried forward without being recovered for more than two years. Hence, the recoverability these balances were in doubt.

Name of the Account	**Amount Rs.**
FD Loan Recoverable	418,635
National Security Levy	785,954
Interest paid in Advance – Ascharya	916,800
Total	2,121,389

(d) Out of the debit balance of Rs.7,197,693 shown in the advance accounts, a sum of Rs. 5,376,153 related to the year 2015 had not been identified and adjusted in the accounts. Hence, the reliability and recoverability of this balance could not be ascertained in audit.

(e) It was observed that a debit balance of Rs.1,518,610 had been shown under other debtors as accrued assistant to provident fund account. Since this balance was not confirmed by the respective parties, the recoverability of this balance is in doubt.

(f) An amount of Rs.799,884 had been shown under other debtors as suspense nature in the financial statements as at 31 December 2016. However, the reasons and the details of this had not been submitted to audit.

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.706 million as compared with the corresponding pre-tax net profit of Rs.681 million in the preceding year, thus showing an improvement of Rs.25 million or 4 per cent in the financial results.

Increase of interest income by 9.3 per cent and decrease of impairment for the year by 67 per cent as compared with the corresponding figures of the preceding year were the main reasons attributed for this improvement.

3.2 Value Addition

Although the financial result of the Bank for the year under review was Rs.436,017,785, the value addition of the Bank had gradually increased from Rs.933,770,458 in year 2013 to Rs.1,662,254,618 in year 2016 after taking into account the personal emolument, depreciation and tax payable to the government aggregating Rs.1,226,236,833 for the year under review and total value addition of the Bank had increased by Rs.86,232,972 or 5.5 per cent as against the previous year.

3.3 Analytical Financial Review

3.3.1 Profitability

The following observations are made.

i. The interest income had increased from Rs. 2,611 million to Rs. 4,241 million or 62.4 per cent during the period from 2011 to 2016 while, interest expenses had also increased from Rs. 1,214 million to Rs.2,425 million from 2011 to 2016 or by 99 per cent. Accordingly, the net interest income had dropped by 11 per cent from 53.5 per cent in 2011 to 42.8 per cent in 2016.

ii. The net profit after tax had decreased from Rs.510 million to Rs.436 million or by 14.5 per cent during the period of 2011 – 2016. However, it had increased from Rs.409 million to Rs.436 million or by 6.6 per cent in the year under review as compared with the previous year.

3.3.2 Significant accounting Ratios

According to the information made available, some important accounting ratios of the Bank for the year under review and for the preceding 02 years as compared with sector ratios are given below.

	The Bank		**Sector Ratios (Licensed Specialized Banks)**	
	2016 Percentage	**2015** Percentage	**2016** Percentage	**2015** Percentage
Profitability Ratios				
i. Net Interest Margin	5.36	5.81	3.5	3.8
ii. Return on Equity	9.50	9.90	18.3	20.3
iii. Return on Assets	2.03	2.11	1.5	1.6
iv. Staff Cost to Operating Expenses	20.27	22.14	51.1	52.1
Capital Adequacy Ratios				
Tier I	22.96	22.17	13.5	16.6
Liquidity Ratios				
i. Liquid Assets/ Deposits	22.82	23.64	61	67.2

Although the net interest margin was higher than the Licensed Specialized Banking Sector by 1.86 per cent, the return on equity was not in satisfactory level and it was behind the sectorial ratio by 8.8 per cent. Further, the liquidity of the Bank was also far below as compared with the sectorial ratio both in the year 2015 and 2016.

3.3.3 Market Share of the Bank

Market share position of the Bank based on the total deposits and total assets with compared to the Banking Sector (BS) and Licensed Specialized Banking Sector (LSBS) is given below.

Year	Market Share on Deposit Base As a percentage of		Market Share on Asset Base as a percentage of	
	BS	LSBS	BS	LSBS
2016	0.46	3.41	0.39	2.94
2015	0.52	3.64	0.42	3.10
2014	0.52	3.40	0.43	2.79
2013	0.51	3.43	0.45	2.91
2012	0.47	3.05	0.44	3.03
2011	0.49	2.94	0.48	3.04

The following observation is made in this regard.

The market share based on total deposits had increased by 0.47 per cent as compared with the LSBS from year 2011 to 2016. However, it had decreased by 0.23 per cent as compared with the year 2015. In the meantime, the market share of the Bank based on total Assets had decreased by 0.10 per cent as compared with LSBS during the period from 2011 to 2016 and it had decreased by 0.16 per cent as compared with year 2015.

4. Operating Review

4.1 Performance

4.1.1 Achievement of Main Objectives

According to Section 2 (2) of the State Mortgage and Investment Bank Law, No. 13 of 1975, the main objective of the Bank is to assist in the development of agriculture, industry and housing, by providing financial and other assistance in accordance with the provisions of this Law. Accordingly, details of providing financial assistances to each sector based on the information provided to the Central Bank of Sri Lanka as at 31 December 2016 is given below.

Sector	Value of Total Assistance Rs. "000"
Agriculture and Fishing	3,586,627
Tourism	40,344
Construction	24,906,652
Total	**28,533,623**

The Bank had provided 99.9 per cent of its loans as agricultural and housing loans in order to comply with statutory requirements.

4.1.2. Non-performing Loans (NPL)

The following observations are made.

(a) According to the information made available total outstanding loans as at 31 December 2016 was Rs.28,530 million and out of that a sum of Rs.7,815 million was identified as non-performing loans and it represented 27 per cent of the total outstanding loans.

(b) The value of major eight non-performing loans as at 31 December 2016 was Rs.48,462,023 and the following observations are also made in this regard.

(i) No installment had been recovered during the year 2016 from these 8 non-performing loans and two loan files to the value of Rs.33,302,506 and Rs.2,693,389 respectively had not been submitted for audit.

(ii) The Bank had not taken any legal action against the borrower in order recover the Non-performing Loan of Rs. 33,302,506 even up to 31 December 2016.

4.1.3. Loan Portfolio of the Bank

The variety of loans and advances granted during the year 2016 as compared with the preceding year are given below.

	2016		2015		Variance {favourable /(Adverse)}
Types of Loans	**Number of Loans granted**	**Value Rs. Mn**	**Number of Loans granted**	**Value Rs. Mn**	**Value Rs. Mn**
Mortgage Loans	1846	2,018	1916	1,874	144
EPF Loans	6238	1,824	8031	2,451	(627)
Personnel Loans	6018	4,441	5608	3,503	938
Refinance Loans	0	0	1	1	(1)
Other Loans	60	4	0	0	4
Total	**14,162**	**8,287**	**15,556**	**7,829**	**458**

Although the total value of loans granted during the year under review had increased by 6 per cent as compared with the previous year, the number of loans granted had decreased by 9 per cent.

4.1.4. Recovery of Outstanding Loans

According to the information furnished to audit, the balances of loan aggregating Rs.4,009 million is in arrears for more than 12 months as at 31 December 2016 without being recovered . Out of this, Rs.3,904 million represented mortgage loans and EPF loans.

4.2 Transactions of Contentious Nature

Pay As You Earn (PAYE) tax amounting to Rs.21,035,164 had been paid by the Bank on behalf of its employees without deducting it from the salaries of the respective employees contrary to the provision in the Public Enterprises Department Circular No. PED 03/2016 dated 29 April 2016.

4.3 Human Resources Management

The following observations are made.

(a) According to the cadre position of the Bank, the approved cadre and actual cadre as at 31 December 2016 were 523 and 375 respectively and as such the number of vacancies on that date was 148. However, out of total vacancies, 76 positions had been filled by contract basis employees as at 31 December 2016.

(b) Two Deputy General Managers and four Chief Managers had been included in the above vacant positions which may affect the smooth operation of the Bank.

4.4 Management Activities

The following observations are made.

(a) Nine programs set out in the Marketing Plan for the year under review such as automate SMS facilities, introduction of marketing risk rating manual, producing branding TV commercials, redesigning the customers' documents etc. had not been launched during the year under review.

(b) Although an amount of Rs. 17.5 million had been allocated for 21 programs, it was observed that these programs were at the initial stage as at the end of the year 2016. Further, the Marketing Division of the Bank had not prepared a detail budget for each program which expected to be implemented during the year under review.

5. Accountability and Good Governance

5.1 Budgetary Control

Even though the Bank had revised the budget for the year 2016, significant variations in respect of interest income on loans and expenditure for staff study and training were observed between the revised budget and actual figures, thus indicating that the budget had not made use of as an effective instrument of management control.

5.2 Internal Audit

The following observations are made.

(a) Although the approved cadre of the Internal Audit Division was limited to five employees, the staff of the Internal Audit Division is not adequate to cover the important areas of the internal control such as investments of the Bank, loan recovery, Branch operations etc.

(b) The post of Chief Internal Auditor of the Bank had remained vacant since 1 January 2016. However, fruitful actions to fill this vacancy had not been taken even up to 31 October 2017.

6. Systems and Controls

Deficiencies observed in systems and controls during the course of 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 control.

Control Areas	Observations
Maintenance of Market Share	The Bank should have a plan to maintain or uplift its market share position among the banking industry which has increasing rivalry because acceptable growth of the market share had not been observed.
Accounting of Loans and Deposits	Significance differences were observed between the loan and deposit balances shown in the financial statements and corresponding records. Hence Bank should take adequate actions to mitigate these differences.