

Merchant Bank of Sri Lanka & Finance PLC – 2017

The audit of the financial statements of the Merchant Bank of Sri Lanka & Finance PLC (“the Company”) and the consolidated financial statements of the Company and its Subsidiary (“the Group”) for the year ended 31 December 2017 comprising the statement of financial position as at 31 December 2017 and the statement of profit or loss and other comprehensive income, statement of changes in equity and the statement of cash flows 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 misstatement, 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 2017, and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.1.1 Emphasis of Matter

Without qualifying my opinion, I draw your attention to the note 44 to the financial statements which described the going concern assumption in the preparation of the financial statements of the Subsidiary, MBSL Insurance Company Limited.

2.1.2 Report on Other Legal and Regulatory Requirement

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 my examination, 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 2017, 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 the 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.

- 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 and 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 2017 and end of the preceding year was as follows.

Name of the Company	Position of Investment	
	2017 Rs.'000	2016 Rs.'000
Subsidiary - Unquoted Company		
MBSL Insurance Company Ltd	516,096	516,096
Less-Provision for Impairment	(494,979)	(438,790)
Net Investments	21,117	77,306
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	102,201	158,390

2.3 Comments on Financial Statements of the Company

2.3.1 Long Outstanding Balances - Other Assets

- (a) Long outstanding balances in respect of other debtors, Legal charges, Claims on bank guarantees as at end of the year were Rs. 5,359,147, Rs. 1,313,886 and Rs. 1,776,489 respectively and recoverability of those are doubtful.
- (b) Out of the total insurance agency commission receivable of Rs.14 million, a balance of Rs. 10,614,474 was outstanding more than one year.

2.3.2 Long Outstanding Balances - Other Liabilities

- (a) A balance amounting to Rs. 11,625,290 in the creditors balances was outstanding for more than one year.
- (b) As at the end of the year, there were unidentified direct deposits amounting to Rs. 17,352,539 which was outstanding more than 6 months and unrepresented payments amounting to Rs. 13,374,061 which was outstanding more than one year in the bank reconciliation.
- (c) An un-reconciled balance amounting to Rs. 33,727,741 was observed in the suspense account and a break up was not provided to the audit.

2.3.3 Fully depreciated assets

Fully depreciated assets amounting to Rs.543.8 million are still used by the bank. However, formal process with reasonable documentation for review the estimated useful lives of assets was not done by the bank.

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.239.46 million compared with the corresponding pre-tax net profit of Rs.239.83 million for the preceding year, thus indicating a decrease of Rs.0.37 million or 0.15 per cent in the financial results. The operations of the company excluding a subsidiary during the year under review had resulted in a pre-tax net profit of Rs. 228.65 million as compared with the pre-tax net profit of Rs.232.9 million in the preceding year, thus indicating decrease of Rs.4.25 million or 1.82 per cent in the financial results. The reason for the above decrease was the increase of impairment charges for loans from Rs.24.24 million to Rs.244.23 million in the year under review.

3.2 Value Addition Statement

The value addition of the bank was Rs. 1,544 million and Rs. 1,202 million for the year under review and the proceeding year respectively and it shows an increase of 28 per cent. The bank had allocated Rs. 1,027 million and Rs.307 million to their employees and government respectively when compared with previous year allocation of Rs.782 million and Rs.266 million.

3.3 Analytical Financial Review

3.3.1. Significant Accounting Ratios

The following observations are made in this regard.

- i. Return on average assets and return on equity of licensed specialized banks for the year 2017 were 1 per cent and 19.2 per cent respectively. However, above ratios of the bank were only 0.3 per cent and 3.18 per cent respectively for the year 2017.
- ii. Net profit ratio of the bank reported 1.58 per cent for the year 2017 as compared with the sector ratio of 8.35 per cent.
- iii. NPA ratio (gross) of the bank had been reported as 10.10 per cent as compared with the sector ratio of 4.3 per cent.

3.4 Maturity Gap Analysis of the Company as at 31 December 2017.

	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 (Rs.000)
Assets							
Financial Assets	1,145,550	6,361,615	9,472,681	12,695,973	4,362,205	519,539	34,557,563
Non-Financial Assets	-	271,114	42,603	-	-	773,927	1,087,644
Total Assets	1,145,550	6,632,729	9,515,284	12,695,973	4,362,205	1,293,466	35,645,207
Equity & Liabilities							
Financial Liabilities	1,349,831	11,547,276	9,135,985	5,725,831	3,878,401	-	31,637,324
Non-Financial Liabilities	-	129,893	7,473	-	-	636,697	774,063
Equity	-	6,577	-	-	-	3,227,243	3,233,820
Total Equity & Liabilities	1,349,831	11,683,746	9,143,458	5,725,831	3,878,401	3,863,940	35,645,207
Maturity Gap	(204,281)	(5,051,017)	371,826	6,970,142	483,804	(2,570,474)	-

4 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. Valuation of Investment Property
- b. Physical Cash in verification
- c. Handling Cheques in hand
- d. Preparation of Bank Reconciliation
- e. Managing bank accounts
- f. Issuing Bills receivable