State Mortgage and Investment Bank – 2017

The audit of financial statements of the State Mortgage and Investment Bank for the year ended 31 December 2017 comprising the statement of financial position as at 31 December 2017 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

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.

1.3 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 judgement, 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.

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 2017, 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 Accounting Deficiencies

The following observations are made.

(a) Loan releases and loan recovery of Rs.420,000 and Rs.1,112,305 respectively under the Wayaba Diriya project relating to the month of December 2017 had not been posted to the margin account whilst loan release of Rs.2,040,000 and capital recovery of Rs.1,100,658 for December 2016 had been posted to the margin account for the year 2017.

(b) A total sum of Rs.2,436,835 directly received to a branch current account in the year 2017 and the previous year had not been taken in to accounts even up to the end of the year under review.

2.2.2 Unexplained Differences

The following observations are made.

(a) A net difference of Rs.6,975,092 was observed between the loan balances as per the system generated schedules of loan portfolio and the balances in the financial statements in respect of Mortgage, EPF, and Personal loans. These differences had not been reconciled.

(b) A net difference of Rs.234,228 was observed between the loan balances shown in the schedule used for impairment calculation, and balances shown in the financial statements in respect of Mortgage, EPF, Personal and Microfinance loans, as at 31 December 2017.

(c) A difference of Rs. 4,268,346 was observed in inter branch accounts.

(d) A difference of Rs. 2,923,635 was observed between the amount shown in the remittance forms, and the bank contribution to EPF and ETF accounts shown in the financial statements for the year under review.

(e) A balance of Rs. 493,558 had been shown as unidentified differences under the prior period adjustment of the statement of changes in equity.

(f) A total difference of Rs.250,867 was observed between the system balances of savings scheme deposits and balances in the financial statements.

(g) A difference of Rs.2,632,245 was observed between the balance appearing in the financial statements and the balances appearing in the records of marketing division relating to Advertising & Promotional expenses.

(h) Difference of Rs. 28,883,653 had been observed between the balance of un appropriated account shown in the financial statements and the relevant system generated schedule.

2.2.3 Account receivables and Payables

The following observations are made.

(a) A balance of Rs.2,917,537 brought forward before the year 2016 which was included in the balance of advance of Rs.5,362,744 under the deposits and pre payments in the financial statements had not been identified even up to the end of the year under review. Hence, the reliability and recoverability of this balance could not be ascertained in audit.

(b) According to the accounting method maintained by the Bank, the balance of the branch advice account should be a credit balance. However an unsettled debit balance of Rs. 7,529,740 was observed in branch advice account as at 31 December 2017.

(c) Although a debit balance should be shown in the claim voucher account normally, an abnormal credit balance of Rs. 23,590,021 had been shown in the said account as at 31 December 2017.

(d) Balances of six accounts amounting to Rs. 1,513,448 had been carried forward under the other debtors for more than a period of two years without being identified the recoverability of those balances was uncertain.

(e) A debit balance of Rs.1,512,882 and Rs.6,696 had been shown in accrued assistant to provident fund account and debit tax account respectively under the other debtors as at 31 December 2017. Since this balance was not confirmed by the respective parties the recoverability of this balance could not be confirmed.

(f) A sum of Rs.139,936 had been included in the sundry debtor balance since the year 1988 up to the year 2014, Actions had not been taken to settle this balance even up to the end of the year under review.

(g) An abnormal debit balance of Rs. 14,265,463 had been shown in Cheques on Realization account under the other debtors as at 31 December 2017 and thus, the other debtors shown in the financial statements had been overstated by similar amount.

(h) An unidentified debit balance of Rs.3,005,380 had been shown in the withholding tax payable account as at 31 December 2017 . Actions had not been taken to identify and settle the said balance even up to the end of the year under review.

(i) According to the methodology followed by the bank, processing fees for mortgage loan granted on the balance of the employees provident fund, should be paid to the Assistant commissioner of Labours within 20 days of the following month of which the loan was granted. However an unidentified debit balance of Rs.179,500 had been shown in the payable ACL charges account and a sum of Rs. 216,500 had been remained more than one year as creditors as at 31 December 2017 without being settled.

2.2.4 Lack of evidence for Audit

Although a debit balance of Rs. 22,350,414 had been shown under other assets in the Financial Statements for the year under review, the recoverability of this amount was uncertain due to lack of adequate information.

2.3 Non-compliances with Laws, Rules, Regulations, and Management Decisions

Instances of non-compliance with following Laws, Rules, Regulations and Management Decisions observed during the course of audit are given below.

	Reference to Laws, Rules, Regulations and Management Decisions	Non-compliance
(a)	Treasury circular No. IAI/2002/02 dated 28 November 2002	Even though, a fixed assets register for computer should be maintained in accordance with the given format.such a register had not been maintained by the bank relating to computers valued at Rs.127,189,798.
(b)	Financial Regulation of the Democratic Republic of Sri Lanka Financial Regulation No. 396	Actions had not been taken as per the regulation in connection with cheques not presented for payment more than 6 months aggregating Rs.1,792,650.

2.4 Transactions not Supported by Adequate Authority

As per the Board Decision No.16.07.83.07 dated 29 July 2016, estimates valued more than Rs.200,000 should be approved by the Assistant General Manager. Contrary to this requirement estimate valued at Rs.314,145 for relocating the Kiribathgoda branch, had been approved by the chief manager.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the financial result of the Bank during the year under review was a pre-tax net profit of Rs.379 million as compared with the corresponding pre-tax net profit of Rs.706 million in the preceding year, thus showing a decrease of Rs.327 million, in the financial result. The increase of impairment charge for the year by Rs. 190,115,588 was mainly by affected to this decrease.

Although the financial result of the Bank for the year under review had decreased to Rs.173, 457,667, after taking into account the personal emolument, depreciation and tax payable to the government the value addition of the Bank had gradually increased from Rs.933,770,458 for the year 2013 to Rs.1,662,254,618 for the year 2016. However it had decreased by Rs.344,599,816 or 21 per cent for the year under review against to the previous year.

3.2 Analytical Financial Review

3.2.1 Significant financial ratios

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

	2017		2016	
	State Mortgage and Investment Bank	**Licensed specialized banking sector**	**State Mortgage and Investment Bank**	**Licensed specialized banking sector**
Profitability Ratios				
i. Net Interest Margin	4.35	3.2	5.36	3.5
ii. Return on Average Equity	3.52	19.2	9.50	18.3
iii. Return on Average Assets	0.97	1.5	2.03	1.5
Capital Adequacy Ratios				
Tier I	23.74	12.8	22.96	13.5
Liquidity Ratios				
i. Liquid Assets/ Deposits	22.10	61.6	22.82	61

Though the net interest margin was higher than licensed specialized banking sector by 1.15 per cent, Return on average equity was below by 15.68 per cent. Further liquidity of the bank was below the licensed specialized banking sector both in year 2016 and 2017.

4 Operating Review

4.1 Performance

4.1.1 Operating and Review

The following observations are made.

(a) According to the Goal 5 of the Action Plan for the year 2017, targets of the non-performing loan ratio for the personal loans and Mortgage loans shall be reduced to 3 per cent and 5 per cent receptively at the end of year 2017. However, it was observed that 4 branches had failed to achieve the personal loan target and 12 branches had failed to achieve mortgage loan target.

(b) According to the loan disbursement targets given by the Branch Operation Division of the Bank, 6 out of 24 branches had not achieved 75 per cent of the targets as at the end of the year 2017.

(c) Marketing department had prepared its marketing plan for year 2016/2017 with the main target of achieving Rs. 2 billion profit by 2020. However, the profit after tax of the Bank had decreased by Rs.257,493,476 or 59 per cent in year 2017 as compared with 2016.

(d) The Child banking concept which was implemented in the year 2016, was at the basic level even up to 31 December 2017.

(e) According to the Section 2 (2) of the State Mortgage and Investment Bank Law No.30 of 1975, the purpose 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 as per the information provided to Central Bank as at 31 December 2017**,** The bank had provided 99.9 per cent of its loan portfolio as agricultural and housing loan to the customers.

(f) The Bank had obtained a loan of Rs. 2 billion from the National Savings Bank at the interest of AWPLR+1.2 per cent per annum as variable rate. If the AWPLR was 10 per cent the Bank requires to pay nearly Rs. 224 million as interest per annum Ignoring the semiannual revision of interest rate as per the agreement. However Bank had reported non performing loan ratio at 22 per cent as at 31 December 2017. After considering these backgrounds it was doubt whether the Bank can yield an optimum return by utilization of this loan funds.

4.2 Management Activities

(a) An amount of Rs.2,400,000 had been shown as fraud account in other debtors in the financial Statements, in respect of the fraud occurred in 1996, Nevertheless action had not been taken to clear up the incident and recover the loss even up to 31 December 2017.

(b) According to the financial statements, fixed assets valued at Rs. 9,613,360 had been disposed by the bank in the year 2017. However the cost of oldest items had been removed from books instead of being identified the items disposed and removed from books.

4.3 Operating Activities

(a) According to the information made available, the value of the loan disbursement had been increased by Rs.2,381 million or 29 per cent and the number of loans had been decreased by 429 or 3 per cent during the year under review as compared with the preceding year. Further, out of total disbursement during the year compared with the previous year, Small and Medium Enterprise and micro finance loans had increased by 2,975 per cent and personal loans had increased by 79 per cent respectively.

(b) Bank had granted loan facilities amounting to Rs.32,540 million and out of that Rs.7,466 million or 23 per cent had shown as non- performing as at 31 December 2017.Further Out of total EPF loans, a sum of Rs.5,894 million or 18 per cent had reported as non performing as at 31 December 2017.

(c) The following observations are made in respect of the age analysis of non performing loans

(i) Total amount of non- performing loans as at 31 December 2017 was Rs.7,460 million and out of that , Rs.4,106 million or 55 per cent was remained outstanding for more than 1 year and out of the said value a sum of Rs.3,670 million represented EPF loans.

(ii) Out of the value of non- performing loans over 3 years, a sum of Rs.66 million represented vested properties.

(iii) Out of the total non- performing loan balances, 07 Major non- performing mortgage loans amounting to Rs.48 million had remained outstanding for more than 3 years and out of that legal actions had not been taken for 04 loans aggregating Rs. 46 million.

(iv) Out of the total non performing loan balances of Major non performing personal loans, Rs. 18 million had remained outstanding for more than 3 years.

4.4 Transactions of Contentious Nature

According to the Public Enterprises Circular No.PED 03/2016 dated 29 April 2016 PAYE tax should be deducted from the employee's salary. Contrary to that PAYE tax amounting to Rs. 20,122,583 had been paid by the bank, without deducting from the employees salaries.

4.5 Apparent Irregularities

Total value of loans amounting to Rs.68.34 million had been obtained by 47 individuals providing fraud documents and fraud information and the total amount of above loan was included in the non performing balance at 31 December 2017.

4.6 Staff Administration

Following observations are made.

(a) According to the cadre position of the Bank, Approved cadre and actual cadre was 471 and 365 respectively thus there were 106 vacancies as at 31 December 2017.

(b) Three posts of Deputy General Managers, Three post of Assistant General Managers and four post of chief Managers had been included in the above vacant positions which may affect the smooth function of the bank operations.

4.7 Market Share

Market share based on deposits of the Bank compared with the licensed specialized banking sector had increased by 2 basis points from the year 2013 to 2017. Further market share based on assets of the bank compared with licensed specialized banking sector had increased by 17 basis points from year 2013 to 2017.

5. Accountability and Good Governance

5.1 Internal Audit

The post of Chief Internal Auditor of the Bank had remained vacant from 1 January 2016.

5.2 Procurement and contract process

5.2.1 Procurements

(a) According to the procurement plan for the year 2017 sums of Rs.1,300 million and Rs.62 million had been estimated for purchasing of new building for Head Office and a land and building for Horana Branch respectively. However according to the information furnished to audit, It was observed that the procurement of new building was in primary stage and bank had failed to purchase the land for Horana branch.

(b) According to the chapter 4.2.1.(e) of the Government Procurement Guideline, Master Procurement Plan shall be regularly updated at intervals not exceeding six months. The bank had not adhered to that guidance.

(c) According to the procurement plan for the year 2017 the bank had expected capacity expansion in five branches. However, the bank had totally failed to achieve the aforesaid targets.

(d) According to the chapter 2.3.2 (c) of the procurement guideline, staff of a procurement action shall responsible in preparation of the draft bidding documents including the specifications and the submission of same to the TECs for review and approval, However actions had not been taken accordingly by the bank in respect of partition of 8 branches and head office incurring a sum of Rs. 2,370,878 as at December of 2017.
Further the chapter 6.3.2 of the procurement guideline Bids shall be closed at the time specified in the bidding documents and late Bids shall not be accepted and shall be returned unopened. Contrary to this requirement procurement relating to the above mentioned Contract had been awarded to a contractor who had submited the bid after the due date.

(e) According to the paragraph 5.1.1. (a) of the Government procurement guideline 2006 the Procurement Entity should initiate the drafting of bidding documents including Technical specifications, drawings, etc. The bank had not submitted technical specifications when drafting of bidding documents for purchasing of computer accessories valued at Rs.2,112,357.

5.3 Budgetary Control

Significant variations were observed between the budgeted and actual figures, in respect of loan related expenses, expenditure of staff study & training, fixed assets and borrowings, thus indicating that the budget had not made use of as an effective instrument of management control.

6. Systems and Control

Differences observed in 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 following areas of control.

Areas of systems and control	Observation
a)Accounting	General ledger not being updated.
b)Presentation of financial statements	Attention not being paid to rectify the accounting deficiencies and unexplained differences.
c)Maintaining market share	Acceptable growth of the market share not being achieved.
d)Maintenance of Registers	Inventory numbers not being mentioned. Detail not being mentioned in the fixed assets register. Registers not being updated.