

Merchant Bank of Sri Lanka and Finance PLC company and its subsidiaryies - 2019

1.1 Opinion

The audit of the Financial Statements of the Merchant Bank of Sri Lanka and Finance PLC (“Company”) and the consolidated financial statements of the company and its subsidiary (“Group”), which comprise the Statement of Financial Position as at 31 December 2019, and the Statement of profit or loss, the statement of comprehensive income, statement of changes in equity and statement of cash flow for the year then ended, and notes to the financial statements, including a summary of significant accounting policies, was carried out under my directions in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with provisions of the National Audit Act No. 19 of 2018. My comments and observations which I consider should be report to parliament appear in this report. To carry out this audit I was assisted by a firm of Chartered Accountants in public practice.

In my opinion, the accompanying financial statements of the company and the group give a true and fair view of the financial position of the Company and the Group as at 31 December 2019 and of their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basis for Opinion

I conducted my audit in accordance with Sri Lanka Auditing Standards (SLAuSs). My responsibilities, under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of my report. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation of Financial Statements that give a true and fair view in accordance with Sri Lanka Accounting Standards, and for such internal control as management determine is necessary to enable the preparation of Financial Statements that are free from material misstatement, whether due to fraud or error.

In preparing the Financial Statements, management is responsible for assessing the Group’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intend to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company’s and the Group’s financial reporting process.

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Company is required to maintain proper books and records of all its income, expenditure, assets and liabilities, to enable annual and periodic Financial Statements to be prepared of the Company.

1.4 Auditor's Responsibilities for the Audit of the Financial Statements

My objectives are to obtain reasonable assurance about whether the Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an Auditor's Report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Sri Lanka Auditing Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Financial Statements.

As part of an audit in accordance with Sri Lanka Auditing Standards, I exercise professional judgment and maintain professional scepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 and the Group.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the management.
- Conclude on the appropriateness of the management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in my auditor's report to the related disclosures in the Financial Statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the Financial Statements, including the disclosures, and whether the Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.

The scope of the audit also extended to examine as far as possible, and as far as necessary the following;

- Whether the organization, systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of the presentation of information to enable a continuous evaluation of the activities of the Company, and

whether such systems, procedures, books, records and other documents are in effective operation;

- Whether the Company has complied with applicable written law, or other general or special directions issued by the governing body of the Company;
- Whether the Company has performed according to its powers, functions and duties; and
- Whether the resources of the Company had been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws.

1.4.1 Financial Statements

1.5.1 Internal Control over the preparation of financial statements

| Audit Issue | Management Comment | Recommendation |
|---|--|---|
| ----- | ----- | ----- |
| (i) Instances were observed that the Company has changed the maturity date, tenor and interest rate of the existing credit facilities. However, those facilities have not been captured as restructured or rescheduled by the IT system of the Company. | Change in maturity dates are due to change the rental due date of the customer as per their request. There is no tenor change apparently. However, this matter will be further verified. Change in interest rate is due to adjusting the interest rate of staff loan to current market rate when the staff member is resigned from the Bank's service. | Recommended to upgrade the system to accurately capture the rescheduled and restructured loans. |
| (ii) Seven numbers of facilities with minus balance and another 310 number of facilities with minimal balances ranging from Rs.1 to Rs.10 were observed in the loan portfolio as at 31 December 2019. | Action will be taken to remove the zero or below minus facilities from the portfolio in future. | It is recommended to remove the minus and minimal balances from the system. |
| (iii) Though there are 13,379 number of facilities amounting to Rs.2,375 million flagged in the system as non performing facilities, no legal action has been taken against them. | Due to several defects in the documentation this was delayed. | Recommended to take legal actions against defaulted customers. |
| (iv) Seventy number of facilities which has zero disbursements have been | The seventy number of facilities include 04 lease | Recommended to remove the zero |

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| | <p>created and included in the portfolio. The fund has not yet been disbursed to the customers. Out of seventy facilities thirty facilities have been created during the period of November and December 2019.</p> | <p>facilities and others are pawning facilities.</p> <p>Three lease facilities have already been disbursed and the other facility has been closed.</p> <p>Zero balance pertaining to pawning advances have been removed from the active portfolio.</p> | <p>disbursed facilities in the system.</p> |
| (v) | <p>There are 213 numbers of facilities with existing legal cases which were not flagged in the system as non - performing customers.</p> | <p>Normally when a facility transferred to legal via system it marked as Legal. However, if the erroneous report was selected for the comparison and analysis of legal sub system and signature system details, the analysis would change. We will further analyze.</p> | <p>Recommended to upgrade the system to flag all the non performing customers in the system.</p> |
| (vi) | <p>Two Bank accounts which are closed as per the particular Board Paper are still appearing as active in general ledger.</p> | <p>Agreed. General ledgers will be closed by the end of 2020 after reconciling the amounts with the receipt of necessary details for reconciliation.</p> | <p>Recommended to speed up the respective accounts closure process.</p> |
| (vii) | <p>There were some entries which were posted directly to the financial statements subsequently without adjusting to the GL (SLFRS Adjustments). Such information is maintained on spreadsheets. This might lead to loss or manipulation of data. Therefore, the bank needs to evaluate the necessity of stronger process to ensure the data accuracy of such entries.</p> | <p>It is not practical to get completed Financial Statements from the system and we will ensure to check the accuracy and completeness in all future information.</p> | <p>The Company needs to go for a system solution for financial reporting to ensure the data protection and accuracy.</p> |
| (viii) | <p>The entire impairment calculation working of the Company is carried out manually in excel workbooks which increase the risk of material errors in the impairment estimation.</p> | <p>The main process of impairment that is LGD is calculated from the system. In addition, finance division rechecks that the portfolio balances agree with the excel sheets before calculating impairment computation.</p> | <p>It is recommended to the management to implement necessary actions to increase check and balances of the data output which are used for the impairment calculation.</p> |

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| (ix) | The Company has WHT balance of Rs.1,311,828 which has not included in the return due to unavailability of certificates. | Approval to be obtained from management to write off the balances if the respective departments are not in a position to submit the certificate prior to the conclusion of financial year 2020. | It is recommended for the management to maintain proper certificates of WHT. |
| | | Strict follow-up to be carried out to collect the certificates from respective departments within the financial year in future. | |

1.5.2 Unreconciled Control Accounts or Records

| Audit Issue | Management Comment | Recommendation | |
|-------------|--|--|--|
| (i) | There is an excess of Rs.4,470,035 in the overpayment account as at 31 March 2019 which the Bank was unable to trace against the loan and lease portfolio. The Company was unable to provide an aging of the mentioned excess as well. | Individual facility wise break, down available for the loan overpayment balance. Branch officers have not transferred available overpayment before close the facilities. Hence the over payment balance will be recognized as an income. | Ensure that general ledger balances are reconciled with the relevant portfolio balances. |
| (ii) | As per the Financial Statements the Bank owns 540 shares of CRIB. However, the share certificate states only purchase of 100 shares. | Call the confirmation from CRIB to determine the exact number of shares. The concern matter will be cleared by December 2020. | Ensure the exact number of shares owned by the Bank. |

1.5.3 Suspense Accounts

| Audit Issue | Management Comment | Recommendation |
|---|---|---|
| The Company was unable to reconcile Rs.2,867,968 worth of debit balances and Rs.2,525,500 worth of credit balance included in the suspense account and also unable to provide the origin or supporting documents for the relevant balances. | A balance amounting to Rs.1,418,425 was rectified on 30 January 2020 and other balances will be rectified by the year end 31 December 2020. | Recommended to reconcile and clear the balances included in the suspense account. |

1.5.4 Inappropriate Valuation or Estimation

| Audit Issue ----- | Management Comment ----- | Recommendation ----- |
|---|--|--|
| (i) The Company has fully depreciated property, plant and equipment which are still in use amounting to Rs.436 million. The Bank has not taken necessary arrangements to reassess the useful life of those assets based on the useable condition. | The process of developing a system-based PPE system to be completed by end of 2020. With the development, annual reviews will be made on residual values and adjust the useful life of the assets if required. | Recommended to reassess the useful life of fully depreciated assets which are still in use. |
| (ii) The Company has not get confirmed that the value of land and building has not changed significantly since its last valuation. | Company obtains full valuation every three years to check whether value of the land and building has changed significantly. However, in future company will obtain the desktop valuation at the end of each reporting period to identify any significant changes compared to the prior year. | It is recommended for the Company to undertake evaluations to ensure that the value of Land and Buildings have not changed significantly since its last valuation. |

1.5.5 Documentary Evidences not made available for Audit

| Audit Issue ----- | Management Comment ----- | Recommendation ----- |
|--|---|---|
| The management was unable to provide the share certificate of San Michele Limited for the shareholding of 50,000 shares. | The share certificate of San Michele Limited is currently unavailable at Company Secretary Division and Corporate Advisory Division. This matter has been further verified to make sure the status of shareholding. It should be noted that the book balance of LKR 500,000 is coming over the years in the accounts as the provision made in full. | Ensure the safe custody of important documents within the Bank. |

1.4.2 Accounts Receivable and Payable

1.6.1 Payables

Audit Issue

Long outstanding balances were observed in temporary accounts of creditors, unidentified direct deposit, un-presented payments and unscheduled payment collection accounts. The age analysis of the long outstanding balances is given in the below table.

| Description | Outstanding Period (Years) | | | |
|--------------------------------|----------------------------|-------------------|-------------------|--------------------|
| | 0-1 | 1-3 | 3-5 | More than 5 |
| Creditors | 2,757,977 | 3,385,165 | 3,575,125 | 101,876,139 |
| Unidentified Direct Deposit | 3,828,498 | 20,178,176 | 13,243,884 | 3,394,665 |
| Un-presented Payments | 227,050 | 4,144,888 | 5,696,461 | 4,846,159 |
| Unscheduled Payment Collection | 6,841,504 | 304,012 | - | 7,145,516 |
| Total | 13,655,029 | 28,012,241 | 22,515,470 | 110,116,963 |

Management Comment

Agreed. Reconciliation is in progress with the relevant divisions. In additions, a policy is to be developed and approved by year end 2020 to clear all un-reconciled balances at the year end.

Recommendation

Recommended to clear the long outstanding balances in temporary accounts.

1.7 IT General Controls

Audit Issue

- (i) The segregation of duties has been violated in the change management documentation captured in the change management software for signature and velocity system.
- (ii) UAT was performed by the staff of the IT department but not by the respective business units in signature and velocity system.
- (iii) "UAT performed by" information is not captured in the change management documentation of the Velocity system.

Management Comment

A standardized process has already been introduced for change management system from 2020 onwards with the implementation of manage engine change management module.

Recommendation

Recommended to maintain segregation of duties in relevant IT applications.

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|--------|--|--|--|
| (iv) | The manager of IT -Velocity system act as the administrator of the velocity system at the application, database and operating system levels, the manager who is responsible for the change management procedure of the velocity system, the head of the development team of the velocity system which violates the principle of segregation of duties. | The person who is concerned here, is not the person who responsible for the change management procedure of MBSL. The same person is only having the view access to the application. However necessary corrective action will be taken by MBSL. | Recommended to maintain segregation of duties in relevant IT applications. |
| (v) | There is no system generated development log to track the developments done to the live environment of the velocity system. | In order to have a system generated development log, we need to have an application life cycle management solution implemented in MBSL which is budgeted for fourth quarter of 2021. Until such time MBSL will continue the existing manual process of maintain development log. | Recommended to have a system generated development log to track the developments done to the live environment. |
| (vi) | The company employs an outdated disaster recovery plan which was last revised on 14 August 2014. | This will be updated with the ISO:27001(ISMS) certification for IT department. | Recommended to review and update the disaster recovery plan of the Bank. |
| (vii) | The company had not tested the existing business continuity plan (BCP) during the financial period. | Agreed and target date for completion is August 2021. | It is recommended to test the existing business continuity plan of the Company. |
| (viii) | It was unable to review the timely deactivation for user accounts for resigned employees in the Velocity system due to not providing "Deactivation Date" by the active directory. | Velocity system are not designed to capture the termination date of the user enrollment to the AD user account. AD has not provided in-build option itself to maintain the user deactivation date. However all the user creation/transfer/termination information are captured by the Velocity UMS (User Management System). | It is recommended to make necessary changes to the Velocity system to capture the termination date of user enrollment. |
| (ix) | It was observed that one employee has been enrolled to two user accounts | One of these enrollments are invalid. Hence, the invalid | It is recommended to make necessary |

(based on employee ID) in the velocity system. enrollment was disabled and re-enrolled the same user to the system with the correct information as the system does not facilitate to delete the user enrollment data. modifications to the system to avoid duplications.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs.57 million and the corresponding profit in the preceding year amounted to Rs.447 million. Therefore, a deterioration amounting to Rs.390 million of the financial result was observed. The main reasons for the deterioration are the increase of interest expense, increase of impairment charges and reduction of other operating income during the year under review when compare with the preceding year.

2.2 Trend Analysis of major Income and Expenditure items

Analysis of major income and expenditure items of the year under review as compared with the preceding year with the percentage of increase or decrease are given below.

| Description | 2019 (Rs.'000) | 2018 (Rs.'000) | Change (%) | Reason for the Variance |
|---|-------------------|-------------------|---------------|--|
| Interest and Similar Expenses | 4,331,275 | 3,752,471 | 15.4 | Deposit base has increased from 21 billion in 2018 to 23 billion by end of 2019 showing a 9 per cent growth rate. |
| Other Operating Income | 68,938 | 177,129 | 156.9 | Profit on sale of real estate, recovery of bad debts write off and profit/(loss) on sale of property, plant and equipment has decreased by 4 percent, 33 percent and 992 percent respectively in the year under review when compare with the preceding year. |
| Impairment charges for loans and other losses | 279,673 | 134,531 | 107.9 | Non-performing loan ratio has been increased by 22 per cent in the year under review when compare with the preceding year by following similar situation of the whole industry. |

2.3 Ratio Analysis

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

| Description | Sector Ratio | Company | |
|----------------------------------|---------------------|---------|-------|
| | | 2019 | 2018 |
| Performance Ratios | | | |
| Return on Equity (ROE) | 10.6 | 4.0 | 6.3 |
| Return on Assets (ROA) | 1.0 | 0.28 | 0.51 |
| Interest Margin | 3.6 | 6.52 | 7.83 |
| Assets Quality Ratio | | | |
| Net Nonperforming Advances (NPL) | 4.6 | 7.93 | 6.51 |
| Capital Adequacy Ratios | | | |
| Statutory Ratio | Minimum Requirement | 2019 | 2018 |
| Tier 1 Capital | 6.5 | 5.6 | 5.42 |
| Total Capital | 10.5 | 8.78 | 9.88 |
| Liquid Assets Ratio | 20 | 12.30 | 10.20 |

3. Operational Review

3.1 Identified Losses

| Audit Issue | Management Comment | Recommendation |
|---|--|--|
| (i) The Company has invested Rs.130 million in commercial paper of Seylan Group Companies. The invested companies were later bankrupted and the Bank continues to keep the total investment of Rs.435 million in the books. The management is certain that the amount is irrecoverable and has booked a provision for the same amount. However, this amount keeps been carried forward. | Agreed. A Board paper was presented for write off. Expects to be completed by end of 2020. | Recommended to write off the unrecoverable balances after obtaining necessary approvals. |
| (ii) The Company has recorded losses amounting to Rs.45,203,058 due to frauds and errors in | Whatever amounts recoverable without any | Recommended to strengthen the internal |

2019 and was able to recover a sum of Rs. 8,056,058. The Company had terminated 18 no. of employees who are related for the fraud cases during the year. litigations have been recovered whilst other are subject to legal process. control process of the company to avoid frauds.

3.2 Delays in Projects or Capital Work

| Audit Issue ----- | Management Comment ----- | Recommendation ----- |
|--|---|---|
| (i) The company has completed the project of “Kottawa, Horahena” which has a project cost of Rs.165.8 million on 17 January 2020 and a time delay of 8 months was observed towards the completion. | While we were developing the land, we had to stop the overall project operation from 19th March 2020 to mid-July 2020 as the country was fully lockdown due to pandemic situation. During the corona period, we commenced the sales and sold all the blocks, achieving the budgeted profit (The last block was sold on 11.11.2020). | Recommended to take all necessary steps for the timely completion of the project. |
| (ii) The Project of “Madampella” which has a project cost of Rs.138.3million has not been completed in December 2020, even though it is due to be completed on 17 March 2020. | On 26 February 2020, the selected contractor was terminated from development work, due to the delay in the progress of development. Therefore, we had to follow the procurement guidelines and selected the second lowest contractor. While we were developing the land, we had to stop the overall project operation from 19 March 2020 to 22 May 2020 as the country was fully lockdown due to pandemic situation. We restarted the development in 22 May 2020. Again, we had to stop the overall project operation from 04th October 2020 to 10 December 2020 as the Gampaha District was locked down due to the 02-corona pandemic wave. Ultimately, we completed the developments in end December 2020. We commenced the sales and as at date we have achieved 25% of the sales. | Recommended to take all necessary steps for the timely completion of the project. |

3.3 Human Resources Management

Audit Issue

The actual cadre of the Bank as at 31 December 2019 was 1,000 employees while the approved cadre is 1,338. Hence 338 no. of vacancies exists as at that date.

Management Comment

Approval was obtained focusing the future business growth to increase the cadre accordingly.

Recommendation

It is recommended to take necessary steps to recruit employees for the vacant positions of the company.