

1. Financial Statements

1.1 Opinion

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 2020 comprising the statement of financial position as at 31 December 2020 and the statement of profit or loss, the statement of comprehensive income, statement of changes in equity and the 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 direction 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 2020 and of its financial performance and its 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 Audit Scope

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's internal control.
- 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.

1.5 Audit Observations on the preparation of Financial Statements

1.5.1 Internal Control over the preparation of financial statements

Audit Issue	Management Comment	Recommendation
(i) The objective evidences have not been properly considered by the Company when assessing the individually significant customers for the impairment and hence the real risk of the customer is not taken into consideration.	<p>The following actions have been taken in order to evaluate significant accounts.</p> <ol style="list-style-type: none"> 1. Carrying out analysis of financial statement of the borrower where available. 2. Call for post credit evaluation of the customer quarterly basis from the respective branches. 3. Periodic evaluation of cash flow of the account. 	Recommended to perform a proper customer evaluation in order to make a correct impairment provision.

Current Status

A “Customer Evaluation Form” has been introduced in consultation with the Risk Division to evaluate customer risk properly. Further, a training programme conducted to train staff to assess individual customer risk properly by EY resource personnel.

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| (ii) | <p>105 numbers of facilities which have zero disbursements have been created and included in the portfolio. The fund has not yet been disbursed to the customers. Out of 105 facilities 97 facilities have been created during the period of November and December 2020.</p> | <p>These are duplicate and/or error creation of moratorium loans where customers withdrew their requests while on process. However, some of these accounts were closed and other remaining will be closed in the system.</p> <p><u>Current Status</u>
The said facilities had been cleared in the system.</p> | <p>Actions need to be taken for not to have zero disbursed facilities in the system.</p> |
|------|--|--|--|

1.5.2 Inappropriate Valuation or Estimation

Audit Issue	Management Comment	Recommendation
<p>The Company has fully depreciated property, plant and equipment which are still in use amounting to Rs.521 million. The Company has not taken necessary arrangements to reassess the useful life of those assets based on the useable condition.</p>	<p>Once the physical verification and fixed assets cording completed, necessary action will be taken depending on the amount and cost involved in revaluation.</p> <p><u>Current Status</u> As entire class of asset type useful life need to be reassessed with a high number of items. Considering high cost involved, advice of external auditor is being consulted.</p>	<p>Recommended to reassess the useful life of fully depreciated assets which are still in use.</p>

1.6 Accounts Receivable and Payable

1.6.1 Receivables

Audit Issue	Management Comment	Recommendation
A long outstanding receivable balance of Rs.14,147,683 was observed which is categorized as “Insurance Agency Commission Receivable”. The balance consists of a VAT portion of insurance companies which the client has not received.	A Board approved policy has been developed to clear the long outstanding balances with the Internal Audit Division’s recommendation. Internal Audit has submitted write off paper to the Audit Committee and it has been approved by the Audit Committee to write off the long outstanding balance as per write off policy.	Recommended to clear the long outstanding balances.
	<p>Current Status</p> <p>Long outstanding balance of Rs.14 Mn cleared in October 2021 after obtaining Board approval.</p>	

1.6.2 Payables

Audit Issue	Management Comment	Recommendation																																		
Long outstanding balances were observed in temporary accounts of creditors, unidentified direct deposit and un-presented payments accounts. The age analysis of the long outstanding balances is given in the below table.	Considering average loan period of 5 years, a Board approved policy has been developed to clear the long outstanding balances with the Internal Audit Division’s recommendation. Internal Audit has submitted write off paper to the Audit Committee and it has been approved by the Audit Committee to write off the long outstanding balance as per write off policy.	Recommended to clear the long outstanding balances in temporary accounts.																																		
<table border="1"> <thead> <tr> <th rowspan="2">Description</th> <th colspan="4">Outstanding Period</th> <th rowspan="2">Total</th> </tr> <tr> <th>0-1</th> <th>1-3</th> <th>3-5</th> <th>More than 5 Years</th> </tr> </thead> <tbody> <tr> <td>Creditors</td> <td>12,600</td> <td>7,852,644</td> <td>3,097,115</td> <td>104,601,496</td> <td>115,563,855</td> </tr> <tr> <td>Unidentified Direct Deposit</td> <td>-</td> <td>-</td> <td>4,253,600</td> <td>16,638,549</td> <td>20,892,149</td> </tr> <tr> <td>Un presented Payments</td> <td>-</td> <td>1,399,678</td> <td>2,354,981</td> <td>9,947,389</td> <td>13,702,048</td> </tr> <tr> <td>Total</td> <td>12,600</td> <td>9,252,322</td> <td>9,705,696</td> <td>131,187,434</td> <td>150,158,052</td> </tr> </tbody> </table>	Description	Outstanding Period				Total	0-1	1-3	3-5	More than 5 Years	Creditors	12,600	7,852,644	3,097,115	104,601,496	115,563,855	Unidentified Direct Deposit	-	-	4,253,600	16,638,549	20,892,149	Un presented Payments	-	1,399,678	2,354,981	9,947,389	13,702,048	Total	12,600	9,252,322	9,705,696	131,187,434	150,158,052		
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Current Status

Creditors

Balance mentioned above has been reduced to Rs.104.5 Mn.

Unidentified Direct Deposits

Out of the balance mentioned, more than 5 years amount of Rs.18Mn has been cleared in October & November 2021 after obtaining Board Approval.

Un-presented Payments

Out of the balance mentioned more than 2 years amount of Rs.11Mn has been cleared in October & November 2021 after obtaining Board approval.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a loss of Rs.1,108 million and the corresponding profit in the preceding year amounted to Rs.103 million. Therefore, a deterioration amounting to Rs.1,211 million of the financial result was observed. The main reasons for the deterioration are the decrease of interest income, increase of impairment charges for loans and other losses and the recognition of impairment charge of Rs.463 million on investment in subsidiary.

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	2020 (Rs.'000)	2019 (Rs.'000)	Change (%)	Reason for the Variance
Interest and Similar Income	4,950,638	6,532,729	(24)	Interest income has been decreased mainly due to decrease of gross loans and advances in the year under review when compare with the preceding year and charging of Rs.658 million on moratorium loans. Gross loans and Advances for the year under review have been decreased by Rs.1,912 million or 6 per cent when compare with the preceding year.
Interest and Similar Expenses	3,532,790	4,331,275	(18)	Interest expense has been decreased due to decrease of deposit base and the borrowings of the company. The deposit base of the company has decreased by Rs.1,031 million or 4.5 per cent in the year under review when compare with the preceding year. The borrowings also decreased by Rs.2,312 million or 30 per cent in the year under review when compare with the preceding year.
Fee and Commission Income	116,893	208,928	(44)	Low documentation income and insurance income reported due to low disbursements impacted by negative macroeconomic conditions after COVID 19.
Fee and Commission Expense	22,071	25,847	(15)	Low business introducer commission paid due to low disbursements impacted by negative macroeconomic conditions after COVID 19.

Other Operating Income	46,541	68,938	(32)	Drop in real estate income and written off collection impacted by negative macro-economic conditions after COVID 19.
Impairment Chargers for Loans and Other Losses	563,431	279,673	101	Increase in over 90 arrears portfolio due to negative macro-economic conditions after COVID 19.
Impairment reversal/(charge) of investment in subsidiary	(462,544)	270,692	271	Drop in business valuation due to negative macro-economic conditions after COVID 19.

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	
		2020	2019
Performance Ratios			
Return on Equity (ROE)	10.9	(54.39)	4.00
Return on Assets (ROA)	1.0	(3.20)	0.28
Interest Margin	3.1	4.50	6.52
Assets Quality Ratio			
Gross Nonperforming Advances (NPL)	4.7	13.9	10.6
Capital Adequacy Ratios			
Tier 1 Capital (Minimum 6.5%)		4.41	5.64
Total Capital (Minimum 10.5%)		5.59	8.64
Statutory Ratio			
Liquid Assets Ratio		8.17	12.30

The following observations are made in this regard.

- (i) Return on Equity and Return on Asset ratios became adverse in the year under review due to reported loss of Rs.1,108 million.
- (ii) The Company's Tier 1 Capital and Total Capital ratios were 4.41 per cent and 5.59 per cent respectively for the year 2020 which are below the minimum regulatory requirement of 6.5 per cent and 10.5 per cent. Hence Central Bank of Sri Lanka has imposed with caps of Rs.35 billion on loan and advances (net of interest in suspense) and Rs.23 billion on deposits with effect from April 2019 and May 2019 respectively.
- (iii) The Gross Non performing Advance Ratio of the company has increased to 13.9 per cent during the year under review from 10.6 per cent in the preceding year and it was observed that the ratio is much higher than the sector ratio of 4.7 percent.

3. Operational Review

3.1 Identified Losses

The major fraudulent activities investigated by the Internal Audit division during the year 2020 are summarized below.

Audit Issue		Management Comment	Recommendation
Branch	Description	Total Financial Loss Incurred (Rs.)	
Monaragala	11 leasing facilities were granted on forged documents.	16.63 Mn	According to the instruction given by Legal Division, legal actions have been initiated against the customers and way forward for other cases depending on the progress of the cases. Branch Manager has been transferred to Hatton Branch and presently working in the Recovery Division. Recommended to take necessary actions to prevent from occurring such type of fraudulent activities in the future.

Tissamaharama	Obtaining 21 no. of loans and leasing facilities by presenting forged and false documents.	32.17 Mn	The Branch Manager has been terminated with effect from 20-02-2020 (Later Dated 15-07-2021) based on disciplinary inquiry. Further, case has been filed with CID on 13-07-2021 against the Branch Manager and the third party involved in this fraud.	Recommended to take necessary actions to prevent from occurring such type of fraudulent activities in the future.
Galle	Misappropriation of Mass Eco Cabana cheque.	5.215 Mn	Complaint made to Fraud Bureau on 25 June 2021 to recover the loss from former Galle branch manager.	Recommended to take necessary actions to prevent from occurring such type of fraudulent activities in the future.

3.2 Operational Inefficiencies

Audit Issue

The following common weaknesses have been identified by the internal audit division during their branch audit inspections in relation to the pawning advances of the Company.

- (i) Non availability of updated divisional manual was observed.

Management Comment

We had pawning procedure manual approved in 2019, Pawn brokering procedure manual. However, we did not have updated divisional procedure manual at that time and last updated in 2014. Now, this has been rectified. We have pawning procedure manual by amalgamating pawn brokering procedure manual and divisional procedure manual into one and approved by the Board in 2021.

Recommendation

It is recommended to review and update the Manuals of the Company on frequent basis.

(ii) Approving the pawning advances by violating the delegated authority limits prescribed by the Company.	In case, there was a practical issue to get the manual approval as per DA since approval should have to be obtained from AGM Deposit or CEO depending on the amount. Memo has to be sent to Head Office for these purposes. So that, we have observed the delay in getting manual approval. However, system approval has been taken. This has been rectified now and approval has been taken by Email.	It is recommended to ensure the compliance with circular instructions issued by the Company.
(iii) Granting pawning advances by exceeding maximum pawning limit per customer.	This is not a common deviation and rarely occurred.	It is recommended to ensure the compliance with circular instructions issued by the Company.
(iv) Not signing the Pawning Daily Advance granting report by the relevant authorities.	No Comment	It is recommended to ensure the compliance with circular instructions issued by the Company.
(v) Accepting low caratage gold articles.	This was occurred with bulk pawning advances in many cases. There were some articles below 2g. This has been rectified now amending procedure manual to accept the articles below 2g with bulk pawning advances and even to accept below 2g for individual cases with the approval of Manager Pawning.	It is recommended to ensure the compliance with circular instructions issued by the Company.
(vi) Non-renewal of weighing scale licenses by some branches.	This is not a common deviation, and it has happened rarely due to Covid impact.	It is recommended to renew the weighing scale licenses on due dates.

As per the internal audit reports issued during the year 2020, incomplete and inadequate documentation in the security and correspondence files was the common weakness observed in relation to the loan granting process of the Company.	No Comment	It is recommended to ensure the compliance with circular instructions issued by the Company for the loan granting process.
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3.3 Procurement Management

Audit Issue	Management Comment	Recommendation												
<p>Considerable deviations were observed when analyzing the progress achieved against the procurement targets for the year 2020. The details are summarized below.</p> <table border="0" style="margin-left: 40px;"> <thead> <tr> <th style="text-align: left;">Procurement Type</th> <th style="text-align: right;">Estimated Value (Rs.)'000</th> <th style="text-align: right;">Actual (Rs.)'000</th> <th style="text-align: right;">Progress as a % of Estimate</th> </tr> </thead> <tbody> <tr> <td>Office Equipment</td> <td style="text-align: right;">59,687</td> <td style="text-align: right;">4,662</td> <td style="text-align: right;">7.81</td> </tr> <tr> <td>Branch Relocation</td> <td style="text-align: right;">30,250</td> <td style="text-align: right;">8,181</td> <td style="text-align: right;">27.04</td> </tr> </tbody> </table>	Procurement Type	Estimated Value (Rs.)'000	Actual (Rs.)'000	Progress as a % of Estimate	Office Equipment	59,687	4,662	7.81	Branch Relocation	30,250	8,181	27.04	No Comment	It is recommended to prepare an achievable procurement plan for a particular year.
Procurement Type	Estimated Value (Rs.)'000	Actual (Rs.)'000	Progress as a % of Estimate											
Office Equipment	59,687	4,662	7.81											
Branch Relocation	30,250	8,181	27.04											

3.4 Human Resources Management

Audit Issue	Management Comment	Recommendation
The approved cadre of the Company for the year 2020 was 1,299 employees and the actual cadre as at that date was 976. Therefore 414 posts are vacant as at 31 December 2020. As well 88 numbers of excess employees were observed in Junior Executive category. Details are given below.	There are no 414 vacancies at the company as at 31 December 2020 against the approved cadre Vs actual cadre. The approval cadre is mainly aimed at business expansion which was not materialized. If there is resignation a replacement is given.	It is recommended to fill the existing vacancies for a smooth functioning of company's operations.

Designation	Approved Cadre	Actual Cadre as at 31/12/2020	Variance	Based on the business requirements and to minimize the cost based on resignation staff were recruited to Junior Executive grade who were in higher grades and also to attract marketing staff they were recruited to junior executive grade.
Chief Executive Officer (Actg.)	1	1	-	
Deputy General Manager	5	2	3	
Assistant General Manager	11	5	6	
Chief Manager/Regional Manager	10	8	2	
Senior Manager	28	16	12	
Manager	50	45	5	
Deputy Manager	120	61	59	
Assistant Manager	101	91	10	
Executive	170	122	48	
Junior Executive	75	163	(88)	
Staff Assistant	505	402	103	
Marketing Assistant	131	3	128	
Office Assistant	73	35	38	
Training Assignment	7	7	-	
Drivers	9	10	(1)	
Other	3	5	(2)	
Total	1299	976		