

State Mortgage and Investment Bank - 2023

1. Financial Statements

1.1 Opinion

The audit of the financial statements of the State Mortgage and Investment Bank (the Bank) for the year ended 31 December 2023 comprising the statement of financial position as at 31 December 2023 and the statement of income, 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 material accounting policy 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 provisions of the National Audit Act No. 19 of 2018 and Finance Act No. 38 of 1971. My comments and observations which I consider should be report to Parliament appear in this report.

In my opinion, the accompanying financial statements give a true and fair view of the financial position of the Bank as at 31 December 2023, 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 Bank'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 Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Bank 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 Bank.

1.4 Audit Scope

My objective is 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 skepticism 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 Bank'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 Bank'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 Bank 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 Bank, and whether such systems, procedures, books, records and other documents are in effective operation;
- Whether the Bank has complied with applicable written law, or other general or special directions issued by the governing body of the Bank;
- Whether the Bank has performed according to its powers, functions and duties; and
- Whether the resources of the Bank 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 Suspense Accounts

Item	Amount Rs.	Period in Suspense	Management Comment	Recommendation
1/06/1102	266,809	3 years	The issue originated during the 2020 COVID – 19 period. In 2020, branches took steps to reconcile the discrepancies and after the reconciliation process, the remaining discrepancy was reduced to 244,489.05. Bank expects to write off this balance with concurrence of BAC.	Financial statements should be prepared after clearing the suspense accounts.

1.6 Accounts Receivable and Payable

1.6.1 Payables

Audit Issue	Management Comment	Recommendation
a) Instances were observed where the installments were received for EPF loans even after the settlement of such loans. Such payments received were credited to the “ Customer Refund Closed Loan Account ” and the accumulated balance of that account was Rs.25,241,363 for the year ended 31 December 2023. The corresponding balance in the preceding year amounted to	Balance of the Customer Refund Closed Loan Account as at 24/09/2024 is Rs. 22,021,322.47. Clearance of this balance is being in progress.	Bank should take actions to refund the remaining balance to the relevant customers.

Rs.48,931,177 and therefore a reduction of the balance by Rs.23,689,814 was observed when compare with the last year.

- b) Payments made by customers for their loan installments were credited to a ledger account named “**Un Appropriated Loan Balance Account**” due to multiple reasons such as overpayments and part payments of the installments without being credited to the relevant loan account of the customer. The accumulated balance of that account as at 31 December 2023 was Rs.38,935,963 relating to 16,587 numbers of loans. Details relating to the balance lying in the respective account are given bellow.

Year	No. of Loans	Amount (Rs.)
Before 2020	689	3,133,424
2020	2,474	2,327,850
2021	270	851,451
2022	9,142	6,766,853
2023	4,012	25,856,385
Total	16,587	38,935,963

Un Appropriated Loan Balance Account (UAP) represents the payments made by the customers to their loan account with multiple reasons. Payments made higher amount than given monthly installment. Payments made by client more than the balance principle outstanding. Payments made by customers for future monthly installments. Payments made in relation to loan files with legal proceedings. Payments made in relation to the loan files of the deceased. UAP balances vary daily based on client payments .This UAP a/c's relating to loan accounts are reconciled monthly.

The Bank should take actions to recognize and settle the long outstanding balances in the relevant account.

1.6.2 Advances

Audit Issue	Management Comment	Recommendation
a) The Non-Performing Loan/Stage 3 Loan Ratio of the Bank as at 31 December 2023 was 25.99 per cent. However, the recoverability of EPF Loans are guaranteed by Central Bank of Sri Lanka and therefore the Non – Performing Loan / Stage 3 Loan Ratio of the Bank which was calculated by excluding the EPF loans shows lower percentage of 12.32 per cent which was above the Licensed Specialized Bank Industry Ratio of 10.6 percent. The details are given below.	We have the ability to claim the loans 2 years after completion of the tenure of the loan. (Below 730 DPD). Therefore we should give special attention on EPF Loans which exceeds more than 02 years (730 DPD). As at 31/07/2024 there are 1,498 EPF Loans which are having more than 730 days	Satisfactory actions need to be taken to minimize the Non-Performing Loan/Stage 3 Loan Ratio of the Bank.

Description	31.12.2023	31.12.2022
NPL Ratio (All Loans)		
Total Loans and Advances (millions of rupees)	41,007	41,117
Total Non-Performing Loans / Stage 3 Loans (millions of rupees)	10,659	9,054
Non-Performing Loan / Stage 3 Loan Ratio (%)	25.99%	22.02%
NPL Ratio (Excluding EPF Loans)		
Total Loans and Advances (Excluding EPF Loans) (millions of rupees)	32,167	32,736
Total Non-Performing Loans (Excluding EPF Loans) (millions of rupees)	5,051	3,262
Non-Performing Loan / Stage 3 Loan Ratio (%)	15.7%	9.97%

DPD. Out of those we have already submitted and obtained approval from Recovery Committee and Board of Directors to clear 1,177 loan accounts and the B.P.O is Rs.6.58 Mn.

- b) The bank has granted credit facilities under different product categories. The following observations are made regarding the credit facilities distributed among different product categories and product category wise Non-Performing Loan ratios in past three year's period.
- Personal, Personal Mortgage, Mortgage and EPF Loan including Estate categories were the main product categories of the Bank during the past three years period which contributed 95 per cent of the total loan portfolio of the Bank.
 - Contribution of the Bank by granting loans towards the other sectors of the economy including Micro and SME sectors are insignificant.
 - The Estate Loan category and the EPF Loan category record the highest NPL ratios of the Bank during the past three year's period.

Bank is not permitted to expand its business domain to untouched business segments due to restrictions in act of incorporation, however, deviating of its traditional business segments, bank has moved to granting loans to SEM sector and granting of facilities for working capital requirement of corporate sector. As of 31.12.2023 loans granted to SME sector was Rs 1,100 Mn.

It is recommended to expand the loan distribution among different product categories such as SME, Micro, agriculture and industrial which are allowed under SMIB Act

1.7 Non-compliance with Laws, Rules, Regulations and Management Decisions etc.

Reference to Laws, Rules Regulations etc.	Non-compliance	Management Comment	Recommendation
a) State Mortgage and Investment Bank (Amendment) Act, No.29 of 1984	The Board of Directors consisted with only four directors, though proper persons should be appointed.	Receiving nominations for the Board was delayed due to the chaotic political situation of the country. Subsequent to several requests from the Bank, Seven Nominations were received for the Board of Directors. However, only four directors received CBSL clearance for their appointments.	Stipulated number of directors by SMIB Act, should be appointed to the Board.
b) Central Bank Directions No. 04 of 2022 – Section 7	The bank has not fulfilled the minimum regulatory capital requirement of Rs.7.5 Bn before 31 December 2023.	According to Provisions in the SMIB Act, Bank is not permitted to issue qualifying financial instruments to raise capital. Action has already taken to send a letter to Ministry of Finance to obtain their concurrent to issue perpetual debts to raise capital to arrest this issue.	The bank needs to take actions to fulfill the minimum regulatory capital requirement.

1.8 Non-compliance with Tax Regulations

Audit Issue	Management Comment	Recommendation
The Debt Repayment Levy (DRL) and Nations Building Tax (NBT) amounting to	DRL and NBT balances will be written off in 2024 after obtaining	Ensure the recoverability of balances when

Rs.3,603,588 and 15,591,023 respectively have been recognized as receivable balance in the Financial Statements as at 31 December 2023, even though the grace period of four years given to apply for the refund by section 150(3) of Inland Revenue Act of No.24 of 2017 has already Elapsed.

board approvals.

identifying as receivables in the Financial Statements.

1.9 IT General Controls

Audit Issue

Information System of the Bank is operating with an insufficient storage capacity and had made it impossible to maintain some important data in the system and retrieve data and system backup where necessary.

Management Comment

This issue will resolve after migration to new system.

Recommendation

It is recommended to maintain sufficient storage capacity.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a loss of Rs. 1,164,780,667 and the corresponding loss in the preceding year amounted to Rs. 89,005,118. Therefore deterioration amounting to Rs. 1,075,775,549 of the financial result was observed. The reasons for the deterioration are significant decrease of the net interest margin and the increase in impairment charges.

2.2 Trend Analysis of major Income and Expenditure items

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

Description	Variance Increase/(Decrease) (Rs'000)	Variance (%)	Reason for the variance
Interest income	1,922,164,109	26	Increase of interest rates of existing and newly granted loans and investments.
Interest expense	3,269,613,211	60	Increase of interest rate on savings and fixed deposits.
Net fair value gain/(loss)	159,667,635	7480	Value appreciation on unit trust investments.

Impairment charges	195,645,302	53.5	Increase in NPL loans.
Income tax expenses/ (gain)	(129,153,861)	-44	Significant loss incurred during the year.
VAT on financial services	(225,940,777)	-98	Loss incurred during the year.

2.3 Ratio Analysis

The following important accounting ratios of the Company for the last 4 years period and the sector ratio of the year under review are given below.

Description	Sector Ratio (2023) (%)	Bank Ratio (%)			
		2023	2022	2021	2020
Profitability Ratio					
Return on Average Equity (ROE)	7.72	-16.82	3.17	4.11	6.09
Return on Average Assets (ROA)	0.45	-2.01	-0.16	0.76	1.15
Net Interest Margin (Percentage)	2.94	1.02	3.52	4.34	4.24
Capital Adequacy					
Basel 111 – Tier I (Minimum 7%)		18.81	18.81	21.91	21.58
Basel III – Total Capital (Minimum 8.5%)		18.89	19.76	23.87	22.67
Asset Quality					
Gross Non-Performing / Stage 3 Advance (Including EPF) Loans		25.99	22.02	19.84	22.94
Gross Non-Performing / Stage 3 Advance (Excluding EPF) Loans	10.6	12.32	10.31	-	-
Liquidity Ratios					
Liquidity Coverage Ratio (Percentage) (100%)		175.14	148.1	115	116

3. Operational Review

3.1 Operational Inefficiencies

Audit Issue	Management Comment	Recommendation
a) Non-capitalized EPF loan disbursements were observed in the system which would increase the risk of frauds since the Bank has not recognized all the non-capitalizations due to inefficiencies of the existing system.	The system was checked for all possible non-capitalized loans and there is a very little possibility of such non-capitalized loans in presence.	System controls needs to be strengthened to minimize the fraud risk.
b) Total loan portfolio of the last month should be sent to the Credit Information Bureau (CRIB)	There were some challenges in reporting loans timely due to	Satisfactory actions need to be taken in

within 5 working days. However, the Bank has reported significant delays to send details of newly introduced corporate loans and interest moratorium loans to the CRIB and the delay was counted up to 30 months.

data inconsistencies and time taken to correct data issues. Existing programs developed in AS 400 language are not capable of reporting newly creates loan products without modification to existing programs. Required developments are progressing slowly due to lack of AS 400 developers.

A data cleansing activity is ongoing with the new core banking implementation and with the new core banking system go live, SMIB will be able to report data on time.

order to comply with the reporting requirements to CRIB.

3.2 Procurement Management

Audit Issue	Management Comment	Recommendation
a) The master procurement plan that should be prepared according to section 4.2 of the procurement guideline 2006 has not been prepared by the Bank.	The procurement entity has taken step to prepare the master plan which ever in movements procurement activities has been carried out.	Master procurement plan should be prepared according to the procurement guideline 2006.
b) The Procurement plan prepared of a one year period was not prepared according to the prescribed format given by procurement guidelines 2006, and does not provide adequate information to act upon and measure the performance of planned activities.	While accepting the observation the entity has taken steps to improve the plan given correct formats.	Procurement plan should be prepared according to the prescribed format given by procurement guidelines 2006.
c) According to the PED Circular No.08/2019, dated 17 December 2019 for Implementation of the Electronic Government Procurement System in Sri Lanka, all government entities need to be registered with the national e-GP system before 31 January 2020. However the bank has not registered with the e-GP system up to date of audit on 31 August 2024.	Accepted and the procurement entity has taken action to register National E –GP System.	Bank should be registered with E – GP System.

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| <p>d) The bank has not prepared procurement time schedules as required by section 2.5 and 2.6 of the procurement guidelines 2006.</p> | <p>While accepting the entity has taken step to maintain PTS on going documents.</p> | <p>Procurement time schedule should be prepared by the bank.</p> |
| <p>e) <u>Procurement of marketing promotion service provider</u></p> | | |
| <p>i) Declarations which should be made according to the Section 2.12 of the Procurement Guideline 2006, were not made by the members of the Procurement Committee and Technical Evaluations Committee (TEC).</p> | <p>According to existing organizational practice, statements are not taken from the members of the Technical Committee. However, this will be considered while formulating the new procurement policy manual.</p> | <p>Both TEC and PC members should made declarations.</p> |
| <p>ii) The head of TEC appointed by the Bank had a proven close relationship with a bidder whom was finally selected as the successful bidder.</p> | <p>Technical Committee (TEC) for evaluation of bids and requirements consists of four members. Appointing head of marketing to TEC is indeed a right decision due to expertise and qualification in digital marketing.</p> | <p>Employees those who connected with potential bidders should not be appointed to PC or TEC due to conflict of interest</p> |
| <p>f) <u>Procurement of Core Banking System (Rs.197 Mn)</u></p> | | |
| <p>i) Following documents were not maintained relating to the process of the procurement.</p> <ul style="list-style-type: none"> • Appointment letters for members of the Technical Evaluation committee (TEC). • Approval given by TEC for initial bidding documents. • Minute of the pre bid meeting. • TEC meeting minutes relevant to extension of closing date of bid. • Procurement Committee (PC) meeting minute approving the addendum. | <p>Management comments were not provided.</p> | <p>The Bank should comply with the directions given in Procurement Guideline and should ensure that proper process has been followed up to ensure the transparency of the procurement process.</p> |
| <p>ii) Members of both PC and TEC were not jointly attended the first meeting and agreed with the procurement time schedule as per the section 2.11.1(c) of the procurement guidelines (2006).</p> | | |

- iii) Declarations which should be made according to the section 2.12 of the procurement guideline 2006, has not been provided by the members of Procurement Committee (PC) and Technical Evaluations committee (TEC).
- iv) Payment method has been changed significantly after considering the bidder's request at the pre-bid meeting or later in the procurement process. The participation for the bidding process may be higher if changed the payment terms earlier while later change is controversial.
- v) Though the contract to procure Core Banking System should be signed by 18 June 2020, as per the procurement time schedule, the signing was delayed up to 11 January 2023.

3.3 Defects in Contract Administration

Audit Issue	Management Comment	Recommendation
<p>The Core Banking System should be implemented within one year according to the agreement effective date by 11 January 2023, though the system was not implemented until the reporting date of September 19, 2024</p>	<p>Deliverable scheduled to be delivered by the core banking vendor by Apr 2024 was extended till end Jul 2024. This has resulted an extended time required to test the functionalities. This was due to detail requirement gathering was done after commencement of the project and initially assessed time was not sufficient to provide full requirement. This was discussed during the core banking implementation joint steering committee on 11th Jun 2024. All parties agreed to revise the go live readiness date to 22nd Oct 2024. Since complete data migration of existing data required 3-4 days, live operation of new core</p>	<p>The Bank should ensure the timely implementation of Core Banking solution to overcome the deficiencies experienced in the current system.</p>

banking system will start from beginning Nov.2024.

4. Accountability and Good Governance

4.1 Effectiveness of Management Information System

Audit Issue	Management Comment	Recommendation
An effective management information system was not available within the Bank due to lack of availability and reliability of information.	A new unit will be formulated as the MIS unit which will be the central contact point of providing data. With the go live of new core banking system, this unit will start functioning Referring to board meeting minute 24.06.80.01, the MIS unit will be under Credit Administration Department. New core banking will be the main system in providing financial data and MIS unit will provide consistent data for banks information needs.	Bank should establish an effective management information system which provide accurate data for information need of the Bank.

4.2 Audit Committee

Audit Issue	Management Comment	Recommendation
Audit committee meetings were not held during the first seven months of the year due to non-appointment of members to the board.	Although, there were no meetings held during the first 06 months due to non-availability of Directors, the Bank was able to hold four Audit meetings during the year under review	Audit committee should review the operations of the Bank throughout the year.