
“In an upcoming economic environment SMIB was able to record healthy after tax profit of Rs. 256.4 million”

Chairman’s Review

It is with pleasure I place on record the annual progress and the future prospects for the State Mortgage and Investment Bank before you.

Business Outlook

The economic environment of the country in 2002 largely emerged to with a positive tone specially towards the end of the year from negative trend in the previous year. The peace process initiated by the United National Front government continued to be in effect through out the year thus spilling over the peace dividends to the economy. The contribution was witnessed mainly in the sectors of tourism, capital market development and construction industry.

On the other hand the government practised much discipline in managing government finance thereby reducing inflationary increase in money supply. Consequently the regulators were able to manage the interest rates more prudently. Sri Lanka witnessed switch to a free-floating rate for the country exchange value from a managed floating regime. This approach helped largely to manage the exchange rate. The other significant factor was the low interest rates. The Central Bank of Sri Lanka reduced it’s discounting and re-discounting rates on Treasury Bill discounting window to close at 11.75% and 9.75% respectively by the end of 2002.

In terms of GDP, the country was able to reverse the trend to a positive growth and was able to reach a 4%. We witnessed an improvement in the balance of payment account for the year. All in all the environment is in positive trend which the industrialists should take advantage of. The incentives given to the industrialists, in terms of tax incentives, low cost of funds etc., would bear fruits in the future.

Future Prospects of the Industry

Nevertheless the outlook for the year 2003 is filled with some what mixed opportunities and threats. locally as well as internationally. Local

environment will largely depend on the solid out come of peace process.

Our Performance and Presence in the Housing Financing Sector

In an upcoming economic environment SMIB was able to record a healthy after tax profit of Rs. 256.4 million and a return on assets of 3.58%. We have been able to consolidate our position in the market as the apex housing financier by increasing our loan disbursements by more than 16% over the previous year. Management discussion and analysis on page 4 to 10 further discusses this aspect.

Market and Industry

To further expand our presence in the market it is planned to open new branches in more populated areas. We were able to make our presence in the North and East as well and we would take steps to further strengthen our position in these areas. With the dawn of peace and resettlements taking place we envisage huge market growth in this region and we are well geared to capitalise on these developments.

Future Business Direction and Our Strategies

Proactively addressing the issues such as low cost funding, staff training, accessing long term funding we have revitalized the deposit mobilization through pass book savings scheme which we have already been successful to a greater extent. for empowering the staff with necessary skills and knowledge the bank has allocated more resources and have embarked on massive training programmes to cover every employee of the bank. To overcome the mismatch of our funding and lending the bank obtained a five-year loan from the National Savings Bank. We have included a separate in depth discussion on Our Strategies, Goals, Challenges and Risk in this report.

Appreciation

It is my fervent wish that the bank will further build up its strength on these positive steps and serve the nation with housing finance requirements.

I take this opportunity to thank the colleagues on the Board, the General Manager and the Staff for their invaluable contribution to achieve this progress.

J J Rajakaurna
Chairman

27th March, 2003.

Notes to the Financial Statements

FOR THE YEAR ENDED 31ST DECEMBER 2002

29. MATURITY ANALYSIS

An analysis of the interest bearing assets and liabilities based on the remaining period at the Balance Sheet date to the respective contractual maturity dates is as follows :

ASSETS	Upto 3 Months Rs.'000	3 to 12 Months Rs.'000	1 to 3 Years Rs.'000	3 to 5 Years Rs.'000	More than 5 Years Rs.'000	Total Rs.'000
Cash & Short Term Funds	59,330	0	0	0	0	59,330
Balances with Central Bank of Sri Lanka	423	0	0	0	0	423
Investment in Government securities	760,765	600,986	0	9,726	0	1,371,477
Dealing Securities	4,035	0	0	0	3,000	7,035
Investment Securities	0	0	0	0	1,303	1,303
Loans and Advances	305,897	496,203	1,419,497	1,418,720	4,117,162	7,757,479
Other Assets	56,658	8,726	30,264	0	0	95,648
Property, Plant & Equipment	0	0	0	0	15,595	15,595
	<u>1,187,108</u>	<u>1,105,915</u>	<u>1,449,761</u>	<u>1,428,446</u>	<u>4,137,060</u>	<u>9,308,290</u>
As at 31 December 2001	<u>777,887</u>	<u>682,064</u>	<u>1,392,155</u>	<u>1,377,450</u>	<u>3,998,482</u>	<u>8,228,038</u>
LIABILITIES						
Bank overdraft	19,059	0	0	0	0	19,059
Deposits	1,807,029	2,799,939	1,051,005	0	0	5,657,973
Borrowings	17,504	24,923	334,732	249,452	255,199	881,810
Provision for Taxation & Deemed Dividend Tax	40,930	0	0	0	0	40,930
Other liabilities	655,972	500	2,000	2,000	41,142	701,614
	<u>2,540,494</u>	<u>2,825,362</u>	<u>1,387,737</u>	<u>251,452</u>	<u>296,341</u>	<u>7,301,386</u>
As at 31 December 2001	<u>6,357,840</u>	<u>1,809,200</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>8,167,040</u>

Notes to the Financial Statements

1. Corporate Information

General

State Mortgage and Investment Bank is a public corporation incorporated under State Mortgage and Investment Bank Law, No 13 of 1975 and domiciled in Sri Lanka. The registered office of the bank is located at No 269, Galle Road, Colombo 03.

Principal activities

During the year, the principal activities of the bank were provision of housing finance and savings mobilisation.

Parent Enterprise

SMIB is a fully Government owned enterprise.

Number of Employees

The number of employees at the end of the year was 322 (2001-326)

2 Significant Accounting Policies

2.1 General

Accounting Convention

The Balance Sheet, Income Statement, Cash Flow Statement and statement of Changes in Equity are prepared in conformity with generally accepted accounting principles in state and corporation sector and the Sri Lanka Accounting Standards (SLAS) laid down by the Institute of Chartered Accountants of Sri Lanka (ICASL) applied consistently on a historical cost basis. Where appropriate, the policies are explained in the succeeding notes.

Previous Years Figures

Previous year's figures and phrases have been re-arranged wherever necessary to conform to the current presentation.

Taxation

a) Income Tax

Provision for taxation is made on the basis of the profit for the year as adjusted for taxation purposes in accordance with the provisions of the Inland Revenue Act No. 38 of 2000 and amendments thereto.

b) Deferred Taxation

The tax effect of timing differences which, occur where items are allowed for income tax purposes in a period different from that when they are recognised in financial statements is included in the provision for deferred taxation as far as they are expected to reverse in the short term.

c) Deemed dividend Tax

Deemed dividend tax is computed at 25% of net profit after tax in accordance with the provisions of the Inland Revenue Act No. 38 of 2000.

Notes to the Financial Statements

Post Balance Sheet Events

All material events occurring after the balance sheet date are considered and, where necessary adjustments made to these financial statements.

Borrowing Cost

Borrowing costs are recognized as an expense in a period in which they are incurred

2.2 Valuation of Assets and their Basis of measurements

Stationery Stock

Stationery stock is valued at the lower of the cost or replacement cost. Cost is determined using first in first out basis.

Advances to Customers

Carrying amounts of Advances to customers in the Balance Sheet are determined net of provisions for possible loan losses and also net of interest, which is not accrued to revenue.

Provision for Bad & Doubtful Debts

a) Provisions for possible loan losses are made on basis of a continuous review of all advances to customers based on an aged classification of advances as follows:

<i>Period Outstanding</i>	<i>Classification</i>	<i>Provision Required</i>
6-12 months	Sub-standard	5%
12-18 months	Doubtful	10%
18 months & over	Loss	15%

*Provision required is computed based on gross receivables (i.e. total of capital not fallen due and amounts in arrears).

b) Full provision is made for loans granted to clients at Northern & Eastern provinces.

c) No provision is made for loans granted against Employee Provident Fund balances.

Investments

a) Treasury bills and other securities eligible for rediscounting with central Bank

This includes Treasury Bills and Treasury Bonds are recorded at cost plus a proportion of the discount on a straight line basis over the period to maturity.

b) Government and other securities held for Dealing purposes

Securities are generally held for resale in the near future are classified as Government and other securities held for Dealing purposes . Such securities are stated at the lower of cost and market value determined on an aggregate portfolio basis in total.

c) Investment Securities

Equity shares which are acquired with the positive intention to hold on a long term basis are classified as Investment Securities. Such securities are recorded at cost. Provision is made for fall in value of investments only if such fall in value is expected to be other than temporary.

Property, Plant & Equipment

a) Property, Plant and Equipment are recorded at cost together with any incidental expenses thereon. The assets are stated at cost less accumulated depreciation which is provided for on the basis specified in (b) below.

b) Depreciation is provided at the following rates on a straight-line basis over the estimated lives of different types of assets.

Office Equipment	25%	per annum
Motor Vehicles	25%	per annum
Computer Equipment	25%	per annum
Furniture & Fittings	12.5%	per annum.

Notes to the Financial Statements

No depreciation is made in year of purchase and full year depreciation is provided in the year of sale.

The bank contributes 3% of gross emoluments of employees' to Employees Trust Fund.

Cash & Cash Equivalents

Cash & cash equivalents are defined as cash on hand, demand deposits and short term highly liquid investments readily convertible to known amounts of cash and subject to insignificant risk of changes in value.

For the purpose of Cash Flows statements Cash and Cash equivalents consist of cash in Hand, demand deposits, balances with Central Bank, Treasury Bills and Borrowings from Banks.

2.3 Liabilities and Provisions

Commitments & Contingencies

All discernible risks are accounted for in determining the amount of other liabilities.

Retirement Benefit Obligations

a) Defined Benefit Plan-Gratuity

Gratuity is a defined benefit plan. The bank is liable to gratuity in terms of payment of gratuity act no. 12 of 1983. In order to meet this liability, a provision is carried forward in the balance sheet, based on half month's salary of the last month of the financial year of all employees for each completed year of service, commencing from fifth year of service. The resulting difference between brought forward provision at the beginning of the year and the carried forward provision at the end of the year is dealt with in the income statement.

The gratuity liability is not funded nor actuarially valued. This item is group under Other Liabilities in the balance sheet.

b) Defined Contribution Plans-Employees' Provident Fund & Employees' Trust Fund

The bank and employees contribute 15% and 10% of gross emoluments to an Employees' Provident Fund, respectively.

Grants

Grants, received to finance consultancy services, training and equipment is classified as Revenue Reserve in accordance with the best practices adopted by the State and Corporation sector enterprises for grants.

2.2.1 Income Statement

Revenue Recognition

a) Interest Income from Loans and Advances

Interest income is recognised on an accrual basis.

b) Interest income from suspended loans and advances

Interest ceases to be taken into revenue when the recovery of interest or principal is in arrears for over three (3) months. Thereafter, interest on advances is accounted for on a cash basis.

c) Interest Income from Other Sources

Interest income from Government of Sri Lanka Treasury Bills is recognised on a time proportion basis as discounts on purchase are amortised to income on a straight line basis over periods of maturity. Income from all other interest bearing investments are recognised as revenue on an accrual basis.

d) Dividend Income

Dividend income is recognised on a cash basis in the period in which it is received.

e) Income From Fee – Based Activities

Fees and commissions are recognised on a cash basis in the period in which the income is received.

f) Expenses Recognition

Notes to the Financial Statements

Interest payable is recognised on an accrual basis, other expenses have been recognised in the accounts as they are incurred, in the period to which they relate. Expenses are disclosed in the income statement using the function of expenses method.

The Chairman
State Mortgage & Investment Bank.

Report of the Auditor General on the accounts of the State Mortgage & Investment Bank for the year ended 31 December 2002 in terms of Section 14(2)(c) of the Finance Act No. 38 of 1971.

The audit of accounts of the State Mortgage and Investment Bank for the year ended 31 December 2002 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. My observations on these accounts 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. A detailed report in terms of Section 13(7)(a) of the Finance Act will be forwarded to the Chairman of the Bank in due course.

1:2 Responsibility for Financial Statements and Audit

The Board of Directors are responsible for preparing and presenting the financial statements in accordance with Sri Lanka Accounting Standards. My responsibility is to express an opinion on the financial statements based on the audit.

1:3 Scope of Audit

Audit opinion, comments and findings in this report are based on a review of the financial statements presented to audit and substantive tests of samples of transactions. The scope and the extent of such review and tests were such as to enable as wide an audit coverage as possible within the limitations of staff, other resources and time available to me. The audit was carried out in accordance with Sri Lanka Auditing Standards, methods and practices to obtain reasonable assurance as to whether the financial statements are free of material misstatements. The audit included examination of evidence supporting the amounts and disclosures in financial statements and assessment of accounting principles and significant estimates and judgements made in the preparation of financial statements, evaluation of their overall presentation and determining whether accounting policies adopted were appropriate, consistently applied and adequately disclosed. 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 scope and extent of the audit.

2. Accounts

2:1 Audit Opinion

I am of opinion that, the financial statements have been satisfactorily prepared to present fairly in all material respects, the financial position of the Bank as at 31 December 2002 and the results of its operations and cash flow for the year then ended in accordance with Sri Lanka Accounting Standards other than the Standards referred to in paragraph 2:3:5(a) of this report and stated accounting policies as set out in Notes 1 to 9 to the financial statements.

2:2 Financial Results

According to the accounts presented, the working of the Bank for the year ended 31 December 2002 had resulted in a pre-tax net profit of Rs.314,090,809 as compared with the corresponding pre - tax net profit of Rs.320,466,881 for the preceding year.

2:3 Comments on Accounts

2:3:1 Unreconciled Accounts

Unreconciled balances relating to loans recoverable amounting to Rs. 2,428,662 and unappropriated receipts and interest debtors amounting to Rs. 4,762,647 had been shown under current assets and current liabilities in the balance sheet.

2:3:2 Unidentified Transactions

- (a) A sum of Rs.10,806,418 representing deposits as at end of the year under review remaining unidentified had been shown under current liabilities. The corresponding unidentified amount as at end of the preceding year amounted to Rs.23,447,652.
- (b) A sum of Rs. 738,828 representing Estate Sector Deposits as at end of the year under review remaining unappropriated had also been shown under current liabilities. The corresponding unappropriated amount as at end of the preceding year amounted to Rs.450,454.

2:3:3 Long Outstanding Items

Loans granted to property developers amounting to Rs.622,922 had remained unrecovered for over 06 years. The Chairman informed me that the above loans are under litigation.

2:3:4 Lack of Documentary Evidence for Audit

68 Bank accounts (collection accounts) aggregating Rs.5,821,042, Treasury loan amounting to Rs. 4.8 million, two accrued loans related interest accounts amounting to Rs. 43,704,529, accrued interest, etc. could not be satisfactorily vouched or accepted in audit in the absence of detailed schedules, related documents, confirmation, etc.

2:3:5 Non-compliance with Laws, Rules, Regulations and Management Decisions

Several instances of non –compliance with the provisions in the following Sri Lanka Accounting Standards, Laws, Public Administration Circulars, Public Finance Circulars, Ministry of Finance and Planning Circulars , Financial Regulations of the Government observed in audit were pointed out to the General Manager of the Bank from time to time.

(a) Sri Lanka Accounting Standards

(i) SLAS – 10

Para 48 - Changes in Accounting Policies

Amortization of difference between the acquisition cost and redemption value of Treasury Bonds amounting to Rs.1,202,343 had not been accounted according to the Standard.

(ii) SLAS– 18 - Measurement subsequent to Initial Recognition

When the fair value of assets differs from its carrying amounts, revaluation should be done in every three or five years. Instead of revaluing several items of fixed assets, the Bank had shown fully depreciated assets at zero values.

The Chairman informed me that according to the nature and the value of the fixed assets of the Bank, periodical revaluations are uneconomical, as the movement of the fair value of the Bank's assets is insignificant.

- (b) Inland Revenue Act No. 24 of 1997
(c) Ministry of Finance and Planning Circular No. MF/6/1/1/96 dated 20th April 1996.
(d) Public Finance Circular No. Fin 352 dated 25 September 1997.

3. Financial and Operating Review

3:1 Financial Results

The operation of the Bank during the year under review had resulted in a pre-tax net profit of Rs. 314.09 million as compared with the corresponding pre-tax net profit of Rs.320.47 million in the previous year showing a decrease in net profit by Rs.6.38 million which can be analysed as follows.

	<u>Variance</u>		Rs. (millions)
	Favourable ----- Rs. (millions)	Adverse ----- Rs. (millions)	
<u>Revenue</u>			
Interest Income	8.39	-	
Investment Income	7.47	-	
Other Operating Income	7.01	-	
Other Income	0.85	-	
	----- 23.72	----- -	23.72
	=====	=====	
<u>Expenditure</u>			
Interest Expenditure	-	7.59	
Staff	2.11	-	
Establishment	-	4.16	
Others	-	3.89	
Depreciation	-	2.03	
Doubtful Debts	0.88	-	
Unrealised Income	-	49.99	
Fall in value of Investments	-	1.02	
Provision for Loan Losses	-	9.01	
National Security Levy	49.33	-	
Surrender of Leasehold rights to land	-	4.73	
	----- 52.32	----- (82.42)	(30.10)
	=====	=====	
Decrease in Net Profit			----- (6.38) =====

3:2 Performance

Lending Operations

The position of loan facilities granted as at the beginning of the year, loans granted and recovered during the year under review and the balance outstanding as at end of the year under review are given below.

Balance as at 01 January 2002	Loans Granted/ Recovered in 2002		Balance as at 31 December 2002
	Granted	Recovered	
Rs. (Millions)	Rs. (Millions)	Rs. (Millions)	Rs. (Millions)
7,486.81	3,260.99	2,972.26	7,775.54

3:3 Loan Administration

(a) Processing of Loan Applications

The number of loan applications received and processed by Bank during the year under review and in the preceding year were as follows.

	Number of Applications		Increase/ (Decrease)	
	2002	2001	Number	Per- centage
Balance on 1 January	3,683	4,322	(639)	(14.78%)
Receipts during the year	9,941	9,067	874	9.64%
Total	13,624	13,389	235	1.76%

Number of applications Withdrawn and rejected	988	1,823	(835)	(45.80%)
	-----	-----	-----	-----
Total available for processing	12,636	11,566	1,070	9.25%
Number of Applications approved	8,930	7,883	1,047	13.28%
	-----	-----	-----	-----
Balance on 31 December	3,706	3,683	(23)	(0.85%)
	=====	=====	=====	=====
Number of loans paid	9,169	7,883	1,286	16.31%
Approximate value of loans granted (Rs.M)	1,200	1,210	(10)	(0.83%)

(b) Approval of Loans

The loans approved during the year 2002 could be classified under the following groups.

Group according to amounts	Number of loans	Value	%
-----	-----	-----	-----
		Rs. (Millions)	
Rs. 2.5 million and above	04	12.55	0.90
Rs. 1.0 – 2.5 million	71	90.08	6.44
Rs. 0.5 – 1.0 million	267	165.09	11.81
Rs. 0.2 – 0.5 million	2,173	616.24	44.07
Below Rs. 0.2 million	6,415	514.33	36.78
	-----	-----	-----
	8,930	1,398.29	100
	=====	=====	=====

(d) Estate Sector Housing Development Project

A special loan scheme was operated by the Bank for funding the Housing Development Project for the benefit of the Estate Sector Employees.

Under this scheme, loans have been granted to estate workers for the construction of houses as against the guarantee of their Employees' Provident Fund contributions.

This project was started in the year 1995 and as at 31 December 2002, 12,930 loans amounting to Rs.370,685,600 had been granted to customers. Out of this, 12,122 loans amounting to Rs. 327,308,460 were in arrears and 3719 loans amounting to Rs. 102,505,386 were non performing loans as at 31 December 2002.

(e) Loans in Default

The following observations are made.

Total number of loans where three or more monthly instalments were not paid	-	17,925 *
No. of loans where one or more half yearly instalments were not paid	-	138 *
Percentage of the above number of defaulted loans on the total number of loans granted	-	32.65%
The total arrears of the above loans as at 31 December 2002	Rs.	492,697,848

* (Except Estate Sector arrears)

(f) Observations on Loan Administration

104 loan files had been examined in depth and detailed observations on deficiencies in loan administration pointed out to the General Manager are summarized below.

- i. The income of the applicants had not been properly ascertained and evidence in support of the same not obtained.
- ii. In respect of certain construction loans, loan instalments had been released without ascertaining the value of work done out of previous loan instalments released.
- iii. There were material differences between the values placed by the panel valuers and bank valuers.
- iv. There were instances where the disbursement of loans were not in compliance with the conditions of the loan.
- v. In respect of certain construction loans, instalments had been released eventhough the value of work done from previously released instalments was less than the amount released.
- vi. There were inordinate delays in taking follow up action to recover the loans in arrears.
- vii. In certain instances, necessary fire insurance policies had not been obtained.
- viii. Board approval had not been obtained to transfer the loan to the new owner of the mortgage property where the Balance Principal Outstanding exceeded Rs.250,000.
- ix. It was observed that there were disparities in the physical inspection reports of valuation officers relating to value of work done in different dates.
- x. There were delays in recovery of EPF Loans from the Central Bank.
- xi. Action had not been taken to lodge insurance claims under title insurance policies whenever the borrower has defaulted.

- xii. In certain instances, the valuation inspectors had failed to identify the property mortgaged correctly.
- xiii. Mortgaged properties had been overvalued by valuation inspectors in certain instances.

Many of the above deficiencies had been pointed out in my reports for the previous years and the fact that they are being recurring indicates weaknesses in the overall loan administration.

3:4 Identified Losses

The Bank had incurred losses in respect of two properties mortgaged to the bank against the loan granted due to the over valuation of these properties by the valuation inspectors.

It was observed that values of these properties as per valuation reports obtained at the time of disposal were much lower than the values given by the valuers at the time of granting these loans.

Estimated loss due to this amounted to Rs. 2,506,302.00

4. Systems and Controls

Deficiencies observed during the course of audit will be included in my detailed report to be issued to the Chairman in terms of Section 13(7)(a) of the Finance Act. Special attention is needed in respect of the following areas of control.

- (a) Loan Administration
- (b) Foreign Travelling
- (c) Vehicles
- (d) Utilisation of Computer Programms

(S.C. Mayadunne)
Auditor General

-/dk.