



Merchant Bank of Sri Lanka & Finance PLC

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

ICRA "ISL" A Negative¹

| STATEMENT OF PROFIT OR LOSS | | Rs. '000 | |
|---|--------------------|--------------------|--|
| | 2018 | 2017 | |
| Income | 6,549,905 | 6,402,825 | |
| Interest and similar income | 6,194,937 | 6,157,286 | |
| Interest and similar expenses | (3,752,471) | (3,708,808) | |
| Net interest income | 2,442,466 | 2,448,478 | |
| Fee and commission income | 210,175 | 179,687 | |
| Fee and commission expenses | (7,033) | (59,964) | |
| Net fee and commission income | 203,142 | 119,723 | |
| Net trading income | 6,855 | (16,018) | |
| Net gain/(loss) on financial instruments at fair value through profit or loss | (29,999) | 5,624 | |
| Other operating income | 167,937 | 76,246 | |
| Total operating income | 2,795,401 | 2,634,025 | |
| Impairment charges for loans and other losses | (134,531) | (244,231) | |
| Net operating income | 2,660,870 | 2,389,822 | |
| Personnel expenses | (1,096,230) | (1,073,526) | |
| Depreciation and amortisation | (119,806) | (109,025) | |
| Other operating expenses | (789,583) | (718,952) | |
| Total operating expenses | (2,005,619) | (1,901,483) | |
| Operating profit before VAT on financial services and impairment of investment in subsidiary | 655,251 | 488,339 | |
| Impairment reversal/(impairment) of investment in subsidiary | 58,160 | (56,189) | |
| Profit from operations after impairment of investment in subsidiary | 713,411 | 432,150 | |
| Taxes on financial services | (266,735) | (203,500) | |
| Profit before income tax | 446,676 | 228,650 | |
| Income tax expense | (265,311) | (127,799) | |
| Profit for the year | 181,285 | 100,851 | |
| Earnings per share: | | | |
| Basic/diluted earnings per share (Rs.) | 1.09 | 0.61 | |

Figures in brackets indicate deductions.

| STATEMENT OF COMPREHENSIVE INCOME | | Rs. '000 | |
|---|-----------------|----------------|--|
| | 2018 | 2017 | |
| Profit for the year | 181,285 | 100,851 | |
| Other comprehensive income/(expenses) | | | |
| Other comprehensive income to be reclassified to profit or loss in subsequent periods (net of tax): | | | |
| Gains/(losses) on re-measuring financial investments at fair value through other comprehensive income | (14,038) | 28,379 | |
| Net other comprehensive income/(expenses) to be reclassified to profit or loss in subsequent periods | (14,038) | 28,379 | |
| Other comprehensive income not to be reclassified to profit or loss in subsequent periods (net of tax): | | | |
| Actuarial gains/(losses) on defined benefit plans | 27,670 | (17,867) | |
| Deferred tax effect relating to components of other comprehensive income | (12,750) | 15,942 | |
| Net other comprehensive income/(expenses) not to be reclassified to profit or loss in subsequent periods | 14,920 | (1,925) | |
| Other comprehensive income/(expenses) for the year, net of tax | 82 | 26,454 | |
| Total comprehensive income/(expenses) for the year, net of tax | 181,367 | 127,305 | |

Figures in brackets indicate deductions.

| STATEMENT OF FINANCIAL POSITION | | Rs. '000 | |
|--|-------------------|-------------------|--|
| | 2018 | 2017 | |
| Assets | | | |
| Cash and cash equivalents | 294,622 | 418,885 | |
| Placements with banks & financial institutions | 670,575 | 1,509,597 | |
| Securities purchased under resale agreements | 1,292,670 | 1,302,748 | |
| Financial investments at fair value through profit or loss | 267,106 | 231,264 | |
| Loans & receivables at amortised cost | 30,721,147 | 28,760,494 | |
| Financial investments at fair value through other comprehensive income | 1,180,998 | 1,815,181 | |
| Financial investments at amortised cost | 60,828 | 479,362 | |
| Real estate stock | 78,503 | 42,603 | |
| Investment in associate company | 81,084 | 81,084 | |
| Investment in subsidiary | 79,276 | 21,117 | |
| Investment properties | 120,181 | 123,773 | |
| Property and equipment | 320,113 | 321,660 | |
| Intangible assets | 193,121 | 226,293 | |
| Deferred tax Assets | 187,629 | 325,148 | |
| Other assets | 316,573 | 311,146 | |
| Total assets | 35,864,426 | 35,970,355 | |
| Liabilities | | | |
| Due to banks | 5,869,317 | 1,616,979 | |
| Due to customers at amortised cost | 20,831,021 | 21,948,869 | |
| Debt issued and borrowed funds at amortised cost | 5,331,077 | 7,763,404 | |
| Current tax liabilities | 15,042 | 7,473 | |
| Deferred tax liabilities | 528,073 | 698,859 | |
| Other liabilities | 518,084 | 467,965 | |
| Retirement benefits obligations | 247,708 | 262,986 | |
| Total liabilities | 33,340,322 | 32,736,535 | |
| Equity | | | |
| Stated capital | 2,124,457 | 2,124,457 | |
| Statutory reserves | 214,026 | 177,839 | |
| Retained earnings | 193,012 | 924,947 | |
| OCI reserve | (7,461) | 6,577 | |
| Total equity | 2,524,034 | 3,233,820 | |
| Total liabilities and equity | 35,864,426 | 35,970,355 | |
| Commitments and contingent liabilities | 124,250 | 167,712 | |
| Net assets value per share (Rs.) | 15.22 | 19.50 | |

Figures in brackets indicate deductions.

| SELECTED PERFORMANCE INDICATORS (As per regulatory reporting) | | 2018 | 2017 |
|--|-----------|-----------|----------|
| | Rs. '000 | Rs. '000 | Rs. '000 |
| Regulatory Capital Adequacy | | | |
| Core Capital (Tier 1 Capital), Rs. '000 | 1,678,667 | 3,181,487 | |
| Total Capital Base, Rs. '000 | 3,208,643 | 4,757,631 | |
| Core Capital Adequacy Ratio, as % of (Minimum requirement of 5% up to June 2017, from 1st July 2018, 6%) | 4.70% | 10.21% | |
| Total Capital Adequacy Ratio, as % of (Minimum requirement, 10%) | 8.98% | 15.27% | |
| Capital Funds to Deposit Liabilities Ratio (Minimum requirement, 10%) | 12.67% | 15.44% | |
| Assets Quality (Quality of Loan Portfolio) | | | |
| Gross Non-Performing Accommodations, Rs. '000 | 3,818,930 | 3,037,745 | |
| Gross Non-Performing Accommodations Ratio, % | 11.46% | 10.10% | |
| Net Non-Performing Accommodations Ratio, % | 6.15% | 6.06% | |
| Profitability (%) | | | |
| Interest Margin | 7.83% | 7.64% | |
| Return on Assets (before tax) | 0.51% | 0.30% | |
| Return on Equity (after tax) | 7.18% | 3.18% | |
| Regulatory Liquidity (Rs. '000) | | | |
| Required minimum amount of Liquid Assets | 2,859,480 | 2,930,127 | |
| Available amount of Liquid Assets | 2,872,282 | 3,316,778 | |
| Required minimum amount of Government Securities | 2,163,857 | 1,900,048 | |
| Available amount of Government Securities | 2,296,487 | 1,918,169 | |
| Memorandum information | | | |
| Number of employees | 1,023 | 968 | |
| Number of branches | 40 | 40 | |
| Number of service centers | - | - | |
| Number of planning centers | 9 | 9 | |
| Number of other centers | - | - | |

Certification:
We, the undersigned, being the Head of Finance and the Acting Chief Executive Officer of Merchant Bank of Sri Lanka & Finance PLC certify jointly that:
(a) the above statements have been prepared in compliance with the format and definitions prescribed by the Central Bank of Sri Lanka;
(b) the information contained in these statements have been extracted from audited financial statements of the Licensed Finance Company unless indicated as "Unaudited".

(Sgd.) P J Kandanaarachchi
Head of Finance
27 May 2019

(Sgd.) P J Gamalath
Chief Executive Officer (Acting)
27 May 2019

Report of the Auditor General on the Financial Statements and Other Legal and Regulatory Requirements of the Merchant Bank of Sri Lanka and Finance PLC for the year ended 31 December 2018 in terms of Section 12 of the National Audit Act, No. 19 of 2018.

1. Financial Statements

1.1 Opinion
I have audited the financial statements of the Merchant Bank of Sri Lanka & Finance PLC ("Company") and the financial statements of the company and its subsidiary ("the Group") for the year ended 31 December 2018 comprising the statement of financial position as at 31 December 2018 and 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 and other disclosures, in accordance with the provisions of section 12(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 report to Parliament in pursuance of provisions in Article 154 (b) of the Constitution will be tabled in due course. 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 2018 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 the audit in accordance with Sri Lanka Auditing Standards (SLAUS). My responsibilities, under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements (ISRS) underpinning my basis for opinion. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Emphasis of Matter
I draw attention to the Note 15.4.1 and 5D of the financial statements, which disclose the following matters. My opinion is not modified in respect of these matters.

a) Minimum Capital Adequacy Requirements
Note 30 of the financial statements disclose the minimum capital adequacy ratio required for licensed finance companies and capital adequacy ratio maintained by the Company was below the minimum requirements.

b) Uncertainty Over Accounting Estimates
Note 15.4.1 of the financial statements disclose the basis of recognition of deferred tax assets by the Subsidiary. MBSL Insurance Company Limited announced to Rs. 306 million with the assumption that brought forward tax losses can be recovered within ten years against the taxable income. For the assessment of future taxable income and approval of impairment provisions of the net of cost reporting period, the company has used subjective estimates and assumptions which are disclosed in Note 15.4.1 of the financial statements.

Further, I draw attention to the Note 20.2 of the financial statements which disclose the reversal of impairment provision made in previous year in respect of investment in the Subsidiary amounting to Rs. 18 million based on the future cash flow projections of the Subsidiary in the Note 15.4.1 of the financial statements.

1.4 Key Audit Matters
Key audit matters are those matters that, in my professional judgement, were of most significance in my audit of the financial statements of the current period. These matters were addressed in the context of my audit of the financial statements as a whole, and in forming my opinion thereon, and I do not provide a separate opinion on these matters.

I have fulfilled the responsibilities described in the Auditor's responsibilities for the audit of the financial statements set out in my report, including in relation to these matters. Accordingly, my audit included the performance of procedures designed to respond to my assessment of the risks of material misstatement of the financial statements. The results of my audit procedures, including the procedures performed to address the matters below, provide the basis for my audit opinion on the accompanying financial statements.

Impairment of Loans and Receivables
My audit considered impairment allowance for loans and receivables as a key audit matter. The maturity of the reported amounts for loans and receivables (and impairment allowance thereof), the subjectivity associated with management's impairment estimation and transition to Sri Lanka Accounting Standard 8 (Financial Instruments) (SLFRS) underpinned my basis for opinion on this key audit matter.

As at 31 December 2018, 61.7 per cent of the Group's total assets consisted of loans and receivables amounting to Rs. 30,485 million (Note 22.1) of impairment allowance of Rs. 2,575 million (Note 22.1). The impact on transition to SLFRS on the Group's Financial Statements has been quantified and presented in Note 3.12 of the Financial Statements.

The estimation of impairment allowance for loans and receivables involved complex manual calculations. Significant estimates and assumptions used by the management in such calculations and the related impairment allowance are disclosed in Note 3.3.13.

Among other procedures, I have performed the following key audit procedures to address the above:

- I evaluated design, implementation and operating effectiveness of controls over estimation of impairment of loans and receivables, which included assessing the level of oversight, review and approval of impairment policies by the Board Audit Committee and management;
- I tested the underlying calculations and data;
- In addition to the above, following focused procedures were performed:

For loans and receivables individually assessed for impairment:

- I assessed the credit risks used by the management for determining whether an impairment event had occurred;
- Where impairment indicators existed, I assessed the reasonableness of management's estimated future recoveries including the expected future cash flows, discount rates and the valuation of collateral held. I also compared the actual recoveries against previously estimated amounts of future recoveries;

For loans and receivables collectively assessed for impairment:

- I assessed the completeness, relevance and accuracy of the underlying information in loans and advances used in the impairment calculations by agreeing details to the Group's source documents and information system and performing the calculations;
- I also considered reasonableness of macro-economic and other factors used by management in their judgement overlays for various types of loan portfolios, by comparing them with publicly available data and information sources;
- I assessed the adequacy of the related financial statement disclosures as set out in Note 22 and Note 3.3.13;
- I also assessed the adequacy of the Group's disclosure on the impact of the adoption of SLFRS 8 as set out in Note 3.12. This included testing of the quantitative impact of the transition;

Impairment of Investment in Subsidiary
Investment in subsidiaries are stated at cost, net of any impairment losses which are charged to the Statement of Profit or Loss and it is in accordance with the Sri Lanka Accounting Standard 27 (Investment in Subsidiaries). Management performed assessment at the end of each reporting period whether there is any indication that the investments in subsidiary may be impaired. Should indication of impairment exist, an impairment assessment will be performed accordingly.

The recoverable amount of the investment in subsidiary was assessed by value in use calculations which are based on net asset valuation and residual income methods as a cash-generating unit basis.

This area is significant to my audit because of the significant management judgement involved in determining the value in use. For investments in subsidiaries the judgement focuses on revenue growth rates, gross margins and discount rates. All these factors are with estimation uncertainties and may impact the results of the impairment assessment.

Among other procedures, I have performed the following key audit procedures to address the above:

- I evaluated the group's cash flow forecasts and the process by which they were developed, including considering the mathematical accuracy of the underlying calculations;
- I compared cash flow forecasts to the latest board approved budgets and also ensured that the underlying cash flow forecasts, assumptions used and sources thereof had been reviewed and approved by the Board;
- I reviewed the reasonableness of fair value of assets and liabilities of the subsidiary in arriving at the net assets of those related companies;
- I assessed the reasonableness of key assumptions including the discount rate, terminal growth rates and forecast growth assumptions;

The disclosures associated with investment in subsidiaries are set out in the Note 26.2 of the financial statements.

1.5 Other Information
Management is responsible for other information. The other information comprises the information included in the annual report but does not include the financial statements and our auditor's report thereon.

My opinion on the financial statements does not cover the other information and I do not and will not express any form of assurance conclusion thereon.

In connection with my audit of the financial statements, my responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or my knowledge obtained by the audit or otherwise appears to be materially misstated. If, based on the work I have performed on the other information that I obtained prior to the date of this auditor's report, I conclude that there is a material misstatement of this other information, I am required to report that fact. I have nothing to report in this regard.

1.6 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 the internal control as management determines 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, and, as applicable, matters related to going concerns and using the going concern basis of accounting; management's other intent to liquidate the Group or to cease operations, or to have 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.

1.7 Auditor's Responsibilities for the Audit of the Financial Statements
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 thereon. 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 judgement 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 sufficient audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement, especially one involving 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 internal control 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 conclusion is 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;
- Communicate with those charged with governance regarding, among other matters, significant audit findings, including any significant deficiencies in internal control that I identify during my audit;

2. Report on Other Legal and Regulatory Requirements
National Audit Act, No. 19 of 2018 and Companies Act, No. 7 of 2007 include specific provisions for following requirements:

- I have obtained all the information and explanation that I required for the audit and as far as appears from my examination, proper accounting records have been kept by the Company as per the requirements of section 12(1)(d) of the Companies Act, No. 7 of 2007 and the section 12 (1) of the National Audit Act, No. 19 of 2018;
- The financial statements of the Company comply with the requirements of the section 15(1) of the Companies Act, No. 07 of 2007;
- The financial statements presented is consistent with the preceding year as per the requirement of the section 6(1)(b)(ii) of the National Audit Act, No. 19 of 2018;
- The financial statements presented includes all the recommendations made by me in the previous year as per the requirement of the section 11(1)(b)(ii) of the National Audit Act, No. 19 of 2018;

Based on the procedures performed and evidence obtained were limited to matters that are material, nothing has come to my attention:

- To state that any member of the governing body of the Company has any direct or indirect interest in any contract entered into by the Company which are not of the normal course of business as per the requirement of the section 12(1)(d) of the National Audit Act, No. 19 of 2018;
- To state that the Company has not complied with any applicable written law, general and special directions issued by the governing body of the Company as per the requirement of the section 12(1)(f) of the National Audit Act, No. 19 of 2018 except for non-compliance that are material and given below.

Reference to Law/Direction

| Reference to Law/Direction | Description |
|--|---|
| Rule 7.5(6)(1)(3) of the Colombo Stock Exchange (CSE) Listing Rules | Independent auditor's report contains an emphasis of matter on going concern of the subsidiary. |
| Direction No. 03 of 2018 issued by the Central Bank of Sri Lanka (Risk Weighted Average Capital Adequacy Requirements) | Non-compliance with the Risk Weighted Capital Adequacy Ratios disclosed in Note 30.1 of the financial statements. |
| | To state that the Company has not performed according to its powers, functions and duties as per the requirement of the section 12 (a) of the National Audit Act, No. 19 of 2018. |
| | To state that the resources of the Company had not been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws as per the requirement of the section 12 (i) of the National Audit Act, No. 19 of 2018. |

W.R.C Wickramaratne
Auditor General