SPOTLIGHTS ON MERCHANT BANK'S ANNUAL REPORT

PROFITS ONLY ON PAPER?

OVER the past weeks, *The Sunday Leader* has turned the spotlight onto the Securities and Exchange Commission (SEC), to bring into focus its statutory duties and responsibilities: the enactment and enforcement of laws and regulations to ensure the proper conduct and functioning of listed public companies operating in the Colombo capital market and to ensure fair trading practices in the share market.

The SEC has been statutorily set up mainly to ensure the protection of the interests of the investing public and to ensure compliance with the laws and regulations. Violations of such law & regulations are punishable with jail sentences and/or heavy fines.

With the development of the capital market in a free and open economy, the SEC is the corner stone entrusted with onerous statutory duties and responsibilities carrying the highest degree of public accountability. The public are not only mere consumers of, but shareholders in public services. They would expect standards of disclosure and accountability, no less than shareholders of a listed public company.

The report of the Committee on Standards in Public Life, chaired by Lord Nolan, presented to the British Parliament in 1995, quotes from the written evidence of the UK Audit Commission:" Public scrutiny of what people do is probably the most powerful pressure towards probity of conduct."

It is in this background that issues of codes of conduct, conflicting interests, the " old boy net-work", auditors as members of the commission and the regulatory authority's director general's involvement in privatisation deals/ transactions, were raised in recent weeks by *The Sunday Leader*.

We now shift the spotlight to public listed companies and privatisation transactions in this capital market, the main regulatory authority of which is statutorily required to protect and safeguard the interests of the public.

STOCK EXCHANGE RULES

In addition, listed public companies have to- strictly adhere and conform to the rules and regulations of the Colombo Stock Exchange (CSE), on whose floor their shares are traded.

Section 8 of the rules and regulations of the CSE set out the stipulations concerning corporate disclosure policy. Rule 8.1-5 stipulates:

" A listed company should refrain from promotional disclosure activities which exceeds what is necessary to enable the public make informed investment decisions. Such activity includes inappropriately worded news releases, public announcements not justified by actual developments in a company's affairs, exaggerated reports or predictions, flamboyant wording and other forms of overstated or over-zealous disclosure activity which may mislead investors and cause price movements and activity in a company's securities."

MERCHANT BANK OF SRI LANKA

Changa Samaraweera — CEO of Merchant Bank

A flamboyant and colourful presentation of data in annual report?

In the light of the recent flurry of contradictory reports in the press, we now focus on the listed public company, Merchant Bank of Sri Lanka Ltd., a subsidiary company of the Bank of Ceylon, focusing mainly on its published accounts – the basic communication of information and statement of accountability to the investing public. Sifting the mass of data and colourful presentations, the following data is analytically presented to afford a clear picture.

The consolidated gross incomes and net profits of the Merchant Bank of Sri Lanka Ltd., (MBSL) as per its published annual reports for the last five years have been as follows:

Year	Gross Income	Net Profit
	Rs. (mn.)	Rs. (mn.)
1992	269	102
1993	353	109
1994	702	200
1995	878	33
1996	1,134	54

While the gross income over the past five years had grown from Rs. 269 mn. To Rs. 1,134 mn., the net profit has recorded a reverse trend, diminishing from Rs. 102 mn. to Rs. 54 mn.

The net profit percentage to the gross income had eroded by 90% from 38% in 1992 to levels of 3.9% in 1995 and 4.8% in 1996.

Year	% of Net Profit to Gross Income
1992	38.0%
1993	31.0%
1994	28.5%
1995	3.9%
1996	4.8%

However, on the other hand, the portfolio of funds tied up in investments during this period has grown considerably – 14 times.

Year	Rs. Mn.
31.12.92	141
31.12.93	221
31.12.94	846
31.12.95	1,577
31.12.96	1,974

The steep rise in the interest cost incidence during this period as a consequence of the increase in the levels of borrowings has been as follows:

Year	Rs. Mn.
1992	122
1993	187
1994	316
1995	534
1996	765

The total debt to equity as on December 31, 1996 stood at 84% to 16%, but that is without taking into reckoning the shortfall of Rs. 477 mn. From the costs in the market value of investments and a further Rs. 95 mn., the reported fall in the value of ESOP Plan shares and doubtful dues from Lanka Loha Ltd., which matters have been referred to in the auditor's report.

If provision of loss is reckoned for the above items, then the share capital and reserves would diminish to Rs. Rs. 740 mn., and the total debt to equity would be reckoned at 90% to 10%. The directors, however, have opined that the fall in market value of investments is not a permanent diminution. (The comparable fall in 1995 was reported as Rs. 227 mn., whilst in 1996 it is reported as Rs. 477 mn.)

ADVERSE AUDIT REPORT

In the audit report dated January 13, 1997, the auditors M/s. Someswaran Jayawickreme and Co., chartered accountants, (representing the Arthur Andersen Worldwide Organisation in Sri Lanka) to the members of the Merchant Bank of Sri Lanka Ltd., in certifying the annual accounts of the bank to December 31, 1996, have given their opinion as follows: " In our opinion, so far as appears from our examination, proper books of accounts have been maintained and to the best of our information and according to explanations given to us, the said financial statements which are in agreement therewith read together with the accounting policies and notes referred to therein provide the information required by the Companies Act No. 17 of 1982, except for notes

10.2(a), 10.2(b) and 12.3 to the financial statements, give a true and fair view of the state of the Company's affairs as at December 31, 1996 and of its profit for the year then ended in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year." (Note 10.2(a), 10.2(b) and 12.3 concern the fall in value of investments and doudtful debt referred to above.)

" Without qualifying our opinion, we draw your attention to matters referred to in note 14.1 to the accounts." (This refers to a payment of Rs. 50 mn., for shares in George Steuart and Co., Ltd., which share certificates have not been issued due to legal impediments arising from the articles of association of George Steuart and Co. Ltd.)

The Coopers and Lybrand manual of auditing states:

"In an ' except' opinion the auditor expresses an adverse opinion on a particular matter which is not considered fundamental."

" An uncertainty becomes fundamental when its potential impact on the accounts is so great as to render the accounts as a whole meaningless. A disagreement becomes fundamental when its impact on the accounts is so great as to render the accounts as a whole misleading."

QUESTIONABLE TRANSACTION

In the given scenario of the diminution in the volume of net profits, a few days prior to the end of the first quarter in 1995, i.e. on March 22, 1995, the Merchant Bank of Sri Lanka Ltd., (MBSL) together with its holding Company, the Bank of Ceylon (BoC), Property Development Ltd., and Hayleys Ltd., had incorporated and funded a new company, Alexandria International (Pvt) Ltd (AIPL).

The chairman, the MD and three other directors of the MBSL and another director of the BoC/ chairman, Heyleys Ltd. have been the directors of AIPL.

MBSL immediately thereafter, prior to March 31, 1995, the end of the first quarter of 1995, had sold its portfolio of shares in Veyangoda Textiles Mills Ltd. to AIPL, at a price above the market price to record a " profit" of Rs. 36.4 mn. on this sale transaction in the MBSL quarterly accounts as on March 31, 1995.

This " profit" amounted to 79% of the MBSL's reported trading profit of Rs. 46.1 mn. for this first quarter. AIPL to which such share portfolio was sold by MBSL had been mainly funded by the MBSL and its holding company the Bank of Ceylon. Thereafter during the next quarter in May 1995, the MBSL had repurchased this portfolio of shares from AIPL for a price higher than the market price.

The above transaction conceived intentionally and executed knowingly by the directors common to the MBSL and AIPL had helped to record an enhanced, created " profit" in the accounts of MBSL. Could this have been a bonafide transaction?

This transaction would have the same effect of MBSL having revalued its portfolio of shares in Veyangoda Textiles Mills Ltd., above its cost, to a price higher than the market value and having taken credit for such increase in revaluation, to the profit and loss account to record higher net profit.

SEC INTERVENTION

Kumar Paul — Director general, SEC
Would he fearlessly uphold the law?

Dylan Moldrich — Director general, CSE
CSE rules — are they only for the library?

Having being altered, the SEC intervened and ruled that this transaction to bolster profits was in contravention of the rules and regulations and required a reversal of such created “ profit”. The bank accordingly effectively reversed this profit by making a specific provision in this regard in its accounts.

By this means, the MBSL reported an enhanced annualised earnings per share of Rs. 4.11 in the quarterly report up to March 31, 1995 dated April 21, 1995 and thereafter, corrected the annualised earnings per share to Rs. 2 in its half-yearly report up to June 30, 1995 dated August 30, 1995 i.e. after a period of over 4 months, during which period the investing public were guided by the enhanced profitability and earnings reported in the quarterly report up to March 31, 1995, of in violation of the rules and regulations of the Sec.

Accordingly, on the directions of the SEC the bank carried this note in its half-yearly accounts to June 30, 1995. “ The company sold 3,839,000 shares of Veytex Ltd. from its portfolio of investments to a related company in March 1995, at a price higher than the market price. Later in May 1995 the company re purchased the same parcel of Veytex shares together with a quantum of additional shares which totalled 4,766,600 shares. This transaction was also effected at a price higher than the market price which prevailed at that time.”

“ Subsequently, the SEC informed the company that the above traders are in contravention of the rules and regulations of the securities industry. The profit on the sale of 3,839,000 Veytex shares which amounted to Rs. 36,357,429 was reflected in the last quarter accounts and forms part of the unappropriated profit carried forward to the subsequent period. Since the market value of 4,780,451 of Veytex shares as on June 30, 1995 is lower than the purchased price, a specific provision of Rs. 36,117,291 for diminution in value of this investment has been made on the directive of the SEC. Hence this amount has been provided in the accounts to reflect the current market value of Veytex shares.”

“ The market value of the bank’s portfolio includes Veytex shares, totalling 4,780,451 shares as on June 30,1995. The market value of the MBSL portfolio is Rs. 70,004,516 (including Rs. 36,117,291 representing 4,780451 shares of Veytex), less than the cost of Rs.947, 278,560 of the total portfolio. The directors are of the opinion that the market value of the shares as on June 30, 1995, does not reflect a permanent diminution in the value of the portfolio and consequently no provision has been made.”

The market value of the Veytex shares during the year 1995 had been as follows:

Year	Share value
31.03.1995	Rs. 15.00
30.06.1995	Rs.11.75
30.09.1995	Rs. 9.00
31.12.1995	Rs. 7.75

SEC RULES

Rules 19 and 20 gazetted by the SEC under section 53 of the SEC Act as per gazette extra-ordinary no. 625/3 of August 27, 1990 are as follows:

“ No person shall create, cause to be created or do anything that is calculated to create a false or misleading appearance or impression of active trading, or a false or misleading appearance or impression with respect to the market for, or the price of any securities listed in a stock exchange.”

“ No person shall by means of purchases or sales of any securities that do not involve a change in the beneficial ownership of those securities or by any fictitious transactions or by any other means create a false market in any securities listed in a stock exchange.”

OTHER ISSUES

As per its 1996 annual report, the MBSL during 1996 has disposed of its shareholdings in Kotagala Plantations Ltd., and Kegalle Plantations Ltd. and has acquired shareholdings in Horana Plantations Ltd. It has also disposed of its shareholdings in Lanka Orix Leasing Co. Ltd.

The profits on disposal of investments for 1996 has been reported as Rs. 159.6 mn., (1995 Rs. 42.3 mn.), while the total net profit for the year 1996 has been reported as Rs. 54 mn.(1995 Rs. 33mn.)

In the circumstances, the need for clarification would arise as to whether such disposals and acquisition of investments have been arms-length transactions, standing the test of scrutiny by the SEC?

There is also the matter of the write –off of Rs. 57.8 mn., discovered and reported on in 1995 by the new auditors of the MBSL, M/s Someswaran Jayewickreme & Co. This amount had been shown as debts due on bills discounting in the previous years, and has written-off against the unappropriated balance profit brought forward from 1995, as a prior years’ cost, in reporting the net profit of the MBSL for the year 1996 of Rs. 54mn.

The growth of funds tied up in assets during this period could be reckoned from the following:

	31.12.92 Rs. (mn)	**31.12.96 Rs. (mn)**
Current Assets	1058	5345
Non-Current Assets	277	847
Investments	141	1732
Investments in Associates	-	242
Companies	18	150
Fixed Assets	**1494**	**8316**

The increase in liabilities and the growth in the share capital and reserves to finance the growth in assets during this period could be reckoned from the following:

	31.12.92 Rs. (mn)	**31.12.96 Rs. (mn)**
Current Liabilities	1121	4045
Non-Current Liabilities	83	1086
Debentures	-	1800
	1204	**6931**
Share Capital and Reserves	286	1312

This exceptional treatment in the Accounts was taken after obtaining a ruling from the urgent issues task force of the Institute of Chartered Accountants of Sri Lanka.

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