SHOULD SHAREHOLDERS JUST GRIM AND BEAR IT ?

Last week The Sunday Leader analysed several pertinent facets of the 1996 annual report of the Bank of Ceylon's subsidiary, the Merchant Bank of Sri Lanka Ltd (MBSL).

Annual reports of public companies, comprising the audited accounts, are required to be presented to the shareholders in conformity with the statutory provisions under the Companies Act no. 17 of 1982. Annual reports of listed public companies are required to be presented to the shareholders, in addition, in accordance with the statutory provisions and regulations under the Securities and Exchange Commission (SEC) Act no. 36 of 1987, as amended.

Gazetted rules under the SEC Act mandate that auditors of listed public companies shall certify that the annual accounts are presented in accordance with the accounting standards of the Institute of Chartered Accountants of Sri Lanka (ICASL), which has adopted Sri Lanka accounting standards governing the presentation of accounts.

In addition, ICASL has adopted Sri Lanka auditing standards, to which their members as auditors are required to adhere. ICASL has been established under the Institute of Chartered Accountants Act no. 23 of 1959, inter alia, to maintain professional standards among its members.

Gazetted rules under the SEC Act also require that listed public companies shall report to their shareholders on a regular and consistent basis, as required by the rules of the Colombo Stock Exchange, which has promulgated rules and regulations to govern such reporting requirements.

FAIR TRADING

All these statutory provisions, rules and regulations requiring transparency and public accountability are essentially to ensure the protection of the interests of the investing public and to guarantee fair trading practices in the capital market.

The SEC is the main regulatory authority statutorily charged with the responsibility of enforcing the above statutory provisions, rules and regulations, violations of which, upon prosecution by the SEC, are punishable with jail sentences and heavy fines.

To ensure compliance and enforcement of the statutory provisions, rules and regulations pertaining to annual reports, the president of the ICASL is an ex-officio member of the SEC, under the provisions of the Act.

In addition, the Sri Lanka Accounting and Auditing Standards Act no.15 of 1995 has been enacted, to establish the Sri Lanka Accounting and Auditing Standards Monitoring Board, to monitor compliance with accounting and auditing standards. Failure to comply attracts penalties of imprisonment and fines.

All these regulatory authorities, institutions, laws, rules and regulations are meaningless, unless there is compliance, more so by example, by concerned professionals and peers in society, and unless there is effective enforcement without fear or favour, by those charged with the responsibility of enforcement, not merely regarding such offices as social embellishments.

Going by its annual reports, the net profit of MBSL over the last two years, 1995 and 1996, could be considered in the light of the following; the auditors having specifically referred to some of these items in their report:

Income in 1996 --- Rs.1134 mn as against Rs.878 mn in ’95, net profit after tax to shareholders of the bank ---Rs 54 mn (’96),33 mn (’95), profit on disposal of investments --- Rs 159 mn (’96), 42 mn (’95), debts due on bills discounting written-off to prior years ---Rs 57mn (’96), nil in ’95, fall in market value of quoted equity investments ---Rs477 mn (’96) 227 mn (’95), debt due from Lanka Loha Ltd from 1993 by way of capital –Rs 25 mn (’96), 25 mn (’95), by way of interest – Rs 15 mn (’96), 15 mn (’95) and ESOP Plan sharers – difference in debt and value of shares –Rs 5 mn (’96), 56 mn (’95).

FALL IN VALUE

The market value of the quoted equity investments has fallen considerably in accordance with the trends in the Colombo Share Market. No provision has been made in the accounts for this shortfall in the value of such investment, considered as long-term investments, since the directors of MBSL have not deemed this to be a permanent diminution in value. Hence these quote equity investments have been shown at cost, which has been higher than the market value by Rs.477 mn. as at end 1996.

Accounting standard no.22 of ICASL would be applicable in this regard. Clauses 46 and 47 of this standard read:

> “46. Investments classified as current assets should be carried in the balance sheet at either: a) Market value or b) the lower of cost and market value.
>
> If current investment are carried at the lower of cost and market value, the carrying amount should be determined either on an aggregate portfolio basis, in total or by category of investment, or on an individual investment basis.”
>
> “47. Investments classified as long-term assets should be carried in the balance sheet at either: a) cost, b) revalued amounts, or c) in the case of marketable equity securities, the lower of cost and market value determined on a portfolio basis.”

If revalued amounts are used, a policy for the frequency of revaluations should be adopted and an entire category of long-term investments should be revalued at the same time.

The carrying amount of all long-term investments should be reduced to recognise a decline other than temporary in the value of the investments, such reduction being determined and made for each investment individually.”

Profits from the disposal of these investments, considered as long-term investments, have been credited to the profit and loss account.

The auditors have opined that except for this and two other items, the financial statements provide the information required by the Companies Act no.17 of 1982 and give a true and fair view of the state of the company’s affairs.

Price levels and activity in the stock market comprise an internationally recognised barometer that reflects the health of a free and open economy, particularly from the private sector perspective. Is not public attention being districted from reality when such provision is not made? What has the accounting standard required?

LOSS OF RS.57.8 MN.

Debts shown as due on bills discounting, amounting to Rs.57.8 mn. have been written off against the profits brought forward from the previous years in the 1996 accounts. MBSL auditors from 1994 M/s Someswaran, Jayawickrama & Co., chartered accountants (representing the Arthur Anderson Worldwide Organisation in Sri Lanka) in their report for the year 1995 had given an 'except' opinion, inter alia, in relation to the following note:

> 9.1 Bills discounting--- The total value of the bills discounted as per the financial statement differs from the total of the individual balances of trade finance by Rs.63 mn. No adjustment has been made in the financial statement for this difference. The difference is being reconciled from the year 1991."

International auditing standards, applicable in Sri Lanka according to ICASL, state that a qualified opinion is expressed as 'except for'. In pursuance, the following note is given to the 1996 annual accounts:

> "Six prior year adjustments--- this includes the value of the reconciled (21.1 mn.) and unreconciled (36.7 mn.) balances noted in the bills discounting reconciliation that relates to previous years."

Profit for the current year 1996 has been shown as Rs.54.9 mn., while this write-off to the prior years had amounted to Rs. 57.8 mn.

Accounting standard no.10 of ICASL would be applicable in this instance, particularly clauses 7,10,11,31,32,34 and 37. Issues of presentation and interpretation of accounting standards are matters that need to be considered by ICASL, being responsible for adopting such standards and the SEC, whose rules require adherence to such standards.

President, ICASL and SEC member,
Reyaz Mihular — Conflicting roles?

The Sunday Leader has received a prompt response dated March 4, 1997 from the president, ICASL, M. Reyaz Mihular, who, inter alia, has stated: "While it is true that the Merchant Bank of Sri Lanka did indeed consult the urgent issues task force (UITF), the task force did not issue a definitive ruling on the matter as it involved matters of judgment to be exercised by the directors and the auditors of the Company, who would be in a better position to decide on the appropriate treatment. The task force instead set out to the company the provisions in the relevant accounting standard relating to prior year adjustments and the circumstances when a company can adjust a material error/ omission as a prior year adjustment."

Clearly, MBSL, whose board of directors comprise two chartered accountants, Rajan Asirwatham, senior partners, KPMG, Ford, Rhodes, Thornton and Co. and M.T.L. Fernando, precedent partner, Ernst & Young, the two leading firms of accountants, had consulted the ICASL since obviously they themselves, had been in doubt. ICASL's reply, essentially, has been: you do what you think best.

Reyaz Mihular, president, ICASL and Rajan Asitwatham, chairman, MBSL are partners of KPMG Ford, Rhodes, Thornton & Co. What would Riyaz Mihular's opinion be as a member of SEC responsible for enforcement ?

AUDITORS' RESPONSIBILITY ?

The more cogent issue to the shareholders and the company, is why and how such cognisable amount of Rs.57.8mn. had not been diligently pursued and recovered since 1991 as reported, more so by a Merchant Bank, that too with Rs.36.7 mn. thereof, not even reconciled, the implication being that the specific debtors have not even been identified. Ordinarily debts on bills discounting arise from cash advances to parties. If there are no records even to identify parties to whom such advances had been made, ought the matter not to be investigated to ascertain, whether there had been any defalcation or misdemeanour?

Should the shareholders and the company simply grin and bear such loss without any inquiry? Extent of check and the auditors duty, when put upon inquiry, was succinctly brought out by Lord Alverstone in the case, London oil Storage Co. Ltd. If his suspicion is aroused, his duty is to "probe to the bottom…"

The question arises as to how the former auditors of MBSL M/s KPMG Ford, Rhodes, Thornton& Co., chartered accountants, had failed to detect this in the previous audits? Is not a debtors' ageing analysis an integral part of sound management, as well as an audit programme for checking debts and considering adequacy of provision for bad and doubtful debts ? Would or would not the former auditors be responsible for any negligence? Auditors carry both civil and criminal liability under the law.

Could the MBSL in its interest and that of its shareholders, make an independent decision on this material issue, given the scenario that the chairman, MBSL, Rajan Asirwatham, is also a senior partner of the auditors in question --- M/s KPMG Ford, Rhodes, Thornton & Co.?

Ironically, note no.26.8 to the 1996 accounts has disclosed:

> "26.8 Professional services ----- Rajan N Asitwatham, chairman of the bank, is a director of Secretaries and Registrars Limited and partner, KPMG Ford Rhodes Thornton & Company, which provides registrar's services and internal audit services respectively for a fee".

The MBSL 1995 annual accounts had shown Rs. 50 mn. as an investment in 625,000 shares of George Steuart & Co. Ltd., categorised as an associate company of MBSL. Consequent upon a letter dated August 20, 1996 addressed to the SEC by David L.B. Jansze, a former director of George Steuarts, the SEC, after inquiry, had directed MBSL to make a full disclosure of the correct position. Accordingly, the MBSL quarterly report to September 30 1996 dated November 25, 1996 had carried the following note:

> "The Merchant Bank of Sri Lanka Limited (MBSL) entered into a Memorandum of Understanding (MOU) with George Steuart & Company Limited (GSL) in October 1994 to restructure GSL. As part of the restructuring, MBSL agreed to invest in the equity of GSL. Pursuant to the MOU, MBSL advanced Rs.18.36 mn. by way of a bridging loan to GSL, giving MBSL the option to convert the monies due on the loan to GSL, giving MBSL the option to convert the monies due on the loan to settle the amount due on account of the purchase of ordinary shares."

> “In December 1994, MBSL notified GSL its decision in pursuant with the MOU to acquire GSL shares to the value of Rs. 18.36 mn. already advanced to GSL. In view of the said exercise of the option, MBSL stopped charging interest on the said sum of Rs.18.36 mn. with effect from 31.12.94 and the annual accounts of MBSL indicated an investment in GSL amounting to Rs. 18.36 mn.”

> “Subsequently in March 1995, a further sum of Rs. 31.64 mn. was advanced by MBSL to GSL having agreed that it will constitute an investment of MBSL in GSL shares.”

Upon payment of Rs.50 mn. MBSL having become entitled to 625,000 shares in GSL in terms of the MOU at a price of Rs.80 per share, the annual report for the year 1995 disclosed the same as an investment in the shares of GSL. By their company secretary’s letter of December 7,1995, GSL confirmed that Share certificates for 625,000 shares pertaining to MBSL investment will be issued as soon as the formalities are finalised.

> “Contrary to our expectations, the allotment of shares has been delayed by GSL’s failure to amend the memorandum and articles of association which was necessary to facilitate the allotment. Upon being queried, GSL has by their letter of 13.11.96 confirmed their commitment to allot the shares upon removal of certain legal impediments perceived by them.”

KOTAGALA CONTROVERSY

MBSL’s associate company, George Steuart & Co. Ltd., through its subsidiary George Steuart Management Services (Pvt) Ltd., having purchased the controlling interest of Kotagala Plantations Ltd. in November 1995 had sold such controlling interest shortly thereafter, to a Malaysian/Thai consortium in December 1995. In addition, in 1995, MBSL had also directly purchased 950,725 shares in Kotagala Plantations Ltd. for Rs.9.5 mn.

The Kotagala Plantations privatisation transaction steeped in controversy, with critical exposures in the media is now before a Committee of Parliament, and it is understood that matters are being investigated. Then Chairman, Public Enterprise Reform Commission (PERC) that privatised Kotagala Plantations was Chairman of MBSL. It has been reportedly alleged by the former Director of George Steuarts, David Jansze, that his representations to then Chairman, PERC, had been of no avail.

George Steuarts is also a beneficial owner of deferred shares in Ceylon Guardian Investment Trust Co. Ltd., having diversified share portfolios in companies including Hayleys.

CONTROVERSIAL MOVE

A recent controversy in business circles was the move by significant shareholders, Carson, Cumberbatch Group to have adequate representation on the Ceylon Guardian Board, resulting in, amongst others, M.T.L. Fernando and J.S. Mather, partners of Ernst and Young, eventually resigning from the Board of Ceylon Guardians in 1996.

In 1995, MBSL, where M.T.L. Fernando is a director, had purchased 58,800 shares in Ceylon Guardian at a cost of Rs.24.5 mn., the market value of which, in December 1996 stood at Rs.8.5 mn., a shortfall of Rs.16 mn. In addition, David Jansze, the former director of George Steuarts has further alleged in his letter dated December 23,1996 to the SEC that MBSL had advanced further interest free funds in excess of Rs.6 mn. to George Steuarts, to persuade George Steuarts to desist from selling its interest in Ceylon Guardians to Carsons.

Also in 1995, MBSL had acquired 348,111 shares costing Rs.56.8 mn. in Hayleys Ltd., in addition to the 81,470 shares it already had costing Rs.20.5 mn. After disposal of 420,915 shares at the cost of Rs.1.3 mn. MBSL has also invested Rs.20 mn. in 909,091 shares of Hayleys ADC Textiles Ltd. in 1994 and Rs.15 mn. in 833,000 Shares in Hayleys MGT Knitting Mills Ltd. in 1996. Both investments are shown as non-quoted investments. Chairman, Hayleys, is a director of Bank of Ceylon, the holding company of MBSL.

CENTRAL BANK ASLEEP?

Governor, Central Bank,
A. S. Jayawardene —
Turning a Nelsonian eye?

The Central Bank statutorily and administratively controls and supervises the operation of banks, as well as finance, companies, This inter alia, includes the adherence to certain prudent financial parameters and reserves. There are special guidelines on loans to bank directors or to companies in which they are specifically reviewed by the Central Bank.

Are not merchant banks statutorily and administratively controlled and supervised by the Central Bank? If not, why? With the growth of a number of merchant banks ought not the Central Bank to have already taken action to control and supervise them ? Circumstances in the secondary money market of finance companies, compelled the Central Bank to enhance its control and supervision over them. If banks are subject to control and supervision, why not merchant banks?

In the case of MBSL it is a subsidiary of Bank of Ceylon, and in such circumstances would it not be accountable to supervisory controls by the Central Bank? Or is it that a bank is free to form a merchant Bank, as a subsidiary, and divert its funds, free from the control and supervision of the Central Bank?

ACCOUNTING STANDARDS

I REFER to your article on the Merchant Bank of Sri Lanka appearing in last Sunday's edition in wherein it was stated that the accounting treatment followed in 1996 accounts of the bank, where certain items were treated as prior year adjustments, was done on a ruling obtained from the Urgent Issues Task Force (UITF).

While it is true that the Merchant Bank of Sri Lanka did indeed consult the UITF, the task force did not issue a definitive ruling on the matter, as it involved judgment to be exercised by the directors and the auditors of the company, who would be in a better position to decide on the appropriate treatment.

Instead, the task force made known to the company the provisions in the relevant accounting standard relating to prior year adjustment, and the circumstances when a company can adjust a material error/ omission as a prior year adjustment.

The mandate of the Urgent Issues Task Force, which comprises chartered accountants from all the leading accountancy firms in the country as well as from industry, is to provide clarification and guidance on the applications of Sri Lanka Accounting Standards in the preparation and presentation of financial statements, and not to exercise judgments on accounting matters of individual companies which are clearly matters that rightly belong to the realm of the company’s management and their auditors.

I hope the above clarification will help in understanding the role played by the UITF when matters are forwarded to it for a ruling.

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