

Lankaputhra Development Bank Limited - 2015

The audit of financial statements of the Lankaputhra Development Bank Limited (“The Bank”) for the year ended 31 December 2015 comprising the statement of financial position as at 31 December 2015 and the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory 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.

This report is issued in terms of Article 154 (6) of the Constitution of the Democratic Socialist Republic of Sri Lanka

1.2 Board’s Responsibility for the Financial Statements

The Board of Directors (“Board”) is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards and for such internal control as the Board determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

1.3 Auditor’s Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with Sri Lanka Auditing Standards consistent with International Auditing Standards of Supreme Audit Institutions (ISSAI 1000 – 1810). Those Standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Bank’s preparation and fair presentation of the financial statements 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by Board, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

2. Financial Statements

2.1 Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2015, and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Financial Statements

2.2.1 Accounting Deficiencies

(a) Impairment Calculations and Provision for Loans

The following observations are made.

- (i) Loss Given Default Ratio of 20 per cent used by the Bank for collective impairment calculation was not supported by any computation.
 - (ii) The Bank had not considered interest receivable balances on loans and advances amounting of Rs.517,356,607 for the collective impairment calculation.
- (b) The following observations are made relating to the Property Plant and Equipment amounting to Rs. 91,117,122 shown in the financial statements.
- (i) The Bank had classified some items of computer software as computer equipment in the general ledger. As per the financial statements for the year ended 31 December 2014 the computer software which is included in the computer equipment account had been reclassified into as intangible assets. However, the relevant entries had not been made in the general ledger even up to 31 December 2015. As such the opening balance of the computer equipment and accumulated depreciation thereon had been understated by Rs.10,927,698.
 - (ii) The computer software purchased during the year 2015 amounting to Rs.3,960,630 had been accounted to the computer equipment account in the general ledger. Further, the amortization thereon for the year under review amounting to Rs.2,255,276 had been charged to the financial statements as well. However, the corrective entries had not been made in the accounts even up to the end of the year under review.
- (c) National Building Tax calculated for the month of December 2015 amounting to Rs. 817,979 had not been brought to accounts.

- (d) The following deficiencies were observed in relation to accrued expenditure classified under other liabilities.
- (i) The finance account of the Polonnaruwa Branch shows a debit balance of Rs.732,752 in sundry creditors due to erroneous entries.
 - (ii) There was an unidentified customer deposit of Rs.1,235,669 under accrued expenditure. It was further observed that there was no proper procedure introduced to identify this customer deposit and account accordingly.
- (e) Value Added Tax (VAT) payable on legal fees and commissions aggregating Rs.638,912 classified under other assets in the financial statements for the year ended 31 December 2014 had not been settled even in the year under review.
- (f) The following observations are made in relation to deposits and prepayments accounts classified under other assets.
- (i) Western Union receivable account shows a negative balance of Rs.867,035 and the reasons for this was not explained.
 - (ii) Two general ledger accounts namely Rent Paid in Advance and Rent Deposit Colombo are used by the Bank to record similar type of transactions without maintaining separate accounts to record refundable rent deposits and rent paid in advances separately.
 - (iii) There is an advance of Rs.749,812 made to a leasing company. Though the lease agreement period was lapsed, this amount still appears in the financial statements as a receivable balance. Further, there is no any documentary evidence made available to prove this amount.
 - (iv) Stamp duty paid on behalf of the Head Office building owner amounting to Rs.390,680 had not been set off against the rent expense for the month of November 2015.
 - (v) An amount of Rs.213,645 accounted under stamps does not reflect the stocks, prepayments or deposits and no documentary evidence was made available to prove the accuracy of this amount.
- (h) Differences aggregating Rs. 6,826,769 were observed between the balances of consumables, stationeries and promotional items shown in the general ledger and the physical stock verification records maintained at the Head Office as at 31 December 2015.
- (I) According to the bank reconciliation statements prepared for a current account by the Bank, an adjustable balance of Rs.1,161,647 relating to the year under review and the previous years had not been adjusted in the cash book even up to 31 December 2015.
- (J) According to the returns prepared for the crop insurance levy for the year 2015, a sum of Rs.2,036,236 should be charged to the income statement as crop insurance levy expense.

However, only Rs.1,697,420 had been charged to the income statement and no provision for difference of Rs.338,816 had been made in the financial statements.

2.2.2 Unidentified differences

The following unidentified differences were observed.

- (i) There was a balance as a inter branch current account amounting Rs.1,954,056 due to unidentified issue in the bank mate system and the Bank has reported to the software company regarding this issue.
- (ii) There was a difference of Rs.348, 400 between the Clearing Control Account and Cheques Sent on Collection Account.
- (iii) According to the previous year reconciliation, it was observed a non-adjustable amount of Rs.3,749,758 and Rs. Rs.774, 318 between the Polonnaruwa Branch Account 2 and accounts of the Head Office and Colombo Branch Account 2 and the accounts of the Head Office respectively. Further, these were not adjusted even up to the date of this report.
- (iv) There was an erroneous entry for Rs.2, 000,000 in the reconciliation between the Head Office and Branch Account Colombo 2.
- (v) A difference of Rs.1,256,364 was observed between the net book value of property plant and equipment shown in the financial statements and the fixed asset register.

2.2.3 Lack of Documentary Evidence

Invoices for SME debtors amounting to Rs.1,432,019 had not been furnished for audit.

2.2.4 Non – compliance with Laws, Rules, Regulations and Management Decisions

Reference to Laws, Rules, Regulations and Management Decisions.

Non- Compliance

Section 56 of the Companies Act, No. 07 of 2007

Solvency test had not been performed by the Bank before distribution of dividends in 2015

Section 3 (2) of the Banking Act, No.12 of 2007 on Corporate Governance for LSB's direction

As per the cited direction, the number of Directors of the Board shall not be less than 7. However, the Board consists only 5 Directors including Chairman in the year 2015

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2015 had resulted in a pre-tax net profit of Rs.192,745,957 as compared with the corresponding pre-tax net profit of Rs.178,655,721 in the preceding year, thus indicating an increase of Rs.14,090,236 or 8 per cent in the financial results for the year under review.

Increase of interest income and other operating income by Rs.19,364,609 and Rs.31,260,902 respectively as compared with the preceding year were the main reasons attributed for this improvement in the financial results for the year under review.

3.2 Value Addition of the Bank

Although the profit for the year under review was Rs. 192,745,957, the value addition was Rs.403,938,936 and it had been increased by 13 per cent as compared with that of 33 per cent decrease in the preceding year. The increase of net profit and personnel emoluments by Rs.14,090,236 and Rs.28,209,403 respectively had been mainly attributed for this increase in value addition.

A gradual decrease in value addition was observed since the financial year 2012 to 2014. However, the financial value addition had increased in the year 2015 by 13 per cent as compared with the preceding year. It was further observed that, if it was not considered the foreign currency revaluation gain which is not a recurring transaction of the Bank, the increase of financial value addition is limited only to 5 per cent as compared with the preceding year.

3.3 Analytical Financial Review

According to the information made available, some of important accounting ratios of the Bank for the year under review and the preceding year as compared with the sector specialized ratios are as follows.

Indicator -----	Sector Ratio (Licensed Specialized Bank)		
	-----	-----	-----
	%	%	%
Profitability Ratio			
Net Profit Ratio	16.1	28.85	30.38
Net Interest Margin	3.8	6.90	6.93
Net Interest Income to Interest Income	38.1	88.91	89.42
Non-Interest Income to Total Income	10.9	5.35	0.62

Interest Cost to Interest Income	61.9	11.09	10.58
Staff Cost to Operating Expenses	52.1	54.94	47.59
Return on Average Assets	1.6	2.36	2.39
Return on Equity	16.1	4.00	3.98
Earnings per Share	-	5.34	4.95
Capital Adequacy Ratio			
(i) Tier i	19.7	69.35	74.29
(ii) Tier ii	18.2	69.92	74.72
Liquidity Ratios			
Liquid Assets Ratio (Minimum 20 per cent)	67.9	888.2	1146.20
Asset Quality			
Non Performing Advance Ratio	6.4	35.2	44.6

The following observations are made in this regard.

- (i) The total capital adequacy ratio of the Bank is 69.92 per cent which is excessively high level than the minimum requirement of 10 per cent.
- (ii) High interest margin of 6.90 per cent had reported as at 31 December 2015 as compared with the average Licensed Specialized Bank ratio of 3.8 per cent. This indicates that the Bank had failed to pass the advantage of low cost borrowings to its customers
- (iii) The contribution of non-interest income to the total income of the Bank was only 5.35 per cent which was significantly lower than average Licensed Specialized Bank ratio of 10.9 per cent. Therefore, the Bank was highly concentrated on interest income and would be vulnerable to change in interest rates.
- (iv) High NPL Ratio that stood at 35.2 per cent as at 31 December 2015 which is far above the LSB average of 6.4 per cent.
- (v) The statutory liquid asset ratio had far above the minimum requirement of 20 per cent and recorded as 888.2 per cent as at 31 December 2015. This is due to maintenance of high liquid assets without investing in high yield sources.

4. Operating Review

4.1 Performance

According to the Primary objectives of the Lankaputhra Development Bank Ltd, it has mainly focused on accepting time and saving deposits, strengthening entrepreneurship at regional, national and international levels, carry on finance leasing businesses and engage in the business of pawn broking. The lapses observed in the performance of the Bank during the year 2015, with compared to its main objectives are summarized below.

(a) Operational Performance

Out of total interest income, the interest income on loans and advances and leases reflect only 46 per cent. Therefore, the Bank may have sustained an operational loss of Rs.136,287,708 for the year under review if the Bank had not been able to earned interest income on investments and foreign currency revaluation gain of Rs.370,911,903 and Rs.28,699,749 respectively during the year under review.

(b) Deposits

The Bank had a customer deposits of Rs.520,106,852 which is only represent 13 per cent of the total loan portfolio of the Bank.

(c) Loan Portfolio

The Bank is mainly focused on investments which represent 66 per cent of its total assets despite its main objective to strengthening entrepreneurship at regional, national and international levels through granting of loans. Further, the loans and advances (net of impairment provision and interest in suspense) represent only 31 per cent of its total assets. On the other hand opposed to high quality assets, the Bank focused on low yielding investments.

4.2 Operating Activities

The following observations are made in this regard.

- (a) As per minutes of the meeting held by the Department of Public Enterprises with Board of Directors and officials of the Lankaputhra Development Bank Ltd on 26 July 2011, it was decided to limit the maximum loan amount for an individual customer to Rs. 20 million in order to eliminate the high credit risk. However, 03 customers have been granted loans amounting to Rs.134 million exceeding the maximum limit. The total outstanding of the above loans as at 31 December 2015 was Rs.108 million.
- (b) The Bank had sought the approval of the Central Bank of Sri Lanka (CBSL) in December 2015 to open the help desks in Thambuttegama and Akuressa. However, the help desks have been opened in Thabuttegama without such approvals. In the meantime, CBSL had informed to the Bank in early part of 2016 that the approval has not been granted to open the new service desks in view of many pending supervisory concerns. As well they have requested to make necessary arrangements to close down the service desks in the above locations if any and continue the operations of the Bank without expanding the existing business in any areas using service desks and mobile banking units. The operations of the above service Centres were further rejected by CBSL through the letter dated 05 September 2016. However it was observed that the above help desks are still in operation.

- (c) Through a letter dated 24 March 2016 issued by the Director of Bank Supervision of CBSL to the Chief Executive Officer of the Bank, had informed that they refused the appointment of the Chairman of the Bank. Further, the Monetary Board had confirmed the refusal of his appointment as a Chairman of the Bank through their letter dated 02 September 2016.
- (d) It was noted that during three days (29 December 2015, 30 December 2015 and 31 December 2015) of the year under review, the fixed deposits of Rs.50.6 million have been created on 11 customers' names and at the same days 90 per cent of the deposits amounting to Rs.45.54 million had been granted as a loan against these deposits by Wennappuwa Branch. However, all these deposits had been uplifted and settled the loans taken just few days after the placement of deposits (07 January 2016 and 11 January 2016).

When considering the total deposits created and total loans disbursed by the Branch during the year 2015, it was revealed that, 83 per cent of the deposits and 23 per cent of the loans are created and disbursed respectively during the month of December which is highly unusual. It appears that there had been no physical cash movement for these transactions and only manipulation of new deposits and advances to boost the Branch performance.

- (e) According to the verification carried out on selected top 15 non performing customers it was revealed the followings.
 - (i) All those loans granted during the period of 2006-2014 had been subsequently categorized under loss category.
 - (ii) Total capital outstanding as at 31 December 2015 was Rs.576.90 million which represents 51 per cent of total Non Performing Loans of the Bank.
 - (iii) Total interest outstanding on the above loans was Rs.326.80 million.
 - (iv) Though the legal actions had been preceded, due to lapses in the loan granting process, the recoverability is doubtful.
 - (v) A plaint has been filed in the Financial Crimes Investigation Unit against 14 defaulted customers and investigations are in progress.
- (f) According to the audit test check carried out on selected 03 performing customers (loans granted during the period 2006 – 2014) and 08 performing customers (loans granted during the year 2015) revealed following deficiencies. The capital outstanding as at 31 December 2015 of those selected customers was Rs.67.4 million.
 - (i) Although the mortgaged properties were the leased hold properties of the government, the lease agreements entered into between the borrowers and the government was not made available for audit.

- (ii) Primary mortgaged bond, insurance over the mortgaged property, extracts issued by the Land Registrar, visits report over mortgaged property, post inspection reports, certified NIC copies, project proposals, and reports of the Credit Information Bureau of guarantors had not been submitted for audit.
 - (iii) The loans had been granted on unsatisfactory conditions in the reports of Credit Information Bureau.
 - (iv) The audited financial statements had not been submitted to the Bank by customers.
 - (v) Mortgage bonds had not been submitted by the Bank for the registration to the company registrar.
 - (vi) There were incomplete loan applications and guarantors' statements.
 - (vii) Chairman's involvement regarding loan expansion, reduction of interest rates and loan approvals was observed.
 - (viii) Salary remittance details were incomplete.
 - (ix) Loan protection policy was not in place.
- (g) According to the Cabinet Memorandum dated 22 January 2007, the cabinet approval had been granted to provide a sum of Rs.2,000 million to the Bank from the Ministry of Finance in order to utilize the funds to assist in the restructuring process of the closed down factories. Out of that an amount of Rs.750 million had been given by the Ministry of Finance to the Bank and a sum of Rs.174.23 million was payable to the Ministry of Finance as at 31 December 2015. The following observations are made in this regard.
- (i) The Ministry of Finance had instructed the Bank to provide facilities approximately Rs.750 million to the Tri- Star Apparel Exports (PVT) Ltd, at zero interest rate for 10 years with 01 year grace period. Accordingly a sum of Rs.700 million had been granted to Tri-Star Apparel Exports (Pvt) Ltd up to the end of the year under review. However, No collateral was collected by the Bank before granting the loan.
 - (ii) The amount outstanding as at 31 December 2015 was Rs.555.76 million and according to the records of the Legal Department of the Bank it was revealed that the recoverability of the loan is doubtful due to the company's going concern is in uncertainty.
- (h) An approved investment policy was not in place at the Bank which helps for effective treasury management.
- (i) Even though the Batticaloa Branch had shifted to another place, the refundable deposits of Rs.225,000 made on the rented out building for the Branch operation had not been recovered.

4.3 Apparent Fraudulent Nature Transactions

At an audit test check carried out at the Wennappuwa Branch of the Bank, it was revealed that a sum of Rs.738,138 had been withdrawn by the officers from the customers' accounts by placing customer's signatures fraudulently.

4.4 Human Resources Management

The following observations are made in this regard.

- (a) Sixty four employees had been recruited to the Bank during the period from 01 January 2015 to 03 March 2016. Out of those employees, 21 employees had not been possessed the minimum educational qualifications required for such posts.
- (b) According to the Banking Act Direction No.12 of 2007 with regard to Corporate Governance for Licensed Specialized Banks, the Chairman shall not engage in activities involving direct supervision of Key Management Personnel or any other executive duties whatsoever. However, it was evidenced that most of the appointment letters given during the above mention period had been signed by the Chairman.
- (c) The Bank had recruited a person for the post of legal consultant and company secretary on a contract basis without following acceptable recruitment procedure. Further, any job description was not given to him.

4.5 Market Share

The market share of the Bank, computed based on selected indicators of the industry for the year under review and previous 4 years is summarized below.

Description	2015	2014	2013	2012	2011
-----	-----	-----	-----	-----	-----
	%	%	%	%	%
Interest Income	0.60	0.63	0.66	0.93	0.93
Interest Expense	0.11	0.09	0.09	0.11	0.13
Non-Interest Income	0.62	0.03	0.49	0.86	0.05
Profit Before Tax	1.13	1.12	4.40	2.30	0.82
Assets	0.76	0.73	0.83	0.94	0.97
Gross Loans and Advances	0.74	0.66	0.76	0.85	0.89
Gross Non-performing Advances	4.03	2.94	3.55	5.68	6.74
Investments	1.02	1.02	1.14	1.25	1.11
Deposits	0.07	0.05	0.04	0.04	0.04

The following observations are made in this regard.

- (i) The market share of the Bank against selected indicators except Gross Non-Performing Advances are marginal and nearly about 1 per cent. No major change was observed during the above period.
- (ii) The Bank's contribution to the industry by way of deposits and interest expense are highly low and nearly about 0.1 per cent.
- (iii) The Bank had contributed 4 per cent Gross Non-performing Advances to the industry, which is considerable as compared with other indicators for the year 2015.

5. Accountability and Good Governance

5.1 Corporate Plan

The Corporate Plan covers the period 2012-2016. The targets set out to achieve in the year under review and their achievements are summarized below.

Description	Target Rs.(Mn)	Actual Rs.(Mn)	Actual as a Percentage of Target
Loans & Advances	7,800.00	3,371.00	43
Deposits	3,820.00	520.00	13
Interest Income on Core Business	698.70	294.00	42
Interest Income on Investments	139.00	338.00	243

gets set out in Corporate Plan, especially for loans and advances, deposits and interest income on core business seems to be unrealistic due to actual result is far below the target. Therefore, the Board had decided in its meeting held on 28 July 2015, the existing Corporate Plan is ineffective. However, actions had not been taken to prepare a new Corporate Plan.

5.2 Internal Audit

The following observations are made.

- (i) Repetitions of same lapses pointed out by the internal audit were observed without taking prompt actions to rectify the highlighted deficiencies.

- (ii) In terms of Section 3 (6) (II) (i) and (l) of the Banking Act Direction No. 12 of 2007 on Corporate Governance, the Audit Committee has not reviewed the external auditor's management letter and management responses thereto for the year 2014 and the external auditor had not been invited for any of the Audit Committee meeting held during the year 2015

5.3 Budgetary Control

Variances ranging 6 per cent to 297 per cent were observed between the budgeted and actual items, thus indicting that the budget had not been made use of as an effective instrument of management control.

6. Systems and Controls

Weaknesses observed in system and controls during the course of audit were brought to the notice of the Bank. Special attention is needed in respect of the following areas of control.

Control Area	Observation
-----	-----
(a) Accounting	Calculation of impairment provision, classification of property plant and equipment and intangible assets, recognition of accrued expenditure, reconciliation of control accounts, tax calculations, recognition of deposits and prepayments.
(b) Inventory Management	Physical verification of inventories and reconcile with the ledger balance, taking proper actions to rectify the variances.
(c) Loan Administration	Strict compliance with the procedures introduced
(d) Human Resources Management	Implementation of a policy to select/ appoint key management personnel and for other staff in complies with the recruitment and promotional procedure of the Bank.
(e) Corporate Governance	Compliance with the corporate governance directives and supervisory concerns issued/given by the Central Bank of Sri Lanka (CBSL).
(f) Internal Control	Strengthen the internal control over operations of the Bank.
(g) Budgetary control	Compliance with the budgetary provision when incurring expenditure.

