Bank of Ceylon - 2011

1 Financial Statements

1.1 Opinion

In my opinion, the consolidated financial statements give a true and fair view of the financial position of the Bank and its subsidiaries as at 31 December 2011 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Comments on Financial Statements

1.2.1 Accounting Deficiencies

Fund Accounts

(i) Following differences were observed between the Provident fund Accounts and the detailed schedules prepared by the Superannuation Department of the Bank.

Provident Fund	**As per the fund Accounts Rs.**	**As per the schedule Rs.**	**Difference Rs.**
Total Members' contribution	2,485,120,816	2,475,443,452	9,677,364
Total Bank Contribution	3,730,876,050	3,721,336,610	9,539,440
Accumulated Interest	12,756,581,521	12,797,780,647	(41,199,126)
Total	**18,972,578,387**	**18,994,560,709**	**(21,982,322)**

(ii) Following differences were observed between the financial statements and the fund accounts with regard to the bank's contribution to the provident fund and pension trust fund.

Name of the fund	Bank contribution as per Financial Statements Rs.	Bank contribution as per Fund Accounts Rs.	Difference Rs.
Provident fund	523,382,654	524,676,577	(1,293,923)
Pension trust fund	1,608,447,451	1,612,050,672	(3,603,221)

1.2.2 Suspense Accounts

Action had not been taken to recover and settle the Suspense Account Debtors and Creditors amounting to Rs. 135,078,799 and Rs. 2,583,233,504 respectively which had been brought forward for a long period of time.

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

Instances of non-compliance observed during the course of audit of the branches of the Bank are given below.

Reference to Laws, Rules, Regulations, etc.	Non – compliance
a) Office Instruction Circular No: 45/2010 dated 08/02/2010	Maintenance of the Register of Fixed Assets, Coding system and annual physical verification of Assets had not been carried out as per circular instructions.
b) Office Instruction Circular No: 29/1995 dated 05/09/1995	i) The staff members who have worked over 5 years in the same Branch had not been transferred out.
	ii) Most of the staff members were continuously assigned the same duties for long period without being rotated.

2 Financial and Operating Review

2.1 Financial Results of the Bank

a) According to the financial statements presented, the operations of the Bank and the Group during the year under review had resulted in a pre-tax net profit of Rs. 15,546 million and Rs. 15,851 million respectively as compared with the corresponding pre-tax net profit of Rs. 10,053 million and Rs. 11,075 million in the preceding year respectively, thus showing an increase of Rs. 5,493 million and Rs. 4,776 million respectively in the financial results.

Increase in the foreign exchange profit and dividend income amounting to Rs.1,338 million and Rs. 244 million respectively were the main reasons for this increase. Further the Bank had reversed a provision for fall in value of investments in related companies made in a previous year amounting to Rs. 815 million.

However, as a result of unfavourable conditions prevailed in the stock market the Bank had to bear a massive loss from investment in securities amounting to Rs. 1,271 million, though there was a net gain of Rs. 3,106 million from investment in securities in the previous year.

The following table gives a summary of the financial results of the Bank and the Group at various stages for the year under review and the preceding year.

	Bank		**Group**	
	2011 Rs.Million	**2010 Rs.Million**	**2011 Rs.Million**	**2010 Rs.Million**
Interest income	60,745	50,843	63,728	53,052
Interest expenses	(36,229)	(31,200)	(37,384)	(32,014)
Net interest income	**24,516**	**19,643**	**26,345**	**21,038**
Other income	10,876	12,047	10,864	13,254
Total income	**35,392**	**31,690**	**37,209**	**34,292**

Total expenses	(19,846)	(21,638)	(21,357)	(23,216)
Net profit before tax	**15,546**	**10,053**	**15,851**	**11,075**
Tax	(4,025)	(3,687)	(4,364)	(4,162)
Net profit after tax	**11,521**	**6,365**	**11,487**	**6,913**

b) Following observations are made in connection with the foreign branches.

i) Profits of Male and Chennai branches for the year ended 31 December 2011 amounted to Rs. 881.76 million and Rs. 287.79 million respectively as compared with the profits of Rs. 172.42 million and Rs. 228 million for the preceding year thus indicating an increase of 411 per cent and 26 per cent respectively.

ii) Non-performing advances of Male branch had increased to Rs. 162.57 million or 69 per cent in the year under review from Rs. 96 million in the preceding year, while non-performing advances of Chennai branch had decreased from Rs. 45 million to Rs. 32.97 million by 27 per cent in the year under review.

2.2 Significant Ratios

Certain significant ratios for the year under review and preceding five years are given below.

		Actual					
	CBSL Norms %	**2006 %**	**2007 %**	**2008 %**	**2009 %**	**2010 %**	**2011 %**
(a) Capital Adequacy Ratio (Tier 1)	5.00	11.90	11.38	11.29	11.22	10.30	8.52
(b) Capital Adequacy Ratio (Tier 2)	10.00	12.30	11.40	15.88	14.16	13.73	11.64
(c) Income Growth		28.80	42.53	19.98	5.45	(0.16)	12.63

(d) Return on assets	1.19	1.11	1.13	0.82	1.60	2.01
(e) Liquidity Ratio	22.19	21.20	24.21	21.13	28.65	23.36

Following observations are made in this regard.

a) Even though the Bank had maintained adequate Capital Adequacy Ratio (Tier 1), it had gradually deteriorated since 2006 and further decreased to 8.52 per cent in the year under review, which was 17.3 per cent decline as compared to the preceding year. Total Capital Ratio had also decreased up to 11.64 per cent, which was 15.2 per cent decline, as compared to the preceding year.

b) Income growth rate of the Bank had been reported as 12.6 per cent with a sharp increase as compared to the preceding year which had a negative income growth rate, overcoming the drastic deterioration experienced since 2008.

c) The Bank was able to improve its return on asset ratio to 2.01 per cent during the year under review as compared with the previous year, which was an increase of 25.6 per cent.

d) Liquidity Ratio of the Bank had decreased to 23.36 per cent, which was 18.5 per cent decline as compared with the preceding year.

2.3 Loan Administration

Audit test check revealed that certain loans and advances had been granted without proper evaluation of securities mortgaged as well as evaluation of credit worthiness of the customers. Audited accounts of the customers and legal documents relevant to establishment of the companies had not been obtained on a timely manner. Correspondence files for advances had not been updated with relevant documents and information. In certain instances the insurance policies against the mortgaged properties had not been obtained/ duly renewed. Regular inspections had not been carried out on mortgaged properties. In certain instances, letter of set off had not been taken from the borrowers concerned.

The following observations are made during the course of audit in this regard.

a) Shipping Agent Company

This company had been granted a credit facility of USD 1.6 million in 2008 by the Offshore Banking Division to purchase a vessel under the corporate guarantee of the holding company and the mortgage over the vessel. The capital outstanding as at 31 December 2011 was USD 1.1 million.

However, now this facility was unsecured as former holding company had revoked their corporate guarantee since the company was sold in 2009 and bank had failed to obtain the corporate guarantee from the new holding company. And also the vessel had become commercially unviable and the scrapped value was "NIL". However, the bank had filed a case against the company to recover the outstanding.

b) Chipboard Manufacturing Company

This company had been granted a package of credit facilities worth of Rs. 50 million under the E-Friends scheme and a term loan of Rs. 1.9 million in 2007 by mortgaging machineries, to produce chip boards using sawdust and the total capital outstanding as at 31 December 2011 was Rs. 51.8 million.

These facilities had been in arrears since 2007 and the factory had been closed down due to lack of working capital. The machineries mortgaged were not duly insured and the Bank had insured those in July 2011 and later recovered it from the customer. Although the company had made some payments, those were not according to an approved settlement plan and the Bank had not negotiated with the company to reschedule these facilities.

It was observed that there were lapses in evaluating this project and legal actions against the company had not yet been initiated.

c) Tea Exporting Company

Package of credit facilities granted to this company had fallen in overdue since 2007, and subsequently in 2008, those facilities were rescheduled for Rs. 96.081 million and the Bank had granted an additional credit facility of Rs. 45 million at the customer's request. Such rescheduled facilities were also not serviced regularly.

The Bank had executed parate right over the property mortgaged for the Rescheduled Term Loan-A2 for Rs. 7.5 million and the property had devolved to the Bank at the auction held in 2010. However, no other recovery actions had been taken to recover the remaining credit facilities. Total credit exposure as at 31 December 2011 was Rs. 99.4 million.

The Managing Director of the company had filed a case against the Bank at the Commercial High Court claiming Rs. 15 million for the business losses he had to occur due to refuse to grant further credit facilities to conduct the business by the Bank.

d) Hardware business and Estate Supplies Company

The credit facilities totaling Rs. 133,148,219 had been granted to the above company by the Nuwara Eliya Super Grade Branch and those were in NPA since 2009.

Eventhough the Bank had published auction notice under Section 21 of the Bank of Ceylon Ordinance in December 2010 and extension of time till June 2011 was granted at borrower's request, notice under Section 22 sent for publication was withdrawn as customer had deposited Rs. 1,015,000. Later, as per the agreement to deposit Rs. 500,000 monthly from August 2011 for one year, the Bank had agreed to waive off 50% of accrued interest as a terminal benefit.

However, bank had fully recovered the reschedule "B" facility from Rs. 3.5million deposit made and recover Rs. 487,344 from another loan in 2012. Total capital outstanding due from other credit facilities as at 31 December 2011 was Rs. 133,058,953. Negotiations to reschedule the facilities are still in progress.

e) Shipping and related services providing Company

This company had been granted credit facilities by the Foreign Currency Banking Unit (FCBU) and those were rescheduled for USD 814,062 in 2005 with an interest concession of USD 65,000 as a terminal benefit. Further, 50 per cent waiver of interest on the overdraft facility amounting Rs. 1.08 million for this company and 70 per cent waiver of interest amounting Rs. 14.8 million for one of its sister company were allowed on full settlement of the facilities.

At present the company is defunct and seized its foreign and local operations and further reschedulement with fresh documents is impossible. Therefore, the repayment plan of the former directors to pay off the facility in 120 months with a 40 per cent waiver of accrued interest (USD 122,215) as at 31 January 2012 together with the interest accruing from 01 February 2012 to the date of final payment upon repaying all dues and with the existing terminal benefit of USD 65,000, was approved on 24 February 2012. However, the company had paid USD 8,133.02 monthly up to September 2012 and not complied thereafter. Further, the bank had requested the legal department to send Letter of Demand. Total capital outstanding as at 31 December 2011 was USD 792,640.

f) Garments Manufacturing Company

This company is a BOI company and the Bank had granted a package of credit facilities which includes loans of Great Britain Pound (GBP) 1,500,000 and trust receipts of USD 350,000 in 2006 through FCBU. Although, the company had acquired another company which had defaulted its credit facilities obtained from the bank and agreed to settle such non-performing loan of that defaulted company, it had defaulted its own facilities.

In the meantime, the private Bank had seized all its assets initiating legal actions causing closure of all operations as the company had defaulted facilities obtained from private Bank as well.

Following of the discussions in 2010, it had settled the total dues of the company acquired and deposited USD 150,000 from which the Bank had recovered the temporary overdraft and part of capital outstanding of hypothecation facility with a 75 per cent waiver of accrued interest (USD 25,524) and the interest accrued thereafter from 24 October 2011. Further, documents had been handed over to the legal department to initiate legal action.

Total capital outstanding of Loans, Trust Receipts and TOD were GBP 1,387,955, USD 170,000 and Rs. 12,478 respectively as at 31 December 2011.

g) Educational Services Providing Company

This company had been granted three term loans amounting Rs. 294 million in 2006 and 2007 which were not serviced regularly and fell into arrears since 2007. Discussions had with the customer to reschedule the facilities were not successful and several attempts taken by the Bank to execute parate action over a property mortgaged were withheld at customer's requests upon making several payments.

However, the company had failed to submit an acceptable repayment plan eventhough it had been granted a considerable time period and the total credit exposure as at 31 December 2011 was Rs. 274.3 million. However the customer had paid a sum of Rs. 19.8 million during the year 2012 as repayment.

2.4 Non-performing Advances (NPA) and Provision for Bad Debts

Following observations are made.

a) According to the information furnished by the Bank, the following table gives the information relating to Non-performing Advances for the year under review and preceding two years.

Year	Total Bills, Loans and Advances Rs. (Mn)	NPA Rs. (Mn)	NPA as a percentage of total bills, loans and advances %	Provision for bad debts Rs. (Mn)	Provision for bad debts as a percentage of total NPA %
2009	275,061	15,542	5.60	9,956	64
2010	382,310	12,639	3.31	9,588	76
2011	552,792	11,416	2.07	9,140	80

b) i) Non-performing Advances of the following branches had also reflected higher percentages for the year under review.

Branch Code	Branch Name	Total Advances Rs Mn	Total NPA Rs Mn	NPA as a percentage of Total Advance (%)
7	Panadura	1,996	275	13.8%
49	Nugegoda	2,737	216	7.9 %
618	Metropolitan	5,469	394	7.2 %
122	Galenbindunuwewa	545	36	6.5%

ii) Non-performing Advances of the ten customers had also reflected higher amounts aggregating Rs. 1,557,318,298.

c) Sums of Rs. 9,688,763 and Rs. 31,494,089 had been written off as capital and interest of the outstanding loans respectively with regard to ten customers.

2.5 Foreclosed Property

A number of properties, which had been mortgaged to the Bank as securities for the advances granted had been auctioned in order to recover the outstanding balances during the year under review. There were 110 of foreclosed properties amounting to Rs. 899

million, which had not been sold up to 31 December 2011. Details of such properties were as follows.

		Rs.
Domestic	Properties unsold as at 31 December 2011 (Note 01)	440,778,551
Foreign	Properties unsold as at 31 December 2011 (Note 02)	457,978,267
Total Properties unsold as at 31 December 2011		**898,756,818**

Note 01

Description	**No of Properties**	**Value Rs.**
Properties Pending Finalization	15	128,882,881
Complication Existed	73	232,664,510
(Court Case and other matters pending)		
Properties scheduled to be advertised for sales	17	70,930,758
Properties where the complete set of documents had not been received	2	8,300,402
Value as at 31 December 2011	**107**	**440,778,551**

Note 02

	No of Properties		**Value USD**
Total Value	3		4,020,527
Value USD 4,020,527.32 @ Rs. 113.905		**Rs.**	**457,958,164**

It was observed that 54 out of 73 properties with complications (court cases and other matters pending) were older than five years.

2.6 Ceybank Card Centre

Following observations are made.

(a) The Card Centre had issued 113,717 cards as at 31 December 2011 and the total outstanding balances as at the same date amounted to Rs.1,954,662,380.Out of this a sum of Rs.74,047,340 or 3.8 per cent were categorized as Non-performing. The details of the total Non- Performing Advances were as follows.

Category	**Rs.**
Overdue	5,067,135
Substandard	8,046,490
Doubtful	5,136,282
Loss	55,797,433
Total	**74,047,340**

(b) The number of card holders who had not paid even a single installment since obtaining the cards up to 31 December 2011 stood at 59 and the total outstanding amount was Rs. 3,419,230.

(c) Capital and interest of the Card Centre written off during the period of 2007-2011 were Rs.57, 841,951 and Rs.45, 932,433 respectively with regard to 1,766 facilities.

2.7 Case Filed Against the Bank

Compensation amounting to Rs. 753 million (approximately) had been claimed up to 31 December 2011 through 135 court cases filed against the Bank for disputes relating to normal banking operations.

2.8 Leasing

(i) The Following branches had recorded the highest Non –Performing Advances ratio in respect of leasing business.

Name of the Branch	Amount of NPA Rs.	NPA Ratio %
Rathmalana	23,368,823	74.64
Walasmulla	8,799,287	62.94
Kegalle	4,682,448	58.35
Karametiya Asc	2,062,164	39.94
Agunakolapelessa	3,324,828	39.05
Dehiwala	6,254,677	38.74
Tangalle	8,867,248	37.39
Fifth City	5,436,222	33.10
Kolonnawa	12,201,963	25.26
Weeraketiya	18,992,470	24.76

2.9 Pawning

Following observations are made.

(a) Audit test checks revealed that spurious pawned articles and unauthorized pawned articles valued at Rs. 7.383 million were found in respect of 6 Branches.

(b) Excess money in the Suspense Creditors Account, older than six months, had not been transferred to the Unclaimed Balance Account.

2.10 Management Inefficiencies

Following observations are made.

(a) Leasehold Properties

(i) 400 Branches including extension offices of the Bank had housed in leasehold premises. 23 lease agreements of those offices had expired by 31 December 2011 and they had not been renewed even by the end of May 2012. Branch activities were continuing in these places without renewing the agreements.

(ii) It was observed that the Bank was carrying its business in 197 leased hold premises without having insurance cover which leads to risk of fire and burglary.

(b) Taxation

The Input Tax on Leasing Accounts of 14 branches amounting to Rs. 1, 675,359 as at 31 December 2011 deductible from Value Added Tax had not been claimed from the Department of Inland Revenue as the respective branches had not sent the original invoices to the Head Office for claiming.

2.11 Investments

(i) Investment in Related Companies

The following observations are made.

(a) Ceybank Holiday Homes (Pvt) Limited

Principal activities of the company during the year under review were operating Pilgrims/ Holiday Homes/ Guest Houses especially for the staff welfare and the company is fully owned by the Bank. Total staff strength of the company for the year under review was 135 and following observations are made in this regard.

(i) The Bank had granted sums of Rs. 7.748 million and Rs. 7.457 million as management fee for the year under review and for the previous year respectively.

(ii) The Kandy and Jaffna Holiday Homes of the company had been operated at a loss of Rs. 0.341 million and Rs. 0.037 million respectively during the year 2011.

(b) Merchant Bank of Sri Lanka PLC

The company's principal activities during the year under review were leasing and hire purchase, trade finance, corporate advisory services, fund management, capital market activities, corporate secretarial services and legal services. The Bank had 72.14 per cent capital in the company. The staff strength of the company was 202.

MBSL Savings Bank is one of the subsidiaries of Merchant Bank of Sri Lanka PLC and accordingly it could be defined as an indirect subsidiary of the Bank of Ceylon. Further, the MBSL Savings Bank is the licensed specialized bank and it should comply with the Directions issued by the Central Bank of Sri Lanka (CBSL).

However, it was observed that the compulsory requirements enforced by the CBSL had not been maintained by the MBSL Savings Bank and following observations are made in this regard.

(i) The Central Bank of Sri Lanka requires Licensed Specialized Banks to maintain a Capital Adequacy Ratio of not less than 10 per cent in relation to total risk weighted assets at all times. But the Bank was able to maintain this ratio only for the first three quarters of the year 2011 and the ratio for the fourth quarter ending 31 December 2011 had decreased to 7.76 per cent.

(ii) According to the directions issued by the Central Bank of Sri Lanka, Licensed Specialized Banks to maintain a minimum average monthly Liquid Assets Ratio of 20 per cent of its total monthly deposit liabilities. However the Bank's Liquid Assets Ratio had decreased to 16 per cent on its total monthly deposit liabilities in 2011.

(c) MBSL Insurance Company Limited

The principal activities of the company were underwriting of all classes of General Insurance and Life Insurance. The Bank's interest in MBSL Insurance Company is 56.28 per cent and it is a subsidiary of the Merchant Bank of Sri Lanka PLC. The following observations are made in this regard.

(i) The company was able to make an after tax profit of Rs. 3.905 million during the year under review.

(ii) This profit had led to bring down the accumulated loss of the company to Rs. 386.097 million in the year 2011, which was Rs. 390.002 million (after restatement) in the year 2010 and Solvency Ratio of General Insurance Business and Insurance Business as at 31 December 2011 were 1.56 per cent and 5.04 per cent respectively.

(d) BOC Travels (Pvt) Limited

This company is fully owned subsidiary of the Bank and its principal activity is engaging in travel related services. The value of the total assets of the company as at 31 December 2011 was Rs. 137.318 million. Following observation is made in this regard.

(i) The Auditors of the company had given a true and fair view of the state of affairs of the company without qualifying by drawing attention regarding calculation of Employees' Benefits of the company.

According to the Sri Lanka Accounting Standard No: 16 (Revised in 2006), the post-employment benefit obligation to be measured by using qualified actuary or using the gratuity formula method. But the company had measured the post-employment benefit obligation under the payment of Gratuity Act No. 12 of 1983 by multiplying half month's salary by the number of years of service. Further, this was found as contradictory to the group accounting policy.

(e) BOC Property Development and Management (Pvt) Limited

The principal activity of the company is renting out of office space of the two buildings owned by the company, namely the BOC Merchant Tower in Colombo 03 and Ceybank House in Kandy. Following observations are made in this regard.

(i) The company had earned a profit of Rs. 90.526 million during the year under review and Rs. 32.633 million in 2010.

(ii) The accumulated loss remained as at 31 December 2011 was Rs. 6.240 million.

(f) BOC Management and Support Services (Pvt) Limited

The principal activity of the company is recruiting employees to facilitate man-power requirement of the Bank and charge a commission from the Bank. It is a fully owned subsidiary of the Bank.

The company had not carried out its main objective during the year under review and income was derived only from investment activities.

(ii) Investment in Non-Trading Shares

Dividends for the year 2010 had not been received from the following non-trading shares.

Company	**Number of Shares**	**Investment Value (Rs.)**
Srilankan Airlines Ltd	12,115,571	3,250,450,000
Kandy Textile Industries Ltd	191,790	1,918,000
Magpek Exports Ltd	300,000	4,355,000
Serendib Coconut Products Ltd	37,500	375,000

(iii) Investment in Sri Lankan Airlines

The Bank had purchased 43.63 per cent of the shares of the Sri Lankan Airlines held by Emirates Airlines during the year 2009. The Monetary Board approval had been granted for the purchase of Sri Lankan Airlines shares subject to divesting its shares within a reasonable period of time.

The accumulated loss of the company as at 31 March 2010 and as at 31 March 2011 amounted to Rs. 2,716 million and Rs. 3,098 million respectively. The bank had not earned any income since the date of investment.

The Chairman of the Bank has informed me that the Bank had provided a sum of Rs. 1.788 billion in the year 2012 for the investment of Rs. 3.25 billion in shares of Sri Lankan Airlines Ltd after carrying out a fresh valuation.

3 Systems and Control

Deficiencies in systems and controls observed during the course of audit were brought to the notice of the Bank by my detailed reports issued to the Chairman of the Bank from time to time. Special attention is needed in respect of the following areas of control.

a) Loan Administration
b) Human Recourses Management
c) Branch Activities
d) Inventories
e) Deposits
f) Customer Services
g) Accounting
h) Insurance
i) Procurements
j) Taxation
k) Investments

l) Litigation

m) Maintenance of Accounting Records

n) Temporary Overdrafts facilities