

Pradeshiya Sanwardana Bank – 2010

1 Financial Statements

1.1 Opinion

So far as appears from my examination and to the best of information and according to the explanations given to me, I am of opinion that the Regional Development Bank had maintained proper accounting records for the 08 months period ended 31 December 2010 and the financial statements have been prepared in accordance with Sri Lanka Accounting Standards and give a true and fair view of the state of affairs of the Regional Development Bank as at 31 December 2010 and the financial results of its operations and cash flows for the period then ended.

1.2 Comments on Financial Statements

1.2.1 Accounting Policies

The following observations are made.

(i) Provision for Loan Losses

Rates relating to provision for loan losses are as follows.

Substandard Loans	20 per cent
Doubtful Loans	50 per cent
Loss Loans	100 per cent

Loan loss provision for property mortgage advances is as follows.

- Substandard and Doubtful
75 per cent of Forced Sale Value of the Property (FSV)
- Losses (1 – 2 years) FSV 60 per cent
- Losses (2 – 3 years) FSV 50 per cent
- Losses over three years FSV 40 per cent

In addition the Bank has to make general provision of one per cent of total performing loans and advances and overdue loans and advances net of interest in suspense that have been debited to the respective accounts, except loans given by pledging cash margin accounts, pawning advances and loans granted against Government Securities until the provision is accumulated to 0.9 per cent of the said performing loans by the 31 December 2010. This provision is to be adjusted to 0.5 per cent by 31 December 2011.

(ii) Related Party Transactions

The identification and disclosure of related party transactions had not been in line with Sri Lanka Accounting Standard No. 30. A few such examples are given below

(a) Transactions and outstanding balances with the Government of Sri Lanka and State Owned Enterprises off balance sheet items.

(b) Balances of Government Directed Loans and Advances.

The Bank has considered only the Board of Directors as the Key Management Personnel in terms of Sri Lanka Accounting Standard No. 30 (Related Party Transactions Revised 2005) whereas Key Management Personnel should include all Bank staff who have the authority and responsibility for directing and controlling the activities of the entity directly or indirectly. However, it was not possible to find any documentary evidence or minutes of a management meeting where such a decision was taken.

1.2.2 Accounting Deficiencies

The following accounting deficiencies were observed.

(a) Leases

The lease loss amounting to Rs. 7.031 million had been categorized under “special mention leases” in the North Central Provincial Office.

(b) Dud Articles

Provision in respect of dud articles had been understated by Rs.290,950 due to calculation errors. Details are as follows.

<u>Branch</u>	<u>Under-provision</u> Rs.
Provincial Office – Wayamba	261,600
Panadura	29,350
Total	<u>290,950</u>

1.2.3 Unreconciled Differences

The differences between interbank transaction interest paid and interest received amounted to Rs. 507,833. This amount has been transferred to Income Statement without carrying out a reconciliation thus resulting in the abnormal increase in the profit.

1.2.4 Non - compliance with Laws, Rules Regulations and Management Decisions

Instances of non-compliance observed in audit are given below.

Reference to Laws, Rules, Regulations, etc.	Non – compliance
(a) Section 156(3) in Inland Revenue Act No. 10 of 2006	It was observed that Panadura Branch of the Bank had paid rent amounting to Rs. 350,000 without deducting the Withholding Tax.
(b) Value Added Tax Act No. 14 of 2002	The Bank had collected Value Added Tax at the rate of 15 per cent from the customers during the entire period instead of the prevailing rate of 12 per cent and the Bank had remitted the total collection to Department of Inland Revenue. Nevertheless, the Southern Regional Office had not claimed the Value Added Tax input on leased motor vehicles within the 12 months period allowed for such claims. Thus it was observed that the Bank had incurred a loss of Rs. 728,981 in that connection.
(c) Office Advice Circular 2010/10 (Development Loans)	Certain pawning advances had been given to staff members without obtaining permission from Regional Office.

Horana and Kalutara Branches can be cited as examples.

2 Financial and Operating Review

2.1 Financial Results

According to the financial statements presented the operations of the Bank during the eight month period ended 31 December 2010 had resulted a pre-tax net profit of Rs. 809.668 million and the after tax net profit amounted to Rs. 280.013 million.

The following table gives a summary of the financial results of the Bank for the eight month period under review.

<u>Item</u>	<u>2010.12.31</u> <u>Rs.Millions</u>
Interest Income	4,377.054
Interest Expenses	<u>1,702.663</u>
Net Interest Income	2,674.391
Other Income	<u>226.990</u>
Total Income	2,901.381
Total Expenses	<u>1,680.508</u>
Operating Profit before Tax	1,220.873
Value Added Tax	<u>411.205</u>
Pre-tax Net Profit	<u>809.668</u>
Tax on Profit on Ordinary Activities	529.655
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Profits on Ordinary Activities after Taxation	<u><u>280.013</u></u>

2.2 Gap between the Objectives and Performance of the Bank

The objects of the Bank shall be to facilitate the overall regional economic development of Sri Lanka by promoting the development of agriculture, industry, trade, commerce, livestock, fisheries activities and empowerment of women, mainly by granting financial assistance to Micro Finance Institutions and Small and Medium Enterprises. Out of the total loan portfolio of Rs.37,020 million granted by the Bank, pawning advances amounting to Rs.13,964 million represented 37.72 per cent thus revealing that the Bank has not achieved the primary objective of the establishment of the Bank.

2.3 Loan Administration

The following observations are made.

- (a) Four facilities amounting to Rs. 2,100,000 had been granted against fixed deposits by the Kalutara Branch. But the fixed deposits certificate was not available in the loan file.
- (b) Eight facilities amounting to Rs. 7,300,000 had been granted by the Panadura and Bulathsinghala Branches. Sufficient securities had not been obtained and the outstanding balance as at 31 December 2010 amounted to Rs. 6,165,415.

- (c) Six facilities amounting to Rs. 1,752,000 had been granted against the personal guarantees by the Badulla Branch. Recovery position was unsatisfactory and the outstanding balance as at 31 December 2010 amounted to Rs. 1,517,210.
- (d) Legal action had not been instituted in respect of following loans.

<u>Branch</u>	<u>Loan Number</u>	<u>Granted Date</u>	<u>Amount Rs.</u>	Balance as at 31 <u>December 2010</u> <u>Rs.</u>	<u>Security</u>
Kandy	602-00274-9	2006.10.13	4,000,000	3,925,644	Property
Rikillagaskada	602-00127-8	2006.04.10	2,000,000	1,154,903	Property
Ginigathhena	17/4/28/101/4	2006.12.14	1,500,000	1,193,782	Property

2.4 Pawning

Dud Articles

Audit test checks revealed that certain pawning advances amounting to Rs. 1,611,300 had been granted against spurious articles in 41 instances in the years 2007/2008 by the Maho Branch to a similar person. The overdue interest as at 31 December 2010 amounted Rs. 854,838. The Branch had not taken any legal action to recover the loss.

2.5 Management Inefficiencies

Statutory Liquid Assets Ratio

According to reports submitted to the Central Bank of Sri Lanka, the Statutory Liquid Assets Ratio in the months of May and December 2010 stood at 23.32 per cent and 19.36 per cent respectively. It had decreased by 3.96 per cent from May to December 2010 and the Bank had failed to maintain minimum liquid assets ratio in following months of the year 2010.

<u>Month</u>	<u>Ratio</u>
October	18.03 per cent
November	19.24 per cent
December	19.36 per cent

2.6 Investments

The value of total investments for the period under review and the preceding year amounted to Rs. 6,711,756,000 and Rs. 8,206,591,000 respectively and the investment had decreased by Rs. 1,494,835,000 or 18 per cent in the period under review as compared with the preceding year. Confirmation in respect of investments valued at Rs. 1,503,166,000 was not made available for audit.

The following observations are made.

- (a) It was noted that the Financial Department had taken short term and long term investment decisions such as REPO and Promissory Notes investments without proper documentary procedures such as calling for quotations. Further, it was noted that there was no evidence available to ensure that the approval had been given for some of the investments made during the period under review.
- (b) In certain instances a formalized procedure had not been following transferring funds for investments such as fixed deposits.
- (c) The value of total nonperforming investments amounted to Rs. 47.413 million whereas a sum of Rs. 50.216 million had been shown in the financial statements. It was observed that a sum of Rs. 2.803 million already written back to revenue of the Bank had been provided for.
- (d) The Uva Provincial Office had paid a sum of Rs. 738,000 as at 31 December 2010 as interest on a Bank overdraft obtained by mortgaging fixed deposits. It was observed that the Bank had paid high interest without obtaining funds from the Head Office. Furthermore the Uva Provincial Office had not followed the instructions in this connection issued by the Head Office.

2.7 Identified Losses

It was observed that the officers of the Bank had made fraudulent withdrawals amounting to Rs. 6,181,409 from the former Ruhuna Development Bank during the period 01 January 2008 to 11 March 2010.

2.8 Items of Contentious Nature

- (a) It was observed that the Bank had not deducted the PAYE tax from the salaries of contract employees which exceeded PAYE threshold appearing in the PAYE Tax Tables of the Department of Inland Revenue.
- (b) The Manager of the Kalutara Branch had obtained a loan of Rs. 600,000 by mortgaging a Fixed Deposit Certificate. But the Fixed Deposit Certificate had not been surrendered to the Bank.

2.9 Assets Management

(a) Property, Plant and Equipment

- (i) Out of the total value of assets amounting to Rs. 46,619 million, the value of property, plant and equipment amounted to Rs. 405 million or 0.86 per cent of the total assets. As such it was observed that the Bank has not maintained appropriate fixed assets ratio.
- (ii) The Bank has not maintained the Register of Fixed Assets in a manner which enables the Bank to derive detailed information on Bank's assets such as year of purchase, purchase cost, depreciation charged, accumulated depreciation, disposal details, etc.
- (iii) The following weaknesses were observed in relation to the purchase of fixed assets.
 - The Bank had used the quotations obtained in earlier occasions for the subsequent purchase of the same type of assets.
 - The Bank had not considered the tax liabilities of the suppliers when making purchase decisions. In certain instances the Bank had purchased fixed assets of high cost without considering the Value Added Tax for which the supplier is liable.
 - In certain instance the Bank has made the payments based on quotations without obtaining an invoice from the supplier.

(b) Branch Network

The Bank had an Island-wide network of 247 Branches as at 31 December 2010. Out of that 224 Branches had been maintained in rented premises and the total monthly expenditure on rent amounted to Rs. 6,369,927. The Head Office of the Bank is maintained in a private building in Colombo 02 taken on rent at a monthly rental of Rs. 1,496,571.

2.10 Estimates and Assumptions

The following observations are made.

(a) Defined Benefit Plans

The cost of defined benefit plans- Gratuity is determined by using actuarial valuations. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future salary increases, mortality rates and future pension increases. Due to the long term nature of these plans, such estimates are subject to significant uncertainty. Provision for staff retirement benefit amounting to Rs. 77.533 million has been made for the year under review and accumulated provision for Gratuity as at 31 December 2010 amounted to Rs. 503.980 million.

(b) Deferred Tax Assets

Deferred tax assets are recognized for all unused tax losses to the extent that it is probable that judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and level of future taxable profits together with future tax planning strategies. Deferred tax asset as at 31 December 2010 amounted to Rs. 92.624 million.

3 Systems and Controls

Deficiencies observed during the course of audit were brought to the notice of the Bank by my detailed report issued to the General Manager of the Bank from time to time. Special attention is needed in respect of the following areas of control.

- (a) Loan Administration
- (b) Property, Plant and Equipment
- (c) Human Resources Management
- (d) Maintenance of Accounting Records
- (e) Pawning
- (f) Compliance with Instructions of the Central Bank of Sri Lanka
- (g) Inventories
- (h) Head Office Current Account

