Housing Development Finance Corporation Bank - 2011

1. Opinion

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

2. Matters of Audit Significance

2.1 Comments on Financial Statements

2.1.1 Sri Lanka Accounting Standards (SLAS)

The following observations are made.

(a) The Awissawella Housing Project had been classified under other assets in the balance sheet. However the intention of the management was to sell this asset. According to SLAS 38, assets that meet the criteria to be classified as held for sale to be measured at a lower of carrying amount and fair value less cost to sell. After classifying, the assets should be presented separately on the face of the balance sheet. However the Bank had failed to comply with this accounting standard.

(b) The Bank had failed to determine the cost of retirement benefits by obtaining actuarial valuation at frequent interval (at least every three years is appropriate) in terms of paragraph 26 of SLAS 16.

2.1.2 Accounts Receivable

The Bank has granted loans against the Employee Provident Fund (EPF) Balance since 2001 and as at the end of the year 2011 the total Non-performing Loan Balances from 5,835 numbers of accounts were aggregating Rs. 147,581,129. Any Non-performing Loan need to be claimed from the Central Bank of Sri Lanka as the outstanding balance in secured by EPF balances. However the Bank had failed to claim such outstanding balances annually, though the balances were outstanding for the period ranging from 12 months to 42 months.

2.1.3 Lack of Evidence for Audit

The Bank had failed to provide details of two Journal Entries amounting Rs. 3,451,125 relating to Special Reserve Account, for audit.

2.1.4 Transactions of Contentious Nature

The following observations are made.

(a) The Bank had increased the share capital and other assets by Rs. 49,838,646 under the Employee Share Option Plan (ESOP) through a private firm without effecting a financial transaction. It was accounted under the name of a private firm as other assets. As a result the Bank had paid dividend tax of Rs. 870,608 to the Department of Inland Revenue with regard to the dividend paid on the above mentioned Share Capital.

(b) As per Public Enterprises Circular No PE/COMC/BF/01 dated 30 December 2010 issued by the Secretary to the Treasury, State Banks and Financial Institutions should get the prior approval by submitting its plan to the Finance Minister before expend their future advertising expenses. Following observations are made in this regard.

(i) The Bank had paid a sum of Rs. 4,239,200 as advertizing expenses to a private company in two occasions during the year 2011 with the approval from the Board of Directors only.

(ii) The approval had been obtained from the Board of Directors to spend Rs. 12 million on 28 July 2011, for the last six months of 2011 subject to following conditions.

- Increase savings By Rs. 1,000 million
- Increase loans by Rs. 3,000 million

However the above conditions had not been fulfilled through the advertising campaign. Details are as follows.

	As at 31 December 2011	**As at 30 June 2011**	**Improvement (For 06 months)**
	Rs.	Rs.	Rs.
Savings	1,544,965,604	1,249,363,948	295,601,656
Loans	14,714,665,721	13,682,536,275	1,032,129,446

(c) (i) The Bank had purchased coffee sets and whistling kettles to distribute as New Year Gifts for 2011.Audit test check revealed that the Bank had purchased such gift items by calling for only one quotation instead of minimum of three quotations.

(ii) According to the Board of Directors approval for the purchase of gift items, the Bank should not exceed the maximum limit of the incremental benefit to the Bank. But the Bank failed to comply with that requirement when purchasing the T-shirts. The incremental loss to the Bank was Rs. 118.50 per every T-shirt. The total incremental loss to the Bank was Rs. 476,370 for 4,020 T-shirts. Further following balance of gift items had been observed as at the date of audit inspection on 1 January 2012.Therefore the success of this promotional campaign is questionable. Details are as follows.

	Coffee Mugs	**Wall Clocks**	**Umbrellas**	**Whistling Kettles**	**T-Shirts**
Gift Items-Purchased	1,000	2,698	2,800	1,500	4,020
Balance as at 1 January 2012	298	2,185	2,081	977	2,815

(d)

The HDFC Bank had paid Rs. 1,121,387 as advance payment to a private company on 3 February 2011 to obtain Internet Banking Solution System. However, the said system had not been opened for customers and opened only for Staff members on 31 September 2011. It was observed that the utilization of Internet Banking Solution System by the Staff members were very low when compared with the annual maintenance expenses of Rs. 366,300.

2.1.5 Investments

The following observations are made.

(i) Documents with related to calling bids for the Investments amounting Rs.4,008,448,456 were not made available for audit and therefore whether the Bank had obtained best interest rate was open to question.

(ii) Even though the HDFC Bank had established separate Treasury Division headed by a Chief Manager for the purpose of evaluating and taking best investment decision, the Bank had invested in commercial papers through a third party. It was observed that the performance of the Treasury Division is open to question as investment decisions were taken through third parties.

(iii) The Bank had invested Rs. 150 million in a Commercial paper on 13 October 2011. However the name of the investor on the face of the commercial paper was a name of a Private Company and the With Holding Tax (WHT) certificate had also been issued to the same name. Therefore the possibility of claiming the WHT credit by the Bank is open to question and the ownership of the commercial paper are also questionable.

2.1.6 Loans and Advances

The following observations are made.

(a) Effective action had not been taken to recover three loans outstanding as at 5 September 2011 amounting to Rs. 3,580,978 with regard to the employees who were currently not working in the Bank.

(b) A loan amounting to Rs. 1.8 million which was categorized under Non Performing loan had been written off during the year under review which was granted by the Bank through fraudulent documents. It was observed that a Banking Assistant of the HDFC Bank had closed the loan account by depositing one rupee (Rs. 1.00) of her own money.

2.1.7 Management Inefficiency

The Bank had borrowed Rs. 1,164,156,085 from the financial market as at 31 December 2011. However the Bank had deposited Rs. 1,275,000,000 on Fixed Deposits with lower interest rates when compared with the borrowing rates. Details are given below.

Borrowings	Amount Rs.	Rate %	Investment	Amount Rs.	Rate %
National Insurance Corporation	93,351,752	15.50	Pradeshiya Sanwardana Bank	425,000,000	9.10
HNB Loan	125,011,000	11.77	Pradeshiya	350,000,000	9.57

			Sanwardana Bank		
Sampath Bank	449,960,000	12.02	Pradeshiya Sanwardana Bank	150,000,000	10.00
BOC	495,833,333	12.77	State Mortgage and Investment Bank	350,000,000	9.00
	1,164,156,085			**1,275,000,000**	

3. Financial and Operating Review

3.1 Financial Results

According to the financial statements presented , the operations of the Bank for the year ended 31 December 2011, had resulted in a pre-tax net profit Rs. 414.3 million as compared with the corresponding pre-tax net profit of Rs. 188.9 million in the preceding year thus indicating an increase in the pre-tax net profit by Rs. 225.4 million.

3.2 Summary of Operating Results

A summary of operational financial results for the year ended 31 December 2011 as compared with preceding three years is given below.

Item	**2011 Rs. (Mn)**	**Increase/ (Decrease) Rs. (Mn)**	**2010 Rs. (Mn)**	**Increase/ (Decrease) Rs. (Mn)**	**2009 Rs. (Mn)**	**Increase / (Decrease) Rs. (Mn)**	**2008 Rs. (Mn)**	**Increase/ (Decrease) Rs. (Mn)**
Interest Income	2,250	85	2,165	51	2,216	275	1,941	245
Interest Expenses	1,353	15	1,339	(243)	1,582	(20)	1,602	355

Net Interest Income	**897**	**70**	**826**	**192**	**634**	**295**	**339**	**(110)**
Non Interest Income	126	40	85	33	52	19	33	(13)
Net Income	1,023	110	911	225	686	314	372	(123)
Non Interest Expenses	603	90	513	74	439	54	385	26
Provision for Bad Debts (Loan Loss)	(79)	186	107	28	79	25	54	11
Operating Profit/ (Loss)	**495**	**204**	**291**	**123**	**168**	**235**	**(67)**	**160**

While the interest income and interest expenses had increased by 3.92 per cent and 1.1 per cent respectively the non interest expenses had increased by 17.54 per cent as compared with the preceding year.

3.3 Significant Ratios

According to the information made available, certain important ratios of the Bank for the year under review and the preceding year were as follows.

Indicator	**2011** %	**2010** %
Profitability		
(i) Net Profit Ratio	13.04	6.01
(ii) Gross Profit Ratio	37.71	36.69
(iii) Interest Cost to Interest Income	60.20	61.86
(iv) Overhead Expenditure to Gross Profit	67.39	62.13
(v) Return on Average Assets	1.77	0.91
(vi) Return on Equity	15.58	7.58

Capital Adequacy		
(vii) Earnings per Share	47.85	20.91
(i) Equity : Total Assets	1:9	1:8
(ii) Equity : Borrowings	1:1.6	1:2
(iii) Tier i	21.34	21.09
(iv) Tier ii	21.95	22.18
Liquid Assets		
Liquid Assets Ratio (Minimum 20 per cent)	21.15	21.09

3.4 Maturity Profile of the Bank

Analysis of the profile of the assets and liabilities of the Bank on a monthly level revealed that the total liabilities were far in excess and the short term liquidity gap up to 3 months, 3-12 months and 1 to 3 years as at the end of the year under review were Rs. 3,034 million, Rs. 2,550 million and Rs. 496 million respectively. Details are given below.

	0-3 Months	**3 -12 Months**	**1 -3 Years**	**3- 5 Years**	**Over 5 Years**	**Total**
	Rs.Mn	Rs.Mn	Rs.Mn	Rs.Mn	Rs.Mn	Rs.Mn
Assets						
Cash	91,605	-	-	-	-	91,605
Due from Banks	107,492	-	-	-	-	107,492
Investments	547,512	3,179,446	-	-	33,798	3,760,756
Loan Advances	709,026	974,284	3,059,509	2,752,779	7,142,250	14,637,848
Fixed Assets	-	-	-	-	763,249	763,249

Other Assets	35,895	67,014	26,447	8,749	198,668	336,773
Total Assets	**1,491,530**	**4,220,744**	**3,085,956**	**2,761,528**	**8,137,966**	**19,697,724**
Liabilities						
Total Capital Fund	-	-	-	-	2,125,084	2,125,084
Deposits	3,957,724	6,019,808	1,938,591	166,447	253,446	12,336,016
Borrowing	182,003	383,219	909,671	834,686	1,246,288	3,555,867
Other Liabilities	385,969	367,473	733,770	28.976	164,569	1,680,757
Total Liabilities	**4,525,696**	**6,770,500**	**3,582,033**	**1,030,109**	**3,789,386**	**19,697,724**
Maturity Gap	**(3,034,166)**	**(2,549,756)**	**(496,077)**	**1,731,419**	**4,348,580**	**-**

Following observations are made in this regard.

(a) More than sixty three per cent of the total customer fixed deposits of the Bank are owned by 20 depositors as at 31 December 2011, which could adversely affect the liquidity and the going concern of the Bank.

(b) HDFC Bank had invested Rs. 925 million in the Regional Development Bank and had obtained Rs. 1,734 million as Fixed Deposits from the same Bank resulted of net amount of deposits mobilized was Rs. 809 million. Accordingly, Bank's investment portfolio had been on risk as both Banks were depending on each other.

4. Systems and Controls

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

(a) Procurements
(b) Fixed Assets, Inventories and Stores Management
(c) Loan Administration
(d) Publicity and Promotional Expenses
(e) Training Programmes and Workshops
(f) Sale of Acquired Properties.
(g) Maintaining of leave records in the branches
(h) Rotation of Staff members who served over 5 years service in the same branch.
(i) Investments
(j) Fixed deposits