Pradeshiya Sanwardhana Bank – 2013

The audit of financial statements of the Pradeshiya Sanwardhana Bank for the year ended 31 December 2013 comprising the statement of financial position as at 31 December 2013 and the statement of income, 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 read in conjunction with Section 13 (1) of the Finance Act, No. 38 of 1971 and Section 33 of the Pradeshiya Sanwardana Bank Act, No 41 of 2008.

1.2 Management's Responsibility for the Financial Statements

Management 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 management 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 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 statement, whether due to fraud or error. In making those risk assessment, 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 management, as well as evaluating the overall presentation of the financial statements.

Sub-sections (3) and (4) of the section 13 of the Finance Act, No. 38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the Audit.

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

1.4 Corporate Information

The operations of Wayamba, Sabaragamuwa, Kandurata, Uva, Rajarata and Ruhuna Development Banks were merged under the Pradeshiya Sanwardhana Bank Act, No. 41 of 2008 to form the Pradeshiya Sanwardhana Bank on 01 May 2010. At the inception the assets and liabilities were transferred from Six Regional Development Banks.

2. Financial Statements

2.1 Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Pradeshiya Sanwardhana Bank as at 31 December 2013 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

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2.2.1 Accounting Deficiencies

(a) As per the Guidelines issued by CBSL to Licensed Commercial Banks and Licensed Specialized Banks on the operations of the Investment Fund Account, information relating to the number of loans granted by using investment fund, total amount outstanding on each category of loan , interest rates and tenure of loans should have been shown as a note to the financial statements.

Since 2011, the Bank had utilized a sum of Rs.961, 314,656 from Investment Fund Account to grant loans. Nevertheless, no disclosures had been made in the financial statements in this regard.

(b) According to the calculation made based on the above guideline it was observed that the total fund need to be transferred to the Investment Fund Account for the year ended 31 December 2013 was Rs. 259,066,092. However, the Bank had transferred only Rs.223, 797,289 and as such a sum of Rs. 35,268,803 had been transferred less than the required amount for the year ended 31 December 2013. As a result the retained earning and investment fund balances had been overstated and understated by the same amount respectively.

2.3 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
Office Circulars	
(I) Development Loan Circular No. 2010/10 Paragraph 7.3	(i) Despite the restriction to accept articles which was under 18 karat, it was observed that there were several occasions the Bank had taken pawning articles which were under 18 karat. The value of such articles was Rs.7,106,900.
Paragraph 17.2	(ii) It was observed that, the normal weight deduction had not been applied by the Badhulla branch for pawning advance of Rs.395, 450 granted to a officer of the Bank which contained number of stones.
Paragraph 14.3	(iii) Bank had failed to conduct a physical verification in quarterly basis relating to the pawning items.
(II) Finance Circular No. 2011/13 dated 23 December 2011	Even though a notice should be published to acknowledge customers to convert all dormant accounts to active accounts, without doing so, a service charge had been charged to dormant accounts which are above the minimum deposit amount.

3 Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2013, had resulted in a after tax profit of Rs. 240,793,906 as compared with the corresponding after tax profit of Rs. 545,490,730 in the preceding year thus indicating a decrease of Rs. 304,696,824, or 56 per cent in the financial results for the year under review.

The main reasons for the above deteriorations are given below.

As analyzed below, the interest income and interest expenses for the year 2013 had increased by fifteen per cent and twenty nine per cent respectively while the non interest income(net) had decreased by thirteen per cent as compared with the preceding year. Personal cost had increased by eight per cent as compared with the preceding year. Impairment charges for loans and other losses had increased by 291 per cent due to providing specific provision of Rs.348, 787,046 for the capital loss on pawning advances.

Item	**2013**	**2012**	**Variance**	
	Rs. Mn	**Rs. Mn**	**Rs. Mn**	**%**
Interest Income	10,441	9,049	1,392	15.38
Interest Expenses	(5,939)	(4,612)	(1,327)	28.77
Net Interest Income	**4,502**	**4,437**	**65**	**1.46**
Non Interest Income (Net)	480	419	61	14.56
Total Operating Income	**4,982**	**4,856**	**126**	**2.59**
Impairment Chargers for Loans and Other losses	(547)	(10)	(537)	5370.00
Net Operating Income	**4,435**	**4,846**	**(411)**	**(8.48)**
Staff Cost	(2,699)	(2,489)	(210)	8.44
Other Expenses	(1,049)	(865)	(184)	21.27
Operating Profit before Value Added Tax	**687**	**1,492**	**(805)**	**(53.95)**
Value Added Tax	(290)	(426)	136	(31.92)
Profit before tax	**397**	**1,066**	**(669)**	**(62.76)**
Tax Expenses	(156)	(521)	365	(70.06)
Profit for the year	**241**	**545**	**-304**	**(55.78)**

3.2 Analytical Financial Review

3.2.1 Cost of Fund and Yield Thereon

According to the information and financial statements made available the following table gives the Cost of Funds and Yield for the year ended 31 December 2013 and the previous year.

Item	2013 Avg. Balance	2013 Cost / Revenue	2013 Rate	2012 Avg. Balance	2012 Cost / Revenue	2012 Rate
	Rs.'000	Rs.'000	%	Rs.'000	Rs.'000	%
Deposits						
Savings	22,492,183	900,907	4.01	20,116,494	758,256	3.8
Fixed Deposits/ Certificate of Deposits	36,156,783	4,607,587	12.74	30,315,563	3,502,796	11.6
Total Deposits	**58,648,966**	**5,508,494**	**9.39**	**50,432,057**	**4,261,052**	**8.4**
Borrowings						
Refinanced Loans	5,903,403	262,271	4.44	3,723,106	180,144	4.8
Other Borrowings	1,378,230	168,011	12.19	1,881,448	171,182	9.1
Total Borrowings	**7,281,633**	**430,282**	**5.91**	**5,604,554**	**351,326**	**6.3**
Cost of Fund on Mobilization (Weighted Average Cost of Capital)	**65,930,599**	**5,938,776**	**9.01**	**56,036,611**	**4,612,378**	**8.2**
Other Liabilities	3,625,624	-	-	4,397,576	-	-
Capital	1,099,400	-	-	1,099,400	104,654	9.5
Reserves	3,158,299	-	-	3,209,284	-	-
Less :						
Other Assets	2,398,289	-	-	3,559,373	-	-
Financial Cost	71,415,633	2,699,190	3.78	61,183,496	3,353,828	5.5
Overhead Costs	71,415,633	1,016,078	1.42	61,183,496	186,117	0.3
Total Cost of Funds	**71,415,633**	**9,654,044**	**13.52**	**61,183,496**	**8,256,977**	**13.5**
Loan Portfolio	57,612,758	8,577,987	14.89	50,433,464	7,854,058	15.6
Investments	13,802,875	1,862,946	13.5	10,750,032	1,195,088	11.1
Financial Yield	**71,415,633**	**10,440,933**	**14.62**	**61,183,496**	**9,049,146**	**14.8**

Margin	71,415,633	786,889	1.1	61,183,496	792,169	1.3
Freebased other income	71,415,633	479,924	0.67	61,183,496	595,603	1.0
Margin	**71,415,633**	**1,266,813**	**1.77**	**61,183,496**	**1,387,772**	**2.3**
Tax	71,415,633	445,996	0.62	61,183,496	946,936	1.5
Net Margin	**71,415,633**	**820,817**	**1.15**	**61,183,496**	**440,836**	**0.7**

The following observations are made in this regard.

(a) Cost of Deposit Ratio had increased by 12 per cent in 2013 as compared with the preceding year mainly due to increase in deposits by 16 per cent.

(b) Even though the borrowings had increased by 30 per cent in 2013, the Cost of Borrowing Ratio had decreased by 6 per cent due to increased of refinance loans by 59 per cent as compared with other borrowings.

(c) As an aggregate result of the above, the Weighted Average Cost of Capital had increased by 10 per cent in 2013 as compared with the preceding year.

3.2.2 Significant Ratios

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

Indicator	**Sector Standard Ratio (Licensed Specialized Bank)**	**Actual**	
		2013	**2012**
Profitability Ratio			
Net Profit Ratio	16%	3.61%	11.21%
Net Interest Margin	2%	5.92%	6.65%
Net Interest Income on Interest Income	28%	43.12%	49.03%
Non Interest Income to Total Income	12%	5.04%	4.89%
Interest Cost on Interest Income	72%	56.88%	48.48%
Overhead Expenditure on Net Interest Income	66%	37.09%	20.76%
Staff Cost to Operating Expenses	54%	72.01%	74.20%
Return on Average Assets	2%	0.54%	1.66%

Return on Equity	16%	5.84%	12.41%
Earnings per Share		2.19	4.96
Gearing Ratio			
(i) Total Assets to Equity	10.71 : 1	19.12 : 1	15.66 : 1
(ii) Borrowings to Equity	1.30 : 1	2.06 : 1	1.38 : 1
Capital Adequacy Ratio			
(i) Tier i	22	9.62	10.30
(ii) Tier ii	20	9.21	10.61
Liquidity Ratio			
Liquid Assets Ratio	67%	25.51%	23.30%

The following observations are made in this connection.

(a) The Capital Adequacy Ratio had become below than the minimum requirement of 10 per cent due to calculation error and subsequently had been adjusted as 10.2 per cent.

(b) The Bank had reported high interest margin of 5.92 per cent as at 31 December 2013 as compared with the average Licensed Specialized Bank ratio of 2 per cent. Bank's Net Margin is 0.7 which arrived after deducting all operating expenses.

(c) The contribution of non-interest income to the total income of the Bank is only 5.04 per cent which is significantly lower than average Licensed Specialized Bank ratio of 12 per cent. Therefore, the Bank was highly concentrated on interest income and would be vulnerable to change in interest rates.

(d) According to the Banking Industry Analysis in 2013, the Bank had recorded the highest ratio of the personal cost out of total expenses (excluding the interest expenses and fee and commission expenses) which was 72 per cent as compared with the average Licensed Specialized Bank ratio of 54 per cent.

3.2.3 Maturity Profile of the Bank

Analysis of the profile of the assets and liabilities of the Bank as at 31 December 2013 revealed that the total long term liabilities were far in excess over total assets and the Long term liquidity gap between to 3 to 5 years and over 5 years as at 31 December 2013 had been Rs. 1,347,651,816 and Rs. 8,294,168,941 respectively. Details are given below.

	0-3 Months Rs.	3 -12 Months Rs.	1 -3 Years Rs.	3- 5 Years Rs.	Over 5 Years Rs.	Total Rs.
Assets						
Cash and Balance with Central Bank	226,501,435	-	-	-	-	226,501,435
Balance with Banks	10,918,990,363	4,701,220,405	-	-	-	15,620,210,767
Financial Assets Held for Trading	-	-	-	-	698,759	698,759
Loans and Receivables from Other Customers	15,211,349,211	21,515,869,538	12,694,777,099	6,644,513,063	4,424,125,297	60,490,634,208
Other Assets	329,083,419	1,090,065,343	17,655,810	2,901,303	4,835,505	1,444,541,379
Total Assets	**26,685,924,427**	**27,307,155,286**	**12,712,432,909**	**6,647,414,366**	**4,429,659,561**	**77,782,586,548**
Liabilities						
Due to Banks	526,838,382	2,439,697,383	3,638,650,255	1,879,450,667	-	8,484,636,687
Due to Other Customers	18,981,797,379	20,594,050,519	5,528,189,022	5,998,708,450	11,525,315,257	62,628,060,626
Retirement Benefit Obligation	-	-	-	-	806,724,857	806,724,857
Other Liabilities	1,847,708,223	347,902,523	39,741,115	116,907,065	391,788,388	2,744,047,313
Total Liabilities	**21,356,343,984**	**23,381,650,425**	**9,206,580,391**	**7,995,066,182**	**12,723,828,501**	**74,663,469,483**
Maturity Gap	**5,329,580,444**	**3,925,504,860**	**3,505,852,518**	**(1,347,651,816)**	**(8,294,168,941)**	**3,119,117,065**

4 Operating Review

4.1 Performance

The observations on the following main areas of the Bank are given below.

(a) Deposits

Bank's deposit structure is highly concentrated on high cost fixed deposits which represent 61 per cent of the total deposits as at 31 December 2013. Interest expenses on fixed deposits represents 83 percent of total interest expenses as at 31 December 2013. Highly dependence on high cost fixed deposits may adversely affect to the cost of funds.

(b) Loan Portfolio

The pawning advances of the Bank were around 38 per cent on the total loan portfolio of the Bank as at 31 December 2013. High credit concentration on pawning advances may affect to the liquidity of the Bank.

The non performing loan against the total loans and advances is 7 per cent in 2013, showing a significant increase with compared to the 4 per cent in the preceding year.

4.2 Operating Inefficiencies

It was observed that, the Bank was unable to recover even a single installment from 2933 loans, aggregating Rs. 256,964,719 granted by the Branches function in seven Provinces up to 31 December 2013. Therefore it was doubtful whether a proper mechanism had been introduced for credit approving and credit monitoring activities by the Bank.

In this regard the following observations are also made.

(a) The Hikkaduwa Branch had failed to recover even a single installment from a loan amounting to Rs. 10,000,000 granted to a customer on 13 December 2011. Loan had been granted even though the required conditions had not been fulfilled by the borrower. The total outstanding balance as at 31 December 2013 was Rs. 12, 027,397.

The letter dated 22 May 2013 issued by the Credit and Recovery Department of the Head Office had informed to the customer to settle the loan within 14 days. As well as the Head Office had informed to the Regional General Manager of Southern Province to take legal action against the mortgage property if customer fails to settle the loan within the given period of time.

However, it was not evident that the provincial office had taken any legal action against the customer to recover the loan.

(b) Dodangoda Branch of the Bank had rescheduled ten loans granted to “Samastha Lanka Praja Sanwardena Mandalaya” as a single loan for the amount of Rs.16,819,437 on 10 August 2011. A difference of Rs. 684,000 was observed between the rescheduled amount as per the loan agreement and as per the loan account opened. Even though the loan was rescheduled, the recoverability was unsatisfactory. The capital and interest outstanding as at 31 December 2013 was Rs.15,285,828 and Rs.2,606,598 respectively. A case had been filed in Western Province Commercial High Court to recover the loan.

(c) Loans Granted to the Paddy Marketing Board

The following observations are made.

(I) A loan valued at Rs.250,000,000 had been granted to the Paddy Marketing Board on November 2010 at 12 per cent interest rate as per the loan agreement. The loan needs to be settled within six months. The Board had not settled the loan on due date and further six months extension was granted by the Bank.

The interest rate had also decreased from 12 per cent to 8 per cent according to the Special Board Approval. Subsequently this loan had been recovered on 31 August 2011.

As a result the Bank had lost the interest income of Rs 11,260,273 due to the interest rate reduction.

(II) Another loan of Rs.130,473,988 had also been granted to the Paddy Marketing Board during the period of October 2010 to February 2011 at 12 per cent interest rate. After granting the loan, the interest rate had been reduced to 8 per cent with a special board approval of the Bank. As a result the Bank had lost amounted to Rs.2, 868,429, mainly due to reduction of interest rate.

4.3 Internal Control

The following observations are made.

(a) Approved and documented internal control procedures over significant operational areas were not in operation. The credit delivery, recovery and credit risk management policy and pawning operation regulations were still in draft form.

(b) It was observed that the present credit policy of the Bank had not provided specific guidelines for loan top ups, loan extensions, post sanctioning monitoring of loans, loan premature settlement, loan pricing and offering preferential interest rates for the borrowers, applicable procedures and authorities for waving of interest and loan write offs and classifying the loan accounts as non-performing based on qualitative parameters.

(c) There was no mechanism to conduct a annual credit review and update the credit rating of the borrowers.

(d) Inconsistencies were observed among Branch operations due to non-availability of properly designed internal control manual for the Branch operation.

(e) It was observed that some important registers such as stationary, inventory, gift items, pass book control, vault access control, fixed deposits and pawning auction were not maintained by the Branches.

4.4 Management Inefficiencies

The following observations are made.

(a) It was observed that the money collected by rural representatives had held for a considerable period of time without handing over to the relevant Bank Branches. (Eg: Beruwala Branch)

(b) The Bank had not established a threshold for individual impairment for the significant credit facilities granted to the borrowers even though the Central Bank of Sri Lanka required the Bank to do so.

4.5 Transactions of Fraudulent Nature

The following observations are made in this regard.

(a) A cheque amounting to Rs.2, 985,550 belonging to a state institution had been deposited in a newly opened personnel saving account in the Kahawattha Branch by representing a forged identity card by an employee of the above institution instead of being deposited in the institute's bank account. It was observed that in several occasions withdrawals had been made from the account with the assistance of an employee who was a office assistant of the Bank and was acting as a cashier at that time. It was further observed, that the covering approval of the Regional Office had not been obtained for the payments. It was also observed that the duplicate key of the safe of the branch was allowed to handle by the said office assistant. Investigations in this connection are still in progress.

(b) Badulla Branch of the Bank had issued a fixed deposit receipt to a customer for a sum of Rs.1,500,000 for the purpose of a private foreign travel. The balance confirmation letter had also been sent to the customer on 03 August 2012 eventhough the account had been opened only on 17 October 2012.

4.6 Identified Losses

According to the records maintained by the Bank the following internal pawning losses observed in audit.

Nature of Loss	Amount of loss Rs.
Disbursement of pawning advance without considering instruction issued by the Bank.	18,493,061
Pawing officer of both Gandara and Devinuara branches had taken dud articles instead of gold securities and had disbursed advances	7,580,500

	26,073,561

The following observations are also made in this regard.

- A provision of Rs.3,128,020 had been made in this regard in the accounts and investigations are still in progress relating to the disbursement of pawning advances without considering instructions issued by the Bank.

- The Bank was unable to recover the loss on dud articles from the Insurance Corporation till the end of August 2014 mainly due to late acknowledgement to the Insurance Corporation.

4.7 Transaction of Contentious Nature

The Bank had remitted a sum of Rs. 500 million in 2012 and another sum of Rs. 500 million in 2013 to the General Treasury. However the Bank had erroneously accounted these amounts as a prepayment for the relevant periods.

4.8 Delayed Projects

Delays in Implementation of Core Banking System (CBS)

Three agreements for a Core Banking System had been entered between the Bank, and two private IT companies in India and Sri Lanka on 9 December 2011 at a cost of Rs.116,422,678 excluding the out of pocket allowances and applicable taxes. Subsequently another agreement in this regard had been signed between the Bank and an IT company in Sri Lanka on 18 September 2012 at a cost of Rs.44,812,678. The Bank had incurred a cost of Rs. 175,234,390 for this purpose up to 31 December 2013. However out of 266 Branches only 131 Branches are covered under this system up to now and 93 issues relating to the system had been identified through a system audit done by a private company. Out of that some issues had been resolved and some are due to be resolved by the service provider or IT Division of the Bank.

5 Accountability and Good Governance

5.1 Corporate plan

A Corporate Plan for the period 2011 - 2015 had been prepared by the Bank. The targets that should have been achieved but not achieved during the year under review are summarized below.

Item	**Target**	**Actual**	**Variance**
	Rs. '000	**Rs. '000**	**Rs. '000**
After Tax Profit	1,442,577	240,794	1,201,783
Investment	22,746,514	15,620,910	7,125,604
Loans and Advances (Net)	65,123,301	60,490,634	4,632,667
Customers' Deposits	81,205,319	62,628,061	18,577,258

- As per the corporate plan, the bank had targeted to maintain the NPL ratio below 4 percent, though it represents 7 per cent as at 31 December 2013.
- The bank had targeted to increase the number of Branches up to 375 and commencement of ATM network in the year 2013. However only 265 branches were in operation and ATM network had also not been established even by the end of the year under review.

5.2 Procurement Plan

The Bank had not been prepared a procurement plan for the year 2013.

5.3 Budgetary Control

Variances ranging from 40 per cent to 204 per cent were observed between the budgeted and actual items, thus indicating that the budget had not been made use of as an effective instrument of management control. Such few instances are given below.

Item	Budget	Actual	Variance	
	Rs. '000	Rs. '000	Rs. '000	%
Cash and Short Term Funds	500,000	226,501	273,499	54.7
Other Assets	5,200,000	1,700,174	3,499,826	67.3
Other Income	386,740	553,772	167,032	43.2
Fee and Commission Expenses	126,829	73,847	52,982	41.8
Provision for Loan Losses	180,249	547,184	366,935	203.6
Other Overhead Expenses	393,608	235,015	158,593	40.3

6 Systems and Controls

Deficiencies in system and controls observed during the course of audit were brought to the notice of the Chairman of the Bank by my detailed report issued in term of Section 13 (7) (a) of the Finance Act. Special attention is needed in respect of the following areas of control.

(a) Loan Administration
(b) Human Resources Management
(c) Corporate Governance
(d) Pawning
(e) Compliance with Instructions of the Central Bank of Sri Lanka
(f) Budgetary control
(g) Staff Cost
(h) Business Promotion Activities