

Housing Development Finance Corporation Bank – 2014

The audit of financial statements of the Housing Development Finance Corporation Bank of Sri Lanka for the year ended 31 December 2014 comprising the statement of financial position as at 31 December 2014 and the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flow 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 26 (2) of the Housing Development Finance Corporation Bank of Sri Lanka Act, No. 7 of 1997 as amended by Act, No.15 of 2003 and Act, No. 45 of 2011. My comments and observations which I consider should be published with the annual report of the Bank in terms of Section 14(2) (c) of the Finance Act appear in this report.

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

auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, 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 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.

2. Financial Statements

2.1 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 2014 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2014, had resulted in a pre-tax net profit of Rs. 777 million as compared with the corresponding pre-tax net profit of Rs. 309 million in the preceding year, thus indicating an increase of Rs. 468 million or 151 per cent in the financial result for the year under review. The reasons for this increase are summarized and shown below.

| Item | 2014 | 2013 | Increase/ (Decrease) |
|--|--------------|--------------|-------------------------|
| | Rs. Mn | Rs. Mn | Rs. Mn |
| Interest Income | 4,378 | 3,528 | 850 |
| Interest Expenses | (2,535) | (2,469) | 66 |
| Net Interest Income | 1,843 | 1,059 | 784 |
| Non-interest Income | 188 | 275 | (87) |
| Net Income | 2,031 | 1,334 | 697 |
| Staff Cost | (671) | (586) | 85 |
| Other Expenses | (452) | (352) | 100 |
| Impairment Charges for Loan and Other Loss | (131) | (87) | 44 |
| Operating Profit Before Value Added Tax | 777 | 309 | 468 |
| Value Added Tax | (142) | (78) | 64 |
| Tax Expenses | (260) | (73) | 187 |
| Profit for the Year | 375 | 158 | 217 |

While the interest income and interest expenses had increased by 24.09 per cent and 2.67 per cent respectively, the non-interest expenses had increased by 22.34 per cent as compared with the preceding year.

3.2 Analytical Financial Review

3.2.1 Cost of Funds and Financial Yield

The cost of funds and financial yield for the year under review based on cumulative cost and revenue are shown below.

| Description | Average Balance | Cost / Revenue | Cost/Revenue as a percentage of Average Balance |
|--|-------------------|-------------------|---|
| | Rs. 000 | Rs. 000 | % |
| (I) <u>Cost of Fund</u> | | | |
| (a) Deposits | | | |
| Saving Deposits | 2,737,513 | 141,484 | 5.17 |
| Fixed Deposits | 19,327,758 | 1,933,912 | 10.01 |
| Dhananidana | 168,519 | 19,684 | 11.68 |
| Total Deposits | 22,233,790 | 2,095,080 | 9.42 |
| (b) Commercial Borrowings | | | |
| Bank Overdrafts | 98,289 | 977 | 0.99 |
| Borrowing from Market | 2,935,948 | 393,696 | 13.41 |
| Total Commercial Borrowings | 3,034,237 | 394,672 | 13.01 |
| (c) Cost of Funds on Mobilization (a+b) | 25,268,027 | 2,489,752 | 9.85 |
| Overhead Cost | 25,268,027 | 1,254,363 | 4.96 |
| Cost of Fund | 25,268,027 | 3,744,116 | 14.82 |
| (d) Other Liabilities | 2,606,110 | - | - |
| Capital | 962,093 | - | - |
| Reserves | 1,794,046 | - | - |
| Total Other Liabilities | 30,630,276 | 3,744,116 | 12.22 |
| Less: | | | |
| (e) Other Assets | 1,643,315 | - | - |
| (f) Financial Cost (d-e) | 28,986,961 | 2,534,685 | 8.74 |
| Overhead Costs | 28,986,961 | 1,254,363 | 4.33 |
| Total Cost of Funds | 28,986,961 | 3,789,048 | 13.07 |

(II) Financial Yield

| | | | |
|--------------------------------------|-------------------|------------------|--------------|
| Loan Portfolio | 21,484,905 | 3,704,719 | 17.24 |
| Investment | 7,502,056 | 673,126 | 8.97 |
| Financial Yield – Performance | 28,986,961 | 4,377,845 | 15.10 |
| Margin | 28,986,961 | 588,796 | 2.03 |
| Fee Based /Other Income | 28,986,961 | 188,281 | 0.65 |
| Margin | 28,986,961 | 777,077 | 2.68 |
| Tax | 28,986,961 | 402,482 | 1.39 |
| Net Margin | 28,986,961 | 374,595 | 1.29 |

4. Operating Review

4.1 Performance

The following observations are made.

(a) Non-Performing Loans (NPL)

Non-Performing Loans as a percentage of total loans were 20.20 per cent, 19.85 per cent and 22.57 per cent as at end of the year 2012, 2013 and 2014 respectively.

(b) Vested Property Loans

The total value of vested property loans as at 31 December 2014 amounted to Rs. 54,741,285. Out of that, the loans valued at Rs. 19,194,775 had been identified as a gain in determination of the cash inflows for the years 2013 and 2014 even

though no any asset out of those had been sold even up to 31 December 2014. Further, no provision had been made in this regard in the above years.

(c) Loans Granted Against the Employees Provident Fund (EPF)

The EPF loans amounting to Rs. 38,880,152 was in arrears for more than 18 months. Although there was a possibility to recover those loans from the Central Bank of Sri Lanka, the Bank had not taken any satisfactory actions to recover those loan balances even up to end of December 2014. Details are as follow,

| Defaulted Period | Number of Loans | Arrears Amount Rs. |
|-------------------------|----------------------------|-------------------------------|
| 18-30 months | 402 | 33,050,468 |
| 30-42 months | 38 | 3,358,871 |
| More than 42 months | 21 | 2,470,813 |
| Total | 461 | 38,880,152 |

4.2 Matters for Emphasis

Out of total customer deposits of the Bank, more than 49 per cent was owned by twenty depositors as at 31 December 2014 and it was 42 per cent in the preceding year, thus indicates that the Bank was more dependent on very limited depositors and exposed to high liquidity risk.

4.3. Issue and Purchase of Debentures

The following observations are made.

- (i) The Bank had issued the secured debentures valued at Rs. 2 billion during the month of October 2013 at the interest rate ranging from 14.5 per cent to 15.5 per cent. In the meantime, the Bank had purchased Rs. 850 million worth of unsecured debentures in

the year 2014 at the interest rates ranging from 8 per cent to 9.75 per cent and as such the financial market forecast made by the management is open to question.

- (ii) Even though the Bank had invested a sum of Rs. 850 million in debentures during the period from September 2014 to December 2014, the Bank had incurred an estimated loss of Rs. 9,871,302 due to decrease of fair value of debentures as at 31 December 2014.

4.4 Transactions of Contentious Nature

(a) Collection of Funds through Third Party

The Bank had entered into an agreement with a Finance Company to collect fixed deposits on behalf of Bank and agreed to pay a commission of 0.5 per cent per annum on the deposits value and for any renewals of the fixed deposits thereafter.

The following observations are made in this regard.

- (i) Even though the Bank had two separate divisions as Treasury and Marketing headed by two Chief Managers, the Bank had incurred an additional cost of Rs. 1,292,914 for collecting the funds through a third party. Details of interest paid to the above Finance Company during the last three years are given below.

| Year | Amount Paid |
|--------------|--------------------|
| | Rs. |
| 2012 | 206,633 |
| 2013 | 931,316 |
| 2014 | 154,965 |
| Total | 1,292,914 |

- (ii) According to the agreement entered with the above Finance Company, the Bank had agreed to pay a special rate for high value deposits of over Rs. 3 million. However, without considering the value of deposits, the Bank had offered the special rate for the deposits less than Rs. 3 million too.

(b) Covering Period of Performance Guarantee

The Bank had entered into an agreement with a private company on 12 July 2013 to operate the Sky Bank- Sky Lease Application Software Project. According to the operational plan, the Project scheduled to be commenced on 15 July 2013 and expected to be completed by 15 July 2014.

The following observation is made in this connection.

In terms of Guideline No. 5.4.8 (b) of the Government Procurement Guideline, “a performance security should be provided by the contractor by way of a performance guarantee issued from an acceptable agency and valid till twenty eight (28) days beyond the intended completion date. Nevertheless, the contractor had submitted a performance guarantee only on 12 July 2013 by indicating the validity period as 3 months up to 10 October 2013.

4.5 Provision for Employees Gratuity Fund

Even though, the provisions for employees gratuity and special employees gratuity amounting to Rs. 152,785,128 and Rs.128, 142,135 had been made in the accounts as at 31 December 2014, those had not been invested separately to meet the future obligations.

5. Systems and Controls

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

- (a) Inventory Control
- (b) Loan Administration
- (c) Personnel Management
- (d) Control over Fixed Deposits
- (e) Control over Fixed and Intangible Assets