

## **Housing Development Finance Corporation Bank of Sri Lanka – 2015**

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The audit of financial statements of the Housing Development Finance Corporation Bank of Sri Lanka for the year ended 31 December 2015, comprising the statement of financial position as at 31 December 2015 and the statement of income, 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. 07 of 1997 as amended by Act, No.15 of 2003 and Act, No. 45 of 2011.

This report is issued in terms of Article 154 (6) of the Constitution of the Democratic Socialist Republic of Sri Lanka.

### **1.2 Management’s Responsibility for the Financial Statements**

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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**

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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 Auditing 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 judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, 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 Finance Act, No. 38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the audit.

## **2. Financial Statements**

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### **2.1 Opinion**

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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 2015 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**

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A difference of Rs. 8,712,617 was observed between the borrowings from other institutions shown in the general ledger as at 31 December 2015 and the balances confirmed by the respective institutions.

#### **2.2.2 Accounts Receivable and Payable**

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The following observations are made.

- (a) The excess loan recoveries amounting to Rs.9,427,494 appeared in the Equal Monthly Installments (EMI) excess account for more than one year without being repaid to the customers.
- (b) Out of Rs. 31,103,309 shown under other liabilities as at end of the year under review, an amount of Rs.2,641,169 had remained in the accounts for more than three years without being settled.
- (c) The Bank had collected cheques from the customers in order to settle the loan installments and those cheques had been credited to the customer's loan account on the same day. As such, the stale cheques worth Rs.1,397,191 had still appeared in the accounts as cheque deposited but not realized.
- (d) An amount of Rs.126,873 shown as sundry debtors as at 31 December 2015 comprised the credit balances of Rs. 6,875,191 and debit balances of Rs.7,002,064. It was further observed that those balances had remained in the accounts for more than three years without taking proper action to settle or recover those balances.
- (e) As a general practice of the Bank, cheque advances should be settled within 21 days. However, the cheque advances aggregating Rs. 2,896,348 had been remained unsettled for a period ranging from 23 days to 196 days as at 31 December 2015.
- (f) Out of Rs.3,016,827 shown as advance received on auctioned properties, a sum of Rs.2,849,676 had remained unsettled for more than seven years.

### 2.2.3 Non – Compliance with Laws, Rules, Regulations and Management Decisions

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Instances of non-compliance with the following Laws, Rules, Regulations and Management Decisions observed in audit are analyzed and given below.

<b>Reference to Laws, Rules, Regulations and Management Decisions etc.</b>	<b>Non Compliance</b>
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(a) Section 16(2) of the Housing Development Finance Corporation Act, No 07 of 1997	Issued (stated) capital of the Bank should be Rs.1,000 million. However, the stated capital of the Bank as at 31 December 2015 was only around Rs.962 million.
(b) Inland Revenue Act, No. 38 of 2000, Public Finance Circular No. PF/PE/06 of 31 January 2000 and Public Enterprises Circular No. PED 03/2016 of 29 April 2016	The Bank had paid the Pay As You Earn (PAYE) Tax amounting to Rs. 25,684,438 for the year under review out of its own funds on behalf of its employees instead of being recovered from the salaries from the respective employees.
(c) Financial Regulation 757 (2)	No Board of Survey had been carried out by the Bank in the year under review to verify the physical existence of its fixed assets.
(d) Public Enterprises Circular No.PED 12 of 02 June 2003	
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(i) Paragraph 5.2.4	Although the draft Budget should be submitted for the approval of the Board of Directors, three months before the commencement of the financial year, the Bank had not complied with this when getting the Board approval for the Annual Budget of the year under review.
(ii) Paragraph 6.5.1	The Draft Annual Report should be rendered to the Auditor General within 60 days after the close of the financial year. Nevertheless, the Bank had not complied with this provision.
(iii) Paragraph 9.2. (b) and (d)	An entity should have an approved Organization Chart with an approved Cadre for such entity and it should be registered with the Department of Public Enterprises, General Treasury. However, the Bank had not got an approval for the Organization Chart and Cadre since its inception.

(iv) Paragraph 9.3.1

Every public enterprise should have schemes of recruitment and promotion for each post and such schemes should be approved by the Board and the appropriate Ministry, with the concurrence of the Department of Public Enterprises, General Treasury. However, the Bank had not complied with this.

## 2.2.4 Unauthorized Transactions

According to the investment policy of the Bank, if maximum single exposure exceeds Rs.100 million, such should be approved by the Board of Directors. However, without having a Board approval, the Bank had invested an amount of Rs. 500,000,000 in debentures issued by the Sanasa Development Bank on 28 December 2015.

## 3. Financial Review

### 3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2015 had resulted in a pre-tax net profit of Rs. 962 million as compared with the corresponding pre-tax net profit of Rs. 777 million for the preceding year, thus indicating an improvement of Rs.185 million or 24 per cent in the financial result during the year under review. The increase of interest income by Rs. 282 million during the year under review as compared with the previous year was the main reason attributed for this improvement.

### 3.2 Analytical Financial Review

#### (a) Significant Ratios

Certain significant ratios for the year under review and the preceding four years as compared with the norms of Central Bank of Sri Lanka are given below.

Name of Ratio	Central Bank Norm	2015	2014	2013	2012	2011
<b>Profitability Ratios</b>						<b>(percentage)</b>
(i) Net Profit Ratio	-	10.02	8.20	4.15	0.09	9.06
(ii) Net Interest Income to Interest Income	-	45.52	42.10	30.01	31.48	40.10
(iii) Interest Cost to Interest Income	-	54.48	57.90	69.99	68.52	59.90
(iv) Return on Average Assets	-	1.29	1.21	0.65	0.27	1.2
(v) Return on average Share Holders Fund	-	15.78	13.72	6.36	2.35	10.3

**Capital Adequacy Ratios**

Tier I	5	13.67	13.78	17.74	20.79	21.34
Tier II	10	12.18	12.92	18.29	21.76	21.95

**Liquid Assets Ratios**

Liquid Assets Ratio	20	35.03	28.90	28.74	22.65	21.15
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**Other Ratios****(in Rupees)**

Earnings Per Share	7.62	5.79	2.44	0.86	3.34
Net Assets Per Share	51.98	44.60	39.80	36.95	36.11
Market Value per Share as at end of the Year	67.10	49.60	49.60	50.60	1,400.30

As compared with the preceding four years, capital adequacy ratio of the Bank (Tier I and Tier II) had reflected declining trend, thus indicating the need for increase the capital requirement of the Bank.

**(b) Maturity Gap Analysis**

Maturity gap analysis and debt to equity ratio of the Bank for the year under review as compared with the previous years are as follows.

	<b>Up to 3 Months</b>		<b>3 to 12 Months</b>		<b>1 to 3 Years</b>		<b>3 to 5 Years</b>		<b>More than 5 Years</b>		<b>Total</b>	
	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>
Assets (Rs. million)	9.9	7.7	8.1	5.9	6.9	5.6	6.5	4.9	10.5	10.1	41.9	34.4
Percentage as total assets	23.5	22.5	19.4	17.3	16.4	16.4	15.6	14.4	25.0	29.4	100	100
Liabilities (Rs. Million)	13.2	15.4	12.3	7.8	9.3	2.6	1.4	3.8	5.8	4.9	41.9	34.4
Percentage as a total liabilities	31.4	44.7	29.3	22.6	22.2	7.5	3.3	11.0	13.8	14.2	100	100

It reflects that there is a maturity mismatch in assets and liabilities of the Bank in short term. However, as a practice the Bank had mitigated its maturity mismatch in assets and liabilities in long term by issuing debentures. As a result, the total borrowings of the Bank as at the end of the year 2015 had increased by Rs.2,824 million or 45 per cent over the preceding year. Further, debt to equity ratio of the Bank had gradually increased in preceding three years. Hence, the Bank had aggressively depended on debts rather than equity in its growth. The position of borrowings and debt to equity ratio of the Bank as at the end of the year under review and in the previous years is as follows.

	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
	<b>Rs. Million</b>	<b>Rs. Million</b>	<b>Rs. Million</b>	<b>Rs. Million</b>
Total Borrowings	9,037	6,213	5,257	3,214
Shareholder's Funds	3,364	2,886	2,575	2,391
Debt to Equity Ratio	2.69	2.15	2.04	1.34

### **3.3 Financial Management**

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The insurance limit for cash in transits amounting to Rs. 300,000 had been excessively given by the Gampaha Branch in nine instances.

## **4. Operating Review**

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### **4.1 Performance**

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The main objectives of the Bank are:

- (a) To grant any loan, credit facility or any type of accommodation to any individual, company, partnership, any institute or to Housing Finance Corporation for housing purposes, for the redemption of residential property.
- (b) To engage in, and promote, the development of the infrastructure related to housing,
- (c) To provide amenities and facilities to persons living in housing schemes

Although a Corporate Plan had been prepared in order to achieve these objectives, some significant variances were observed between the targets for the year under review included in the Corporate Plan and the actuals at the end of the year under review as shown below.

	<b>Targets</b>	<b>Actuals</b>	<b>Variation</b>
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	<b>Rs. Million</b>	<b>Rs. Million</b>	<b>Rs. Million</b>
Customer Deposits	33,573	28,593	4,980
Loans And advances	36,100	26,688	9,412
Net Interest Income	2,337	2,120	217

### **4.2 Loan Administration**

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The following observations are made;

#### **(a) Non-performing Loans and Advances (NPL)**

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The total loans and advances outstanding as at 31 December 2015 was Rs. 26,685 million and out of that the non-performing loans and advances was Rs. 5,542 million or 20.77 per cent and it was 22.57 per cent and 19.85 per cent as at the end of the year 2014 and 2013 respectively.

(b) **Vested Properties against the Loans**

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The value of vested properties against the non-performing loans as at 31 December 2015 was amounted to Rs.47,629,356 and out of that 48.81 per cent of vested properties valued at Rs.23,248,704 had remained over ten years without auctioning.

(c) **Loans granted against the Employee Provident Fund (EPF)**

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The loans amounting to Rs.10,771,956 granted against the EPF had not been recovered 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 measures to recover those outstanding loan balances even up to the end of the year under review. Details are as follows

<b>Defaulted Period</b>	<b>Number of Loans</b>	<b>Outstanding Amount Rs.</b>
18-30 months	412	8,400,109
30-42 months	53	1,562,046
More than 42 months	12	809,803
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Total	477	10,771,958
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**4.3 Management Weaknesses**

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The following observations are made.

- (a). The Bank had invested an amount of Rs. 100,000,000 in commercial papers of a private company at an interest rate of 11 per cent per annum for a period of 03 months. However, the investee is not a rated company. Further, it was observed that a Director of the investee was a non-independent Director of the Bank.
- (b). According to the Central Bank of Sri Lanka letter No. 02/19/315/0062/003 dated 12 September 2014, the Central Bank of Sri Lanka had granted the approval to open a Branch in Deniyaya. However, this Branch had not been opened even up to 31 December 2015. Further, the fixed assets purchased for Rs. 389,030 during the year under review for the use of this Branch had remained in the stores as at the end of the year under review.

**4.4 Matters for Emphasis**

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Out of total fixed deposits of the Bank as at 31 December 2015, more than 41 per cent representing the deposits of eleven customers and its indicating that the Bank had more dependent on very limited depositors and exposed to high liquidity risk.

#### 4.5 Transactions of Contentious Nature

##### Collection of Funds through Third Party

The Bank had entered into agreements with some finance companies to collect fixed deposits on behalf of Bank and agreed to pay a commission of 0.5 per cent and 0.1 per cent per annum on the value of deposits collected and for any renewal of the fixed deposits thereafter respectively.

The following observation is made in this connection.

Even though the Bank had two separate Divisions such as Treasury and Marketing headed by two Assistant General Managers, the Bank had incurred an additional cost of Rs.1,961,540 for collecting deposits through third party during the period from 2012 to 2015. Details are given below.

Year	Commission Amount Paid Rs.
2012	206,633
2013	931,316
2014	154,965
2015	<u>668,626</u>
Total	<u>1,961,540</u>

#### 4.6 Human Resources Management

The following observations are made

##### (a) Promotions

Twenty officers in various posts had been promoted as senior managers, chief finance managers, assistant general managers and deputy general managers with effect from 01 January 2015 without having an approved cadre.

##### (b) Recruitments

The Bank had recruited two employees during the year under review for the posts of assistant legal officer and the secretary who had not fulfilled the minimum requirements as published in the paper advertisements for such posts.

#### 4.7 Operating Inefficiencies

##### Procurement Procedure

In contrary to the Guideline 2.1.1 of the Government Procurement Guidelines – 2006, the Bank had followed a special purchasing manual prepared by them for the purpose of procurements without obtaining approvals from the Director General of Public Finance.



## **5. Accountability and Good Governance**

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### **5.1 Action Plan**

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According to the Action Plan of the Bank for the year under review, It was expected to expand the Branch network by establishing six new Branches. However, only two Branches had been opened during the year under review. In this regard the Chairman had informed me that, due to proposal of merger with State Mortgage and Investment Bank by the government, opening of new branches were temporary stopped by the Central Bank of Sri Lanka.

## **6. Systems and Controls**

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

### **(a) Staff Loans**

In some instances, the Bank had granted a distress loan to the same employee under similar category, before lapse of 18 months from the date of previous loan.

### **(b) Pawning System**

Gold loan system of the Bank facilitates to identify the all the Ran Niwasa Naya facilities granted to a customer through the National Identity Card number. Nevertheless, it was not facilitated to identify renewed, unredeemed and redeemed articles of particular customer separately.

### **(c) Leasing System**

Some of the leasing and hire purchasing facilities granted had been categorized as non-performing within a short period due to inadequate evaluation procedure of the repayment capacity of the customer.

### **(d) Control over Saving Accounts**

Accrued interest related to some saving accounts had not been updated to the savings system at the end of the each month.

### **(e) Branch Operations**

- i). In some instances, the cashier had made withdrawals without obtaining the customer signature.
- ii). The officers of the Bank had opened savings account without inserting the National Identity Card number to the system.