

Sri Lanka Savings Bank Limited - 2016

The audit of financial statements of the Sri Lanka Savings Bank Limited (“the Bank”) for the year ended 31 December 2016 comprising the statement of financial position as at 31 December 2016 and the 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.

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

1.2. Board’s Responsibility for the Financial Statements

The Board of Directors (“Board”) 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 Board 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. 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 risk 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 Board, as well as evaluating the overall presentation of the financial statements.

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

1.4. Basis for Qualified Opinion

- (a) According to Section 15 of the Sri Lanka Accounting Standards (LKAS) 01- “Presentation of Financial Statements”: Additional disclosures are required to be presented when necessary, to achieve the fair presentation of the financial statements. However, un-

reconciled difference of Rs.27,745,091 had been included in the prior year adjustment presented in the Statement of Changes in Equity for the year 2014 without any disclosure due to not having adequate evidence with the Bank. Such balance had been carrying in the retaining earnings as at 31 December 2016.

- (b) According to the E - mail confirmation issued by the Department of Inland Revenue on 31 January 2017 explaining the taxes payable as at 30 September 2016, the penalty charged against the Bank due to non-compliance with tax regulations was Rs.247,085,857. The Bank had not made this payment even up to 30 November 2017. Further, this amount had not been taken into the financial statements as a liability and expenditure based on the request made by Ministry of Finance.
- (c) The Bank had recognized an amount of Rs.215,348,540 as Withholding Tax Receivable and Notional Tax. However, the Bank is exempted from income tax on profit and income other than profit and income from dividends or interest as per Section 7(b) of the Inland Revenue Act No 10 of 2006 as amended by Act No 18 of 2013. Accordingly, the recoverability of this amount was appeared to be doubt since no confirmation was received from the Department of Inland Revenue either to refund this amount or to set off this amount against the future tax payables.
- (d) A difference of Rs.8,464,748 was observed between savings and fixed deposits Accounts then shown in the General Ledger and balance appearing in computer system as at 31 December 2016. As a result, the balance in the General Ledger had been overstated by similar amount.
- (e) It was observed a net difference of Rs11,951,210 between loan balances as per General Ledger and loan balances used for Impairment calculation as at 31 December 2016. Hence, impairment provision for the year 2016 in respect of this balance was not made resulting overstatement of profit for the year.
- (f) The Bank had not made any provision for impairment for pawning advances valued at Rs.38,105,985 presented in the financial statements as at 31 December 2016. However, the Banks in similar risk profile make provision for pawning at least based on requirements of the Central Bank of Sri Lanka. It was further noted that, in 27 instances pawning advances were granted to customers considering in excess of actual gold content which creates credit risk of recovering advances by one of the Branches of the Bank.
- (g) The Bank had considered Rs.30 million as its individual threshold for individual impairment. Accordingly, only 11 individually significant customers had been fallen under this category. Therefore, considering the objective of the Bank as giving micro finance loan to customers and not having any security for those loans, the individual threshold appeared to be unsuitable as at 31 December 2016.

- (h) Leasing Repossession Control Account amounting to Rs.1,784,380 arising from disposal of lease repossessed assets was remained as credit balance under receivables since the year 2015 in the statement of financial position without calculating profit or loss on disposal for those disposed items. Accordingly, receivable in the financial statements was understated by Rs.1,784,380. Further, respective loan balance of Rs.5,543,639 given against the above disposed assets was also remaining under other assets.
- (i) A sum of Rs.4,744,529 payable to suppliers was not confirmed by adequate supporting evidence such as invoices, details of settlement after reporting period, agreements etc. Further, A sum of Rs.2,784,406 included in the other accrued expenses had not been confirmed by adequate evidence and such balance remained unsettled since the year 2014. Further, balances aggregating Rs.3,432,054 appearing under other payables and sundry creditors had not been supported by adequate evidence.
- (j) It was observed an unusual net debit balance of Rs.4,888,069 under other payables in the financial statements. This was due to incorrect ledger postings of deposits of the Bank. Those balances had not been cleared as at 31 December 2016.
- (k) Six account balances in the General Ledger amounting to Rs.6,426,878 had been reported as unusual suspense nature in the financial statements as at 31 December 2016.
- (l) The Bank had maintained an account called "Termination over payment" in the General Ledger to record the cash receipts of Rs.9,859,927 from customers whose loan balances are rescheduled since the Bank's system does not support to post the entries for rescheduled loans. Accordingly, though customers had actually paid their dues, their loan accounts in the General Ledger had not been updated. This had resulted to overstate the loan balances.
- (m) The pawning system of the Bank had recognized interest income on pawning articles in excess of the amount required to be recognized when customer makes part payments. This system error had not been corrected as at 31 December 2016.
- (n) A cash deficit (credit) balance of Rs.3,180,342 relating to a closed current account in year 2014 was included in the financial statements. Hence, the liabilities in the financial statements were overstated by similar amount.
- (o) Payable account balances of Rs.13,010,940 shown under different line items in the statement of financial position were not moving for more than two years. The reasons for not moving these items were not explained to audit. Further, account balances of Rs.6,991,880 reported under other assets had been remained unchanged during the period of 2014 to 2016. Accordingly, recoverability of these assets was in doubt due to not having any information with the Bank.
- (p) Even though all licensed specialized banks require to enhance minimum capital requirement up to Rs.5 billion commencing from 01 January 2016 in terms of Direction

No.02/17/402/0073/002 dated 23 December 2014 issued by the Central Bank of Sri Lanka, the total capital of the Bank as per the financial statements stood at Rs.4.79 billion as at 31 December 2016.

2. Financial Statements

2.1 Qualified Opinion

In my opinion, except for the possible effects of the matters described in the Basis for Qualified Opinion paragraph of this report, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2016, and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.1.1. Report on Other Legal and Regulatory Requirements

As required by Section 163 (2) of the Companies Act No. 07 of 2007, I state the following:

- (a) The basis of opinion and scope and limitations of the audit are as stated above.
- (b) In my opinion, except for the effect of such adjustments as might have been determined to be necessary had I been able to satisfy myself as to the matters disclosed in the basis for qualified opinion paragraph above.
 - I have obtained all the information and explanations that were required for the audit and, as far as appears from my examination, proper accounting records have been kept by the Bank.
 - The financial statements of the Bank, comply with the requirements of Section 151 of the Companies Act No. 07 of 2007.

2.2 Accounts Receivable and Payable

- (i) A sum of Rs.7,983,775 received from the Customers of the Premuka Savings & Development Bank (PSDB) as receipts for PSDB loan had been recorded in margin accounts under other payables instead of being used this money to settle the loan payables.
- (ii) Out of the total insurance receivable amounting to Rs.1,578,525 as at 31 December 2016, a sum of Rs.1,209,890 had not been recovered from the respective parties for more than one year.

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

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

Reference to Laws, Rules, Regulations and Management Decisions etc.	Non-compliance
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(a) Value Added Tax (VAT) Act, No. 14 of 2002 and Amendments made thereto. (i) Section 02	Even though the applicable VAT rate with effect from 01 November 2016 was 15 per cent, the Bank had computed and paid VAT on financial services in the month of November 2016 at a rate of 11 per cent. Hence, the VAT on financial services had been paid by understating Rs.1, 538,204.
(ii) Section 25 (C) (1)	Annual adjustments relating to previous year (2015) should be submitted to the Department of Inland Revenue within six months after the end of relevant accounting period (i.e. On or before 30 June 2016). However, the Bank had submitted such adjustments only on 30 November 2017.
(iii) Section 26	Bank is liable to pay the VAT on financial services for a particular month on or before 20 th of following month. However, the Bank had not paid any VAT on financial services for first 8 months of the year 2016 amounting to Rs.22,775,862 even up to August 2016.
(b) Section 2 of the Economic Service Charge (ESC) Act, No. 13 of 2006	The liable turnover for the computation of ESC should comprise the discount, dividend, commissions and other income derived by the Bank in the course of its business. However, the Bank had not considered such income of Rs.9,292,492 and Rs.15,426,158 in the computation of ESC for first and second quarters of 2016 respectively.

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| (c) Nation Building Tax (NBT) Act, No. 09 of 2009 | The Bank had not paid Rs.2,221,758 as NBT for the period of January to May 2016 by considering that it had an overpayment of NBT as at 01 January 2016. However, such an overpayment was not observed in audit. |
| (d) Inland Revenue Act No. 10 of 2006 | Pay As You Earn (PAYE) tax amounting to Rs.179,387 deducted from the salaries of the employees for the years of assessment 2007/08 to 2014/15 had not been remitted to the Department of Inland Revenue. |
| (e) Section 2 (3) of the Corporate Governance Directions No. 12 of 2007 for License Specialized Banks | Then Chairman of the Bank appointed on 06 August 2015 had not obtained the fit and propriety certification from the Central Bank on Sri Lanka (CBSL) even up to his resignation in March 2018. |
| (f) Credit Circular No. SLSB/CRE/ICL/2014/07 dated 22 September 2014 Issued by General Manager | A loan amounting to Rs.6,000,000 had been released to a particular borrower even though the borrower had not fulfilled the requirements of the Credit Information Bureau as stipulated in the Credit Circular. |
| (g) Section 08 of the Agreement entered into between the Bank and software supplier on 30 April 2013 | Although the performance bond provided by the supplier was elapsed before installation of software, actions had not been taken to extend the validity period of this bond. |

3 Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank during the year under review had resulted in a pre-tax net profit of Rs.600 million as compared with the corresponding pre- tax net profit of Rs.432 million in the preceding year, thus indicating an improvement of Rs. 168 million in the financial results for the year under review. Increase of interest income by Rs. 248 million or 37 per cent as compared with the previous year was the main reason attributed for this improvement in the financial results.

Although the financial results of the Bank for the year under review was Rs.600 million, the value addition of the Bank had gradually increased from Rs.695 million in 2013 to Rs.826 million in 2016 after taking into account the personal emoluments, depreciation and tax paid and payable to the government aggregating Rs.226 million for the year under review and total value addition of the Bank had increased by Rs.267 million or 48 per cent as compared with the previous year

3.2 Analytical Financial Review

3.2.1 Significant Accounting Ratios

According to the information made available, certain important ratios of the Bank for the year under review and the preceding year together with sector ratios are given below.

	<u>Sector Ratios</u>	<u>The Bank</u>	
		<u>2016</u>	<u>2015</u>
<u>Profitability Ratios</u>	<u>Percentage</u>	<u>Percentage</u>	<u>Percentage</u>
(i) Return on Average Shareholder 's Funds	18.3	13.16	10.35
(ii) Return on Average Assets	1.5	6.4	4.8
(iii) Net Interest Margin	3.5	9.4	6.6
<u>Capital Adequacy</u>			
	13.5		
Capital Adequacy Ratio - Tier I (Minimum 5%)		82*	65*
<u>Asset Quality</u>			
Gross Non-performing Advances Ratio (Including PSDB)	4.5	37.06	42.97
Gross Non-performing Advance Ratio (excluding PSDB)	4.5	9.37	11.18
<u>Liquidity Ratios</u>			
Liquidity Asset Ratio	61.4	126*	655*

*Capital Adequacy (Tier I) and Liquidity Ratios were taken from the information submitted to the Central Bank of Sri Lanka.

The following observations are made in this connection.

- (i) The Bank had maintained a higher liquidity ratio both in the year 2016 (126%) and 2015 (655%) as compared with sector ratios. As a result, the Bank had loosed the opportunity to earning a higher income by utilizing the excess funds.
- (ii) The gross non - performing advance ratio at the end of year 2016 (9.37%) was higher than the sector ratio (4.5%). Hence, it had created a significant liquidity risk to the Bank. In the meantime, the gross non-performing advance ratio including defaulted Premuka Savings and Development Bank loans at the end of the year 2016 stood at 37.06 per cent.

3.2.2 Total Assets Base of the Bank

The following observations are made.

- (i) The total asset base of the Bank in the year 2012 was Rs.7,385 million while it was Rs.9,683 million by the end of the year 2016 representing 31 per cent growth. However, total asset base of the License Specialized Banking Sector (LSBS) for the year 2012 was Rs.742,532

million while it was Rs.1,203,245 million by the end of year 2016 representing 62 per cent growth. Accordingly, growth rate of the Bank in terms of asset base was below the growth rate of the LSBS during the period under concerned.

- (ii) The asset base of the Bank in the years 2015 and 2016 was Rs.9,175 and Rs.9,683 million respectively. Although the Bank had planned to achieve Rs. 29,061 million assets base by the end of the year 2019, out of that only 33 per cent had been achieved up to 31 December 2016.
- (iii) The asset base market share of the Bank as against the total assets base of the Licensed Specialized Banking Sector in the year 2012 was 0.99 per cent while it was 0.80 per cent in the year 2016 showing a deterioration of 0.19 per cent.

4 Operating Review

4.1 Performance of the Bank

4.1.1 Achievement of Objectives

The following observations are made.

- (a) As per the Articles of Associations of the Bank, the main objective of the Bank is to identify, develop, promote, catalyze and support sustainable income generating opportunities and a higher quality for the poor through a range of activities including productive self-employment micro enterprises and rural work by provision of financial assistance and services.

Accordingly, The Bank's micro finance loan balance as at 31 December 2016 was Rs.1,421 million and it had increased by Rs.123 million or 9.5 per cent as compared with year 2015. Further, according to the Action Plan of the Bank, it had planned to grant a sum of Rs.2,570 million as micro finance loans by the end of the year 2016. However, only an amount of Rs.1,181 million had been disbursed such loans in the year under review.

- (b) It was observed that the Bank had introduced a new deposit scheme named "SLS Thilina" during the year 2016 as stipulated in the Action Plan for the year under review. However, a sum of Rs.941,708 only had been received as deposit to this scheme even up to 31 December 2016.

4.1.2 Investments of the Bank

The following observations are made.

- (a) The Bank had maintained nearly 60 per cent out of its total assets as short term investments in different instruments such as fixed deposits, reverse repurchase agreements etc. The loans and advances represented only 28 per cent which was 2 per

cent drop as compared with the preceding year. This seemed to be less focus on the main objective of the Bank. Total investments made in reverse repurchase agreements, placement with other banks and equity securities as compared with the total assets of the Bank is explained in the following table.

Year	Total Assets	Total Loan & Advances	As a percentage of Total Assets	Total Investment	As a percentage of Total Assets
	Rs.'000	Rs.'000	%	Rs. '000	%
2016	9,683,201	2,756,196	28	5,979,172	62
2015	9,174,689	2,763,400	30	5,507,843	60

- (b) According to the information made available, the interest income of Rs. 588,868,419 or 64 per cent of the total income had been earned from direct investments, thus showing the inability of the Bank to provide financial assistance and services in order to achieve the main objective of the Bank.

4.1.3 Settlement of Liabilities of the Premuka Savings and Development Bank (PSDB)

The following observations are made.

- (a) According to Section 1.3 of the Cabinet Paper No PED/NDTF dated 24 May 2010, the Bank should provide the relief to the depositors of the PSDB. Accordingly, the outstanding liabilities of the PSDB as at 31 December 2015 and 2016 were Rs.2,131,001,482 and Rs.2,172,176,831 respectively. These balances should be payable by the Bank as per the scheme introduced and published by the Central Bank of Sri Lanka in December 2009. However, only 3.1 per cent and 1.5 per cent had been settled during the year 2015 and 2016 respectively.
- (b) Although it was expected to recover 20 per cent out of the PSDB's non-performing loan balance of Rs.1,117,977,008 as at 31 December 2015, an amount of Rs.45,928,826 or 4 per cent was only recovered during the year under review.

4.2 Management Weaknesses

The following observations are made.

- (a) The Bank had issued seven shares at the time of incorporation as per the previous Companies Act. However, out of that three shares had not been transferred back to the General Treasury even up to June 2018.

- (b) It was observed that eleven bank accounts belonging to the Bank had not been in operation throughout the year under review. The balance of those bank accounts as at 31 December 2016 was Rs.1,126,853. The purpose of maintaining these idle bank accounts was not explained to audit.
- (c) The Bank had established a staff housing loan fund of Rs.100 million by using the retained earnings in the year 2014 for providing Housing Loan facility to its staff. However, the Bank had not utilized this Fund for the intended purpose even up to 31 December 2016.
- (d) Double postings to the Bank's applications system were observed in 07 instances during the course of audit test checks due to shortcoming in the system. However, the applications system of the Bank had not been rectified till 31 December 2016.

4.3 Major Risk Areas of the Bank

The following observations are made.

- (a) Out of total loan portfolio of the Bank, a sum of Rs. 1,311 million or 32 per cent was represented Micro Finance Loan Outstanding as at the ended of the year 2016 and it was Rs. 1,238 million as at the end of the year 2015. Out of these a sum of Rs.561 million or 45 per cent and Rs. 687 million or 52 per cent respectively had been granted to seven Community Base Organizations (CBOs) which outstanding loan balances were in excess of Rs.50 million in the year 2015 and 2016. This creates a considerable risk to the Bank due to not having securities for outstanding balances ranging from 9 per cent to 34 per cent against six loans due from respective CBOs. Details are given below.

Name of the CBOs -----	Amount Outstanding as at 31 December	
	2016 ----- Rs.	2015 ----- Rs.
Rathnapura District Co-op Rural Bank Union Ltd	79,755,623	30,211,477
Sri Lanka Ports Authority Employees' Society	83,106,944	149,573,611
Sri Lanka Ports Authority Employees' Welfare Society	51,400,000	51,433,333
Sareeram Sri Lanka National Foundation	54,594,201	35,565,282
Berendina Micro Finance Institute	199,282,541	99,536,268
Social Envo Vision Organization	58,867,076	58,185,508
Arthavida Intermediary Limited	<u>159,822,746</u>	<u>136,432,568</u>
Total	<u>686,829,131</u>	<u>560,938,047</u>

- (b) Further, the Bank had provided Rs.909,018,213 or 69 per cent of its micro finance financial facilities to 13 CBOs as at 31 December 2016 (2015 - 17 CBOs and Rs.944,123,208 or 76 per cent). Reliance heavily on few customers creates a high credit risk to the Bank.
- (c) Outstanding loan balances over Rs.1,000,000 represented 08 per cent of total outstanding micro finance loans granted to seven CBO's as at the end of the year under review and these balances were not recovered or changed since the year 2015. Details are as follows.

Name of the CBOs	Amount Outstanding as at 31 December 2016
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	Rs.
Trincomalee District Gandhi Sevai Association	6,581,558
Ai-Quraish Social Development	2,777,739
Sri Rohana Death Relief & Society	1,624,691
HOPE Micro Finance Services (Guarantee) Ltd	39,373,610
Kilakkin Olichsuder Social Service Organization	1,631,045
Social Welfare Development Foundation	1,833,896
People Economics Education Development Organization	<u>48,003,977</u>
	<u>101,826,516</u>

4.4 Major Non-performing Loans

According to the applications system of the Bank, the outstanding loan balance from REPPIA as at 31 December 2016 was Rs.55,621,341 and out of that, a sum of Rs.55,586,352 or 99.94 per cent was reported as non performing as at that date.

4.5 Human Resources Management

The following observations are made with regard to the approved and actual cadre position of the Bank as at 31 December 2016.

- (a) The approved cadre of the Bank for the year under review was 183 and the Bank had deployed 123 employees at the end of the year 2016. Accordingly, there were 07 excess positions and 67 vacancies as at 31 December 2016. The Supervision Department of the CBSL by its letter dated 23 February 2017 had instructed the Bank to suspense all recruitments until further notice by considering the significance supervisory concern pertaining to the Bank
- (b) It was observed that 22 Executive Level Management Posts were remained in vacant since the year 2015 and this included the posts of an Assistant General Manager, Chief Managers, Senior Managers, Managers and Assistant Managers. This may have badly effected to smooth operation of the Bank. In particular, vacant post of the senior Manager, Finance had effect to get delayed the finance functions of the Bank.

4.6 Legal Actions initiated by the Bank

According to the information made available, it was revealed that there were 103 unsettled court cases filed by the Bank against outsiders as at the end of the year under review by claiming Rs. 2,121,319,656.

5 Accountability and Good Governance

5.1 Procurement Plan

As per the Procurement Plan for the year 2016, the Bank had planned to procure of Property, Plant and Equipment worth Rs.59.46 million during the year under review for a new Branch. However, no Branch had been opened during the year 2016.

5.2 Actions Plan

- (a) Expansion of Micro Finance Institutions (MFIs) Network Island wide by extending the enrolment of Community Based Organizations (CBOs) with the Bank had not been performed as expected.
- (b) Target of developing and implementing a system for rating MFIs had not been achieved even up to 31 December 2017.
- (c) The Bank had planned to improve the performing loans by Rs. 20 billion during the period from 2015 to 2019. However, the Bank had only achieved a performing loans of Rs 2,055 million up to 31 December 2016

6 Systems and Controls

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

Areas of control	Observations
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(a) Accounting	The Bank should require complying with Sri Lanka Accounting Standards as considerable deviations were noted. Further, it should make effective measures to minimize accounting deficiencies, un-reconciled balances and unexplained differences in financial reporting.

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| (b) Taxation | The Bank should plan to comply with tax regulations as material deviations in the form of computation, payment and submission of returns were observed in audit. |
| (c) Promotion of Micro Finance Sector | As the main objective of the Bank is the promotion of micro finance facilities to poor people, the Bank should pay its attention in this regard while mitigating nonperforming loans. |
| (d) Preparation of Bank Reconciliations | The Bank should implement a strong process to prepare bank reconciliation statements as there were considerable number of un-posted entries were noted. |
| (e) Settlement of PSDB Liabilities | As the Bank was incorporated with the objective of settlement the deposits and other amounts of defaulted PSDB customers, the Bank shall give its priority to settle those balances. |
| (f) Streamlining the Operations | Bank shall properly monitor its banking activities in the branches since significant weaknesses were observed at the time of opening and closing savings accounts, fixed deposits, granting various loans including pawning loans. |
| (g) Modification of Application System | The application system of the Bank was not properly implemented and therefore, lapses in interest computation, duplicate accounts and un-reconciled differences were noted. Further, system shall not support some banking activities such as entering reschedule loans, interest calculation of pawning loan. |
| (h) Transferring the ownership of Shares | Bank shall obtain and transfer the ownership of remaining shares under the hand of General Treasury. |