

Lankaputhra Development Bank Limited - 2016

The audit of financial statements of the Lankaputhra Development Bank (“the Bank”) for the year ended 31 December 2016 comprising the statement of financial position as at 31 December 2016 and the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows 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 pursuance of provisions in Article 154(6) of the Constitution of the Democratic Socialist Republic of Sri Lanka.

1.2 Board’s Responsibility for the Financial Statements

Board of Directors (“the 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 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 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 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 Lankaputhra Development Bank as at 31 December 2016 and 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

- (i) As required by section 163 (2) of the Companies Act No.07 of 2007, I state the followings:
- a. The basis of opinion and scope and limitations of the audit are as states above.
 - b. In my opinion:
 - I have obtained all the information and explanation 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.
- (ii) Theses financial statements had been presented the information required by the Banking Act No.30 of 1998 and subsequent amendments.

2.2 Comments on Financial Statements

2.2.1. Accounting Policies

An approved policy for the computation of impairment on Loans and Advances had not been determined by the Bank.

2.3 Non – compliance with Laws, Rules, Regulations and Management Decisions, etc

According to Section 3 (2) of the Banking Act, No.12 of 2007 on Corporate Governance for Licensed Specialized Bank’s Directions, the Board of Directors (Board) should be consisted minimum 7 members. However, the Board had consisted only 6 members including Chairman in the year 2016

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2016, had resulted in a pre-tax net profit of Rs. 258.7 million as compared with the corresponding pre-tax net profit of Rs. 192.7 million for the preceding year, thus, indicating an improvement of Rs. 66 million or 34 per cent in the financial result for the year under review.

Increase of interest income by Rs. 75 million during the year under review as compared with the previous year was the main reason attributed for this improvement.

3.2 Value Addition of the Bank

The financial value addition of the Bank, during year under review after taking into account the personal emoluments, tax expenses and depreciation aggregating to Rs.229 million was Rs.488 million as compared with the corresponding value addition of Rs.431 million for the preceding year.

3.3 Analytical Financial Review

3.3.1 Significant Accounting Ratios

According to the information made available, some important ratios of the Bank for the year under review and the preceding year as compared with sector ratios for Licensed Specialized Bank (LSB) are as follows.

Name of Ratio	Sector Ratios	2016	2015
	(Licensed Specialized Bank)	Percentage	Percentage
Profitability Ratios			
Net Profit Ratio	9.30	35.22	28.85
Net Interest Margin	3.76	7.84	7.09
Net Interest Income on Interest Income	33.87	91.51	88.91
Non Interest Income to Total Income	4.26	3.69	5.35
Interest Cost on Interest Income	66.13	8.49	11.09
Staff Cost to Operating Expenses	51.14	52.12	54.94
Return on Average Assets	1	3.03	2.36
Return on Equity	18.3	5.30	4.07
Earnings per Share	-	7.17	5.34
Capital Adequacy Ratios			
(i) Tier i	13.5	75.52	69.34
(ii) Tier ii	15.2	76.25	69.90
Liquidity Ratios			
Liquid Assets Ratio (Minimum 20 per cent)	61.4	1053.37	888.18
Asset Quality			
Non performing Advance Ratio	5.28	39.2	35.2

The following observations are made in this regard.

- (a) High net interest margin of 7.84 per cent and net profit ratio of 35.22 had been reported in the year under review as compared with the average Licensed Specialized Bank (LSB) ratio of 3.76 per cent and 9.3 per cent respectively.
- (b) Interest cost on interest income ratio reflecting 8.49 which is far behind the average LSB ratio of 66.13 per cent.
- (c) Total capital adequacy ratio of the Bank is 76.25 per cent which is excessively high level than the minimum requirement of 10 per cent.
- (d) Liquid asset ratio of the Bank was further increased to 1053.37 per cent as at 31 December 2016 as compared with the minimum requirement of 20 per cent.
- (e) The Bank had recorded 3.03 per cent return on average assets which is above the sector ratio of 1 per cent. However, return on equity is well behind than the sector ratio.
- (f) High Non Performing Loans (NPL) ratio of 39.2 had been observed as at 31 December 2016 which is far above the LSB average ratio of 5.28 per cent.

3.3.2 Liquidity Gap of the Bank

Analysis of the profile of the financial assets and financial liabilities of the Bank as at 31 December 2016, it was revealed that the total liabilities for over 5 years were far in excess over the total assets, thus reflecting a mismatch of maturity of assets and liabilities.

	up to 3 months Rs.	3-12 months Rs.	1-3 years Rs.	3-5 years Rs.	Over 5 years Rs.
Assets	1,667,411,700	4,570,961,357	1,032,845,349	878,186,206	522,489,334
Liabilities	157,559,403	80,218,392	28,155,941	17,757,285	8,388,202,925
Difference	1,509,852,297	4,490,742,965	1,004,689,408	860,428,921	(7,865,713,591)

4. Operating Review

4.1 Performance

(a) Achievement of Main Objectives

The following observations are made.

- (a) The performance of the Bank in achieving the targets for the year under review prescribed in the Business Plan prepared for the year 2016 is summarized below.

Targets	Actual Performance
Increase the deposit volume by Rs.1000 million via Branch network	Deposit volume had been decreased by Rs.99.5 million as compared with the previous year.
Reach Break Even Point in all Branches	Six Branches of the Bank had been running at loss and only two Branches made profit in the year under review.
Enhance the loan portfolio of the Bank by Rs.1,500 million	Loans and Advances had been increased only by Rs.341.7 million as compared with the previous year end.
Non Performing Advance (NPA) balances should be reduced to less than 25 per cent and to Rs.1,200 million in absolute terms by year end.	NPA balance of the Bank had increased to 39.2 per cent or Rs.1,467 million as compared with the previous year end.
Upgrade skills of employees for future staff recruitments	It was observed that lack of competent staff in key managerial positions and deficiencies in recruitments and promotions.
Develop core banking system to meet the IFRS and new reporting requirements	Current banking system is not adequate to provide necessary information quickly.

(b) Achievement of the business objectives of the Bank as per the Corporate Plan prepared for the period of 2012-2016 and the progress thereon as at the end of the year under review is summarized below.

Items	Targets	Actual	Variance
	Rs. Million	Rs. Million	{Favourable/(Adverse)}
			Rs. Million
Interest Income	987.8	707.3	(280.5)
Interest Expenses	376	60	316
Non-interest Income	6.75	27	20.25
Profit Before Tax	300.85	258.7	(42.15)
Loans and Advances	9,000	3,675.7	(5,324.3)
Deposits	4,820	420.9	(4,399.1)

The following observations are also made in this connection.

- (i) The Bank had failed to achieve the targets set out in the Corporate Plan for the main business areas of interest income, profit before tax, loans and advances and deposits etc.
- (ii) Achievement of targets towards the deposits and loans and advances were far below as compare with the targets.

- (iii) Achievement of targets towards the plan was not periodically reviewed by the Bank.
- (iv) However, since the existing Corporate Plan was ineffective, the Bank had planned to prepare a new Corporate Plan.

(b) Loans Administration

The following observations are made.

(i) Provision of Loans

The following observations are made.

- The Bank had granted loans amounting to Rs.1,289 million during the year 2016 and outstanding balance of those loans as at 31 May 2017 was Rs.928 million. Out of those loans, a sum of Rs. 236 million or 25 per cent was in non-performing category.
- The Bank had granted the loans aggregating to Rs. 697 million to 9 customers exceeding the individual borrowing limit of Rs.20 million without comply with the provisions in the credit manual of the Bank from 01 January 2016 to 31 May 2017. Outstanding balance of those loans as at 31 May 2017 was Rs.482 million.
- Wennapuwa Branch of the Bank had granted nine short term loans amounting to Rs.65 million during the year under review as pledge loans against paddy stocks. No single installment had been recovered from these loans up to 31 May 2017. As per the internal audit observations, it was revealed that locks of seven paddy stores were broken. Further, paddy stocks related to three facilities were lower than the stocks pledged and no stocks were available in other three stores as well.

(ii) Non-performing Loans and Advances (NPL)

The total outstanding loans and advances as at 31 December 2016 was Rs. 3,675.7 million and out of that Rs.1,467 million or 39.9 per cent were categorized as non-performing. The details the non- performing loans and advances as at 31 December 2016 are shown below.

Category	Balance outstanding as at 31 December 2016	
	Amount Rs. million	Percentage
Special Mention	280	19
Substandard	138	9
Doubtful	130	9
Loss	919	63
Total	1,467	100

Even a single installment could not be recovered from the non-performing loans of Rs.516,560,452 outstanding as at 31 May 2017.

(iii) Operational Performance

Interest income earned through granting loans and advances was only 48 per cent or Rs.339 million out of the total interest income of Rs.707 million earned for the year 2016 reflecting the less focus on core banking activities. Therefore, the Bank may have been sustained an operational loss of Rs.109 million, if the Bank could not be able to earned an interest income of Rs.368 million by investing its excess funds in other sources.

(C) Deposits

Deposit base of the Bank had decreased up to Rs.420.8 million as at 31 December 2016 from Rs.520 million as at 31 December 2015 reflecting a 19 per cent decline as compared with the previous year.

(d) Market Share of the Bank

The market share of the Bank based on Loans and Advances and Deposits as compared with the banking sector and licensed specialized banking sector for the year under review and preceding four years is given below.

Year	As a percentage of Banking Sector		As a percentage of Licensed Specialized Banking Sector	
	Based on Loans and Advances	Based on Deposits	Based on Loans and Advances	Based on Deposits
2016	0.07	0.01	0.69	0.05
2015	0.07	0.01	0.73	0.07
2014	0.07	0.01	0.62	0.05
2013	0.07	0.01	0.70	0.04
2012	0.08	0.01	0.78	0.04

The entire market share of the Bank was less than 1 per cent over 5 years period.

4.2 Management Weaknesses

The following observations are made.

- (a) The Bank had not taken action to identify and rectify the un-identified customer deposits of Rs.2,798,093 existed as at the end of the year under review.
- (b) Repetition of deficiencies those reported in my previous years audited reports were observed even in the year under review.

- (c) The Bank had appointed the Assistant General Manager, Information Technology (AGM-IT) as Assistant General Manager, Human Resources and Administration (AGM HR) without obtaining the approval from the Central Bank of Sri Lanka.

4.3 Operating Weaknesses

The following observations are made.

- (a) A judgment had been delivered against the Bank by the Western Provincial High Court on a legal case filed for recovery of a loan amounting to Rs. 5 million granted to Eksath Deewara Udana Thrift and Credit Co-op Society due to deficiencies in documents and incorrect procedure followed by the Bank in granting such loan.
- (b) Although the rent agreement had been entered into between the Bank and the District Base Hospital, Hambanthota relating to rent out the part of the building belonging to Hambanthota Branch for the purpose of functioning hospital quarters was expired on 16 July 2015, actions had not been taken to renew the agreement even up to 31 May 2017.

4.4 Legal Procedures Initiated by the Bank and Against the Bank

The following observations are made.

- (i) Out of one hundred and fifty three cases filed by the Bank up to 01 May 2017, judgments had been given only for 19 cases and of them three judgments were unfavourable to the Bank. The Bank had not obtained writ orders against defaulted customers due to unavailability of writ officer. In the meantime, the Bank had failed to recover the outstanding loans as per the settlements arrived with the customers in the Court.
- (ii) Ten legal cases had been filed against the Bank by the borrowers against the execution of par ate right and five cases had been filed by the staff as at 01 May 2017.

4.5 Human Resources Management

The following observations are made.

- (a) Approval of the Department of Public Enterprises had been received in the year 2013 for the Cadre included 181 staff. However, the Secretary to the Treasury had instructed the Bank on 13 August 2013 to review the Cadre and obtain the approval for revised cadre from the Department of Management Services. However, without doing such review, the Bank had increased the existing cadre up to 191 as at 31 December 2016 based on Board decision.

(b) Promotions

- (i) As per the decision of the Board meeting held on 16 October 2015, an officer had been promoted as Senior Manager (Overall Branch Supervision) without any such post in the approved cadre of the Bank.
- (ii) Four applications had been submitted by internal candidates for the promotion of the post of Senior Manager based on the Internal Memo No.HR/15/685 dated 15 September 2015. According to the Board meeting held on 16 October 2015, Board had granted the approval to promote the officers who obtained second and third places at the interview as Senior Managers without considering the first place obtained. However, the officer who obtained highest marks had been promoted as Senior Manager with effect from 01 November 2015 as per the decision taken at the Board meeting held on 17 March 2017.

(c) Recruitments

The following observations are made with regard to the recruitments made during the period of 2015/2016 for the post of Trainee Banking Assistants, Trainee Business Development Assistants, Banking Assistants, and Management Trainees.

- (i) The necessity for these recruitments had not been furnished to audit.
 - (ii) At the audit checks carried out on the personal files, it was revealed that recommendations for applications had been made by then Chairman for the above posts and the appointment letters were also signed by then Chairman even though he was not allowed to do so by the Banking Act Direction No. 12 of 2007.
 - (iii) According to the approved cadre of the Bank, the number of posts under the category of Trainee Banking Assistants, Banking Assistants and Development Assistants was 73. However, actual cadre as at 31 December 2016 was 96, thus exceeding the approved cadre by 23 employees.
- (d) Two candidates who had obtained ordinary passes for English and Mathematics subjects at G.C.E Ordinary Level examinations had been recruited for the post of Banking Assistants. However, two diploma certificates had been submitted by them as supplement for the educational qualifications. The following deficiencies were revealed in audit relating to the diploma certificates provided by the educational institution.
- (i) Then Chairman of the Bank was the Managing Director of above educational institution.
 - (ii) As the above institution registered as a vocational training commission, it had not been allowed to provide diploma certificates.

- (e) Sixteen officers had been recruited based on the recommendation of the then Chairman of the Bank, though these officers not fulfilled the minimum age requirements and required qualifications. Further, without considering the required qualifications, the Bank had confirmed the service of seven employees on 31 May 2017.
- (f) One person who had not fulfilled the required qualification had been recruited for the post of Management Trainee. However, no disciplinary action had been taken against the above employee and placed him as a Trainee Banking Assistant, after considering the request made by the employee.
- (g) Twenty persons recruited for the posts of Managers, Trainee Banking Assistants, Trainee Banking Development Assistants, Drivers and Office Assistants during the year 2015/2016 had been fulfilled the required qualifications. Nevertheless, the Bank had not taken actions to permanent them even up to 30 June 2017.

4.6 Retirement Benefit Obligation

A sum of Rs.21,684,018 has been provided in the financial statements as at 31 December 2016 as retirement benefit obligations. However, the Bank had not taken actions to invest such amount in order to mitigate the future obligation.

5. Accountability and Good Governance

5.1 Internal Audit

Four employees had been deployed in the Internal Audit Division, though 5 employees in the approved cadre. However, 8 Branches of the Bank and Departments of the Head Office had to be audited by them.

5.2 Budgetary Control

Significant variances up to 72 per cent were observed between the budgeted and the actual figures, thus indicating that the budget had not made use of as an effective instrument in management control.

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 from time to time. Special attention is needed in respect of the following areas of control.

<u>Areas of Control</u>	<u>Observation</u>
(a) Accounting	Calculation of impairment provision and specific provision as per guidelines of Central Bank of Sri Lanka
(b) Loan Administration	<ul style="list-style-type: none"> - Needs of strict compliance with the introduced procedures - Lack of credit appraisal process - Prevailing high Non-performing Loan Ratio - Verify the accuracy of mortgaged properties - Taking legal actions on unsettled loans
(c) Human Resources Management	<ul style="list-style-type: none"> - Adherence to the regulations laid down in the Scheme of Recruitments and Promotions. - Recruit competent staff to the relevant posts - Provide proper training to the staff
(d) Corporate Governance	<ul style="list-style-type: none"> - Compliance with corporate governance directions - Supervisory on guidelines and directions issued by the Central Bank of Sri Lanka