

Central Bank of Sri Lanka (CBSL) - 2016

1. Financial Statements

1.1 Opinion

The audit of the financial statements of the Central Bank of Sri Lanka (“the Bank”), comprising the statement of financial position as at 31 December 2016, and the statement of income, statement of other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements including a summary of significant accounting policies, 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 42 (2) of the Monetary Law Act (Chapter 422). In carrying out this audit, I was assisted by a firm of Chartered Accountants in public practice to examine the compliance with International Financial Reporting Standards.

In my opinion, the accompanying financial statements present fairly, in all material aspects, the financial position of the Bank as at 31 December 2016, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

1.2 Basis for Opinion

I conducted my audit in accordance with International Standards on Auditing (ISAs). My responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of my report. I am independent of the Bank in accordance with the ethical requirements that are relevant to my audit of the financial statements in accordance with the code of ethics issued by the Institute of Chartered Accountants of Sri Lanka, and I have fulfilled my other ethical responsibilities in accordance with this requirements. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Responsibilities of Monetary Board

Monetary Board of the Bank is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as Monetary Board determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, Monetary Board is responsible for assessing the Bank’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting.

1.4 Auditor's Responsibilities for the Audit of the Financial Statements

My objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, and to issue an auditor's report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, I exercise professional judgment and maintain professional skepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by Monetary Board.
- Conclude on the appropriateness of Monetary Board's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank ability to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in my auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

I communicate with Monetary Board regarding, among other matters the planed scope and timing of the audit and significant audits findings, including any significant deficiencies in internal control that I identify during our audit.

2. **Comments on Financial Statements**

2.1 **Receivables from General Treasury and other Ministries**

According to Section 39 of the Monetary Law Act, each outstanding balance should be recovered prior to profit transfer. Even though, balance of the receivables from General Treasury and other Ministries was Rs. 1,401,497,319 as at the end of the year under review, only a sum of Rs. 1,378,272,467 had been recovered from the profit distribution of 2016.

2.2 **Non-Compliance with Laws, Rules, Regulations and Management Decisions**

Reference to Laws, Rules, Regulations and Management Decisions	Non- compliance
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(a) Section 39 of Monetary Law Act

According to the provisions in this Section, the profits earned by the Bank after the appropriations and making settlement of dues from the Government of Sri Lanka should be transferred to the General Treasury before the expiration of sixty days after the end of each financial year. However, in contrary to this provision a sum of Rs.5 billion had been remitted to the General Treasury on 30 December 2016 as advance payment of Bank's profit.

In this connection the Secretary to the Monetary Board of the Bank had informed me that

“Monetary Board of the Bank on an exceptional basis approved an advance profit transfer of Rs 5 billion considering urgent need of the Government to meet the fiscal targets under International Monetary Fund (IMF).”

(b) Public Enterprises Circular
No.03/2016 of 29 April 2016

The Bank had paid Pay As You Earn tax (PAYE) and tax on tax aggregating Rs. 363 million and Rs. 322.6 million for the year under review and for the preceding year respectively from its own funds instead of being recovered from the respective employees.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year under review had resulted in a pre-tax net profit of Rs.24,014 million as against with the pre-tax net loss of Rs. 17,814 million in the preceding year, thus indicating an improvement of Rs. 41,828 million in the financial result. Increase of gain from unrealized price revaluations specially gold, forex and currency SWAPS by Rs.25,612 million and Rs. 17,285 million respectively had been the main reason attributed for this improvement in the financial results.

3.2 Analytical Financial Review

The total net operating income of the Bank for the year under review was Rs. 36 billion including net foreign exchange revaluation loss of Rs. 6.8 billion as compared with the total net operating loss of Rs. 6.2 billion, (including net foreign exchange revaluation gain of Rs. 10.6 billion) in the preceding year, thus indicating an improvement of 681 per cent in the total net operating income. In the meantime, the operating expenses including depreciation and amortization expenses during the year under review was Rs. 11.9 billion as compared with that of Rs. 11.6 billion in the previous year, thus indicating an increase of 2.6 per cent in the operating expenses. The variances in the revenue and expenditure of the Bank during the year under review, as compared with the preceding year are shown below.

	2016	2015	Variance	
	Rs. Bn.	Rs. Bn.	{Favourable/(Adverse)}	percentage
			Rs. Bn.	
Income from Foreign Currency Financial Assets	26.4	(15.1)	41.5	274.83
Interest Income	14.9	13	1.9	14.62
Gain/(Loss) from Unrealized Price Revaluations	9.7	(34.8)	44.5	127.87
Gain from Realized Price Changes	1.8	6.7	(4.9)	(73.13)
Expenses on Foreign Currency Financial Liabilities	3.9	3.6	(0.3)	(8.33)
Interest Expense	3.9	3.6	(0.3)	(8.33)
Net Foreign Exchange Revaluation Gain/ (Loss)	(6.8)	10.6	(17.4)	(164.15)
Total Net Income/(Expense) from Local Currency Financial Assets	18.8	0.4	18.4	4600
Other Income	1.5	1.6	(0.1)	(6.25)
Operating Expenses	12	11.6	(0.4)	(3.45)
Withholding Tax	1.8	1.8	0	0
Net Profit/(Loss) for the year after Tax	22.2	(19.6)	41.8	213.26

The income from foreign currency financial assets had increased by 274.8 per cent as compared with the preceding year and the income from local currency financial assets had increased significantly by 4600 per cent since increasing interest income on Government Securities and decreasing interest expenses on Securities sold under repurchase agreements as compared with the preceding year, thus resulting an increase in net profit for the year under review.

3.3 Transactions of Contentious Nature

The following observations are made.

(a) Renting out the Building of the Bank

According to Section 117 of Monetary Law Act, “ the Bank should not engaged in trade or otherwise have a direct interest in any commercial, industrial or other undertaking except such interest as it may in any way acquire in the course of the satisfaction of any of its claims”. In contrary to this provision the following building owned by the Bank had been rented out for outside parties without being utilized for the intended purposes and the Bank had earned a rent income of Rs. 426,582,639 during the year under review. Details are shown below.

Name of the Property	Rented out Period	Name of Tenant	Monthly Rental
Central Point Building (A part of the Ground Floor, 2 nd Floor and 3 rd Floor)	27 November 2015 to 26 November 2016	Financial Crime Investigation Division – Sri Lanka Police	Rs. 2,600,000
Head Office of the Bank (Level 12 of Tower 4 and 5)	28 November 2016 to 27 November 2018	Department of EPF	Rs. 1,654,000
Head Office of the Bank (Level 5 of Tower 3 and 5 and Level 1 of Tower 1)	01 January 2016 to 31 December 2017	Department of EPF	Rs. 3,213,860
Lioyed Building	01 January 2016 to 31 December 2017	Department of EPF	Rs. 6,752,500
Central Point Building – 4 th and 5 th Floors	01 February 2016 to 30 November 2017	CHEC Port City Colombo (private) Ltd	Rs.5,187,538 (1 st year) Rs.5,537,373 (2 nd year)
Head Office of the Bank (Level 15 and 16 of Tower 5)	01 December 2016 to 30 November 2018	Department of Project Management and Monitoring, Ministry of National Policies and Economic Affairs	Rs. 2,141,480

Centre for Banking Studies Rajagiriya- Hostel Block	01 July 2016 to June 2017	30	Special Task Force – Sri Lanka	Rs. 220,000
Part of Anuradhapura Regional Office	03 September 2016 to 02 March 2017		AB Securities (pvt) Ltd	Rs. 230,000
Whiteaways Building – 2 nd Floor	01 November 2015 to 31 October 2018		Ministry of Law and Order and Southern Development	Rs. 2,070,000
Whiteaways Building – Ground Floor	01 November 2015 to 31 October 2018		Credit Information Bureau	Rs. 4,140,000
Part of Matara Regional Office	15 September 2014 to 14 September 2017		AB Securities (pvt) Ltd	Rs. 265,816
Property in Brazil	01 February 2015 to 31 January 2017		Ministry of Foreign Affairs	USD 9,000
Property in New York -USA	01 June 2015 to 31 May 2017		Ministry of Foreign Affairs	USD 68,000

The following observations are also made in this connection.

- i. Monetary Board of the Bank has decided on 10 May 2016 to transfer the properties in Brazil and New York to the Government at their respective market values. An approval of the Cabinet of Ministers was granted on 23 November 2016 to take action for transfer the properties to the name of the Secretary, Ministry of Foreign affairs (MFA), at the actual cost of Rs.734.3 million incurred for the said properties by the Bank. However, it was observed that these properties had not been transferred to the MFA even up to the end of September 2017.
- ii. The Bank had failure to include the condition related to late fee in the rent agreement. Therefore, the Bank had not been able to collect rent on time. A test check revealed that some monthly rentals had been received with a significant delay at the range of 104 -254 days.

(b) Consultancy Service Cost to the Advisory Council

The President of the Democratic Socialist Republic of Sri Lanka had appointed three international experts to serve on an Advisory Council to advise the Presidential Commission to investigate into complaints regarding missing persons resident in the Northern and Eastern Provinces on 28 June 2014 and this was notified by the Extraordinary Gazette No. 1871/18 dated 15 July 2014. Expenditure such as consultancy fee, accommodation and other charges of the above Advisory Council and their staff amounted to Rs. 140.6 million and Rs. 116.8 million for the years 2015 and 2014 respectively had been incurred by the Bank without any

reimbursement basis. Further, a consultancy fee of Rs. 21 million had also been paid to the Advisory Council during the year 2016. Even though the above expenditure had been incurred by the Bank without any reimbursement basis, there were no any agreements between the Bank and the above mentioned consultants. It was further observed that the payments made to the consultants were extraneous to the objectives of the Bank.

An approval of the Cabinet of Ministers was granted on 1 November 2016 to recover any payments made by the Bank since 16 August 2016 to the consultants for rendering of services to the Government, provided that they are with the approval of the Ministry of the National Policies and Economics Affairs and for such cost to be set off against profits transfers from the Bank to Consolidated Fund.

(c) Payments for the Consultation

Monetary Board had approved to obtain the services from a Consultant at its meeting No.24/2015 held on 05 October 2015 for an initial period of 6 months with immediate effect. The purpose of obtaining such services is to ensure that the proposed new constitution is consistent with the relevant legislations applicable to the Bank. The payments such as per diem, accommodation, meals and return airfare made to the above Consultant amounted to Rs.3.2 million and Rs.0.8 million for the year under review and for the preceding year had been considered as expenses of the Bank. However, it was observed that the consulting works of the above Consultant were not directly related to the activities of the Bank.

As per the Cabinet approval, any payments made by the Bank from 16 August 2016 to the Consultant rendering service to the Government, permitted to set off against the profits transfers from the Bank to Consolidated Fund. However, payments amounted to Rs.2.3 million and Rs.1.8 million made to the Consultant after the aforesaid date had been considered as expenses of the Bank and receivable from Treasury and other Ministries respectively.

(d) Unsound Practices

The Bank had invested its funds in tradable reverse Repo investments with a primary dealer. The Lanka Secure System had shown a nil balance regarding these investments since the primary dealer had withdrawn the underlying securities without reassigning any security with respect to the withdrawn securities. Then, Monetary Board of the Bank had decided to rollover the above investments without collaterals as per the Board decision taken on 04 December 2015. The outstanding uncollateralized Repo investments made through Bank's funds and funds managed by the Bank with the said primary dealer as at 30 September 2017 was Rs.2.4 billion.

It was observed that even though the Bank had issued warning letters and the Direction dated 06 June 2013 to the said Primary Dealer about its violations (non-allocation of adequate securities to certain customers and using customers' securities for obtaining Intra-day Liquidity Facilities (ILF)) revealed at previous examinations carried out on 10 December 2012 and 14 December 2012. The same unsound practices of the said primary dealer had repeated in 2015 due to not taking remedial action by the Bank. As well as, the Supervision Division of the Public Debt Department of the Bank (PDD) had carried out an on-site examination of the said primary dealer as at 31 March 2015 on 20 May 2015 and 21 May 2015. Violation of the different regulations and directions including the above mentioned violations were observed during the above on-site examinations.

Subsequently, the Governor appointed the Committee to carry out an examination and submit a report on actions and operations of the Bank with respect to the said primary dealer, as decided by the Monetary Board at its meeting No.3/2017 held on 30 January 2017. The Committee had arrived at a conclusion that prudent investment decisions had not been taken consistently at all levels of the reporting line in certain instances.

The following observations were also made by the Committee.

- Supervisors have followed the supervision manual uniformly to all examinations of primary dealers (PDs) without much consideration on the risk profile of individual companies, related parties and management's track records.
- Even in a situation of re-occurring of similar lapses by all PDs as well as continuation of similar lapses by the same PDs, PDD had not considered that as a serious threat to the system.
- Despite repeated regulatory and supervisory concerns, there has been a failure to recognize that such lapses may explode in the future with a significant loss and risk.
- Continuous lapses were identified in recording investments in the Central Depository System (CDS). However, remedial measures were taken at a very slow pace and not up to the level of expectations as compared with other developments which took place in the Government securities market due to various reasons such as cost involved and difficulty in liaising with the service provider.
- When the scripless securities settlement system was introduced, the required other controls/reporting to match with the new developments such as Central Counterparty, were not put in place adequately to mitigate the new risks.
- Adequate investor awareness had not been carried out in order to educate investors on possible risks, need of signing Master Repo Agreements (MRAs), contents of MRAs, subsequent follow up and tradability of securities.
- Examination reports with the supervisory concerns identified and remedial action had been submitted to the management along with the follow up action by the PDD.
- Due to the perception, that the government securities area gilt edge instruments and PDs are regulated supervised by PDD, all departmental Internal Investment Committees (IIC) have paid more attention on highest return in taking investment decisions.
- Even in monthly Investment Oversight Committee (IOC) meetings, attention was to look at the rates offered by PDs without paying adequate attention to the risks involved.
- Certain departments had even been guided by the senior management to follow same.
- However, it was the responsibility of the IOC/IIC to assess the overall risk of the investments but that had not happened at its best.
- If IIC members of each department or IOC members had raised the concerns on CDS statements or regularly looked at the security allocations in early stages of their investments, loss could have been minimized.
- Internal audit had not identified any such lapses before 2015 events.
- The respective staff has not received adequate/appropriate training on fund management.

(e) Settlement of Credit Card Expenses

As per the Circular on advances Payments dated 19 April 2011 issued by the Finance Department of the Bank, original invoices should be presented to settle advances obtained. At the test check , it was revealed that in contrary to the above Circular provisions, original invoices amounted to Rs.4,354,092 and Rs. 1,537,355 for the year under review and the preceding year respectively which were paid through the credit card by then Governor had not been presented to settle advances obtained to pay credit card bills.

A test check revealed that Personal Expenses amounted to Rs. 4,238,853 and Rs.6,564,359 for the year under review and the preceding year respectively had been paid using official credit by then Governor. These expenses had been refunded after a considerable delay.

3.4 Agency function for Management of Public Debt of Sri Lanka

The Central Bank of Sri Lanka (“the Bank”) has been established to ensure economic and price stability and financial system stability of the country. Further, the Bank is responsible for the agency function of Management of Public Debt of Sri Lanka. It also holds the exclusive responsibility for the issuance of Treasury Securities to fulfill the cash requirements of the Government at a minimum cost to the Government.

A Special Audit Report on the Treasury Bonds issued by the Public Debt Department of the Central Bank of Sri Lanka during the Period from February 2015 to May 2016 had been presented to Parliament on 29 June 2016. Observations included in the above Special Audit Report should also be treated as a part of this report.

4. Systems and Controls

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

Control Area -----	Observation -----
(a) Supervision of Non-banking Financial Institutions	Violation of rules by primary dealer
(b) Payments	Payments made to foreign lawyers and consultants on behalf of Government without reimbursement
(c) Settlement of Advances	Advances settled without original invoices