

Pradeshiya Sanwardhana Bank - 2016

The audit of financial statements of the Pradeshiya Sanwardhana 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 read in conjunction with Section 13 (1) of the Finance Act, No. 38 of 1971 and Section 33 of the Pradeshiya Sanwardhana Bank Act, No 41 of 2008.

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 management, as well as evaluating the overall presentation of the financial statements. Sub-sections (3) and (4) of Section 13 of the Finance Act, No. 38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the Audit.

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

2. Financial Statements

2.1 Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Pradeshiya Sanwardhana 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

These financial statements had been presented the information required by the Banking Act, No. 30 of 1988 and subsequent amendments thereto.

2.2 Comments on Financial Statements

2.2.1. Accounting Policies

The under provision of impairment amounting to Rs.105, 425,557 as per the Guidelines of Central Bank of Sri Lanka has been observed as at 31 December 2016.

2.2.2. Accounting Deficiencies

The following observations are made.

- i. The understated interest income for the previous year amounting to Rs. 20,062,822 had been taken into account as the interest income for the year 2016 instead of restating the financial statements of the previous year.
- ii. Out of the total staff loans amounting to Rs. 3,193,923,358, the Bank had not considered staff loans worth Rs.64.6 million for the fair value calculation done at the end of the year 2016.
- iii. A difference of Rs. 2,679,980 had been observed between the lease payable balance shown in the confirmation and the general ledger as at 31 December 2016.

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

The following instances of non-compliance were observed in audit.

	Reference to Laws, Rules Regulations etc.	Non-compliance
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(a)	Banking Act, Directions	
(i)	No.10 of 2007	An instance of not maintaining the minimum capital adequacy ratio of 10 per cent in relation to total risk weighted assets during the year 2016 had been observed.
(ii)	No.1 of 2015	Minimum Liquidity Coverage Ratio of 70 per cent had not been maintained during the year 2016.
(b)	Section 114 of the Inland Revenue Act, No. 10 of 2006, Paragraph 2 of Public Enterprises Circular No. 03/2016 dated 29 April 2016 and paragraph 8.7 of Public Enterprises Circular No.PED/12 dated 02 June 2003	The Bank needs to deduct and remit Pay As You Earn (PAYE) tax from the emoluments of employees. However, without deducting the PAYE tax accordingly, the Bank had paid the PAYE tax amounting to Rs.20, 425,009 for the year 2016 from its own fund.
(c)	Public Enterprises Circular No. PED/12 of 02 June 2003	
(i)	----- Section 9.2 (c)	According to the approved cadre of the Bank, the number of posts approved for the posts of Assistant Manager was 1092. However contrary to that requirement, the Bank had recruited additional 01 employee for the above post during the year 2016.
(ii)	Section 9.2 (d) and 9.3.1	Approval of the Department of Public Enterprises is needed for the Scheme of Recruitments and Promotions for all positions of the Bank. However, the Bank had not prepared and approved a Scheme of Recruitments and Promotions even up to 31 December 2016.
(iii)	Section 9.2 (e)	In the event of creation of a new cadre, though the enterprise should forward the relevant application together with the Organization Chart and seek approval from the Department of Public Enterprises, without doing so the Bank had recruited 03 employees for new cadre positions.

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|------|--|--|
| (iv) | Section 9.3.1 | A Succession Plan had not been prepared by the Bank for the year 2016. |
| (v) | Section 9.7 | Salaries of 05 officers including chief Manager had been determined by the Board of Directors without having an approved Scheme of Recruitments and Promotions. |
| (d) | The Office Instruction Circular
(Development Loan)
No.2010/10 dated 03.08.2010 | Though the Bank had made a provision of 1 per cent from the interest income on pawning advances, with the impairment calculation at end of the year 2016, the above provision had been reversed. |

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.1, 256 million as compared with the corresponding pre-tax net profit of Rs. 972 million for the preceding year, thus, indicating an improvement of Rs. 284 million or 29 per cent in the financial results for the year under review.

Increase of interest income by Rs. 3,054 million during the year under review as compared with the previous year was the main reason attributed for this improvement.

3.1.1 Value Addition of the Bank

The value addition of the Bank for the year under review after taking into account the personal emoluments, tax expenses and depreciation aggregating to Rs.6, 374 million was Rs.7,015 million as compared with the corresponding value addition of Rs.5,797 million for the preceding year. Further, the value addition of the Company had improved by Rs. 1,218 Million.

3.2 Analytical Financial Review

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

Indicator -----	Sector	Ratios	
	(Licensed Specialized Bank)	2016	2015
	----- Percentage	----- Percentage	----- Percentage
Profitability Ratios			
Net Profit Ratio	9.30	4.07	4.23
Net Interest Margin	3.76	6.61	6.84
Net Interest Income on Interest Income	33.87	51.41	56.05
Non Interest Income to Total Income	4.26	5.91	6.00
Interest Cost on Interest Income	66.13	48.59	43.95
Staff Cost to Operating Expenses	51.14	72.9	73.66
Return on Average Assets	1	0.54	0.53
Return on Equity	18.3	11.04	9.80
Earnings per Share		4.68	3.86
Capital Adequacy Ratios			
(i) Tier i	13.5	6.5	7.56
(ii) Tier ii	15.2	9.27	10.53
Liquidity Ratios			
Liquid Assets Ratio (Minimum 20 per cent)	61.4	21.25	21.77
Asset Quality			
Non performing Advance Ratio	5.28	2.86	4.00

The following observations are also made in this regard.

- (i) A high net interest margin of 6.61 per cent is observed for the year 2016 as compared with the average licensed specialized bank ratio of 3.76 per cent.
- (ii) The Net profit Ratio of the Bank reported as 4.07 per cent for the year 2016 which is below the sector ratio of 9.30 per cent.
- (iii) The staff cost to operating expenses of the Bank for the year 2016 was 72.9 per cent as compared with the sector ratio of 51.14 per cent.
- (iv) The return on average assets represents only 0.54 per cent as compared with the sector average of 1 per cent.
- (v) The Non-performing loan ratio of the Bank has decreased from 4 per cent to 2.9 per cent in 2016 as compared with the preceding year.

3.2.1 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 up to 3 months and over 5 years were far in excess over total assets and the liquidity gap on financial assets and financial liabilities as at the end of the year 2016 were Rs. 26,165,176,253 and Rs. 12,411,019,459 respectively.

4. Operating Review

4.1 Performance

4.1.1 Achievement of Main Objectives

According to the Pradeshiya Sanwardhana Bank Act, No. 41 of 2008, the main objectives of the Bank are as follows.

- To facilitate the overall regional economic development of Sri Lanka by promoting the development of agriculture, industry, trade, commerce, livestock, fisheries activities and empowerment of women.
- To granting financial assistance to Micro Finance Institutions and Small and Medium scale Enterprises.

The performance of the Bank in achieving the above mentioned objectives during the year 2016 is summarized below.

Target areas for Granting Financial Assistance	Target Amount as at 31 December 2016	Percentage of total loans	Actual as at 31 December 2016	Percentage of total loans	
	Rs.million		Number of Loans		
				Rs.million	
Agriculture	11,585	16	72,465	9,520	13
Industry	10,367	14	36,426	1,982	3
Trade & Commerce	12,789	17	31,622	7,549	11
Livestock	2,443	3	10,947	1,717	2
Fisheries	830	2	2,925	660	1
Small & Medium Scale Enterprises			6,237	9,317	13
Micro Finance Institutions			05	25	-
Sub Total	38,014	52	160,627	30,770	43
Others	35,721	48	-	40,637	57
Total	73,735	100	160,627	71,407	100

- (i) Except the others category, the Bank had targeted to grant 52 per cent out of the total loan target for achieving specific objectives as mentioned above and only 43 per cent has been achieved as at 31 December 2016.

- (ii) It was observed that the Bank had more focused on consumption loans, housing loans, loans against deposits, pawning, leasing and staff loans rather than focusing the regional development which evidenced that 57 per cent of the total loans had been granted for other purposes.

4.1.2 Achievement of the Business Objectives

Achievement of the business objectives of the Bank during the year 2016 as per the Corporate Plan is summarized below.

Criteria	Target	Actual	Variance {Favourable/(Adverse)}
Net Interest Income (Rs.Bn)	8.2	7.6	(0.6)
Net Operating Income (Rs.Bn)	8.2	8.4	0.2
Profit Before Tax (Rs.Bn)	1.6	1.26	(0.34)
Cost to Income (%)	76.4	86.6	(10.2)
Return On Assets (%)	1	0.54	(0.46)
Return On Equity (%)	17.2	11.04	(6.16)

The following observation is made in this regard.

Adverse variances had been observed against the goals set out in the Corporate Plan and the actuals for the year under review.

4.1.3 Loans Administration

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

The following observations are made

- (i) The total amount of loans and advances as at 31 December 2016 was Rs. 108,103 million and out of that, loans and advances aggregating Rs.3, 047 million or 2.9 per cent was non performing as at the end of the year under review.

Classification of above non performing loans as at 31 December 2016 is as follows.

Category	Balance outstanding as at 31.12.2016 Rs.million	Percentage
Special Mention Loans	492	16
Substandard Loans	544	18
Doubtful Loans	401	13
Loss Loans	1,610	53
Total	3,047	100

- (ii) The Bank had not get recovered even a single installment relating to the advances granted amounting to Rs.132, 119,110 as at 31 December 2016. Age analysis of above advances is as follows.

Age Analysis	Amount
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	Rs.
Less than 1 year	10,619,000
1-3 years	70,342,952
4-5 years	30,966,031
More than 5 years	20,191,127
Total	132,119,110

(b) Liya Isura Loan Scheme

As per the budget proposal of the year 2014, a sum of Rs. 2,443.93 million had been granted by the Bank during the years 2014 and 2015 without charging any interest. However a sum of Rs.62.92 million has been reported as non performing loans as at 31 December 2016 and out of those, a sum of Rs.23.12 million had been recorded under the loss category.

(c) Written off Loans and Advances

Out of the loans under the loss category amounting to Rs.1,826,004,893, sums of Rs.214,898,939 and Rs. 609,321 including the capital and the interest for the year under review and the previous year had been written off.

4.2 Management Weaknesses

A sum of Rs. 170 million had been deposited by the Sri Lanka Co-operative rural Bank Federation Limited in the Kelaniya Branch of the Bank on 15 July 2015 at an annual effective interest rate of 7.75 per cent. However, the Bank has erroneously mentioned in the fixed deposit certificate that the annual effective interest rate was 9.68 per cent. Due to this the Bank had to pay an additional interest of Rs.4,038,082.

4.3 Operating Weaknesses

(a) Under-utilization of Assets

The following observations are made.

- (i) A new building had been obtained on monthly rental of Rs.160, 000 for functioning the Anuradhapura City Branch and a total sum of Rs.2, 880,000 had been paid as advance on 17 December 2015 and 05 July 2016 respectively. Bank had paid monthly net rental of Rs.112, 000 after deducting a sum of Rs.48, 000 from the advance payment. As at 31 December 2016, a sum of Rs.934, 193 had been paid by the Bank to the building owner as rental expenses without being used the building for intended purposes even up to 31 May 2017.

- (ii) The first floor of the building which the Trincomalee Branch is functioned had been obtained in March 2014 at a monthly rental of Rs.25, 000 for the purpose of establishing a Small and Medium Enterprise Centre. However the Small and Medium Enterprise centre had not yet been established and the Bank had incurred a total rental expense of Rs.850, 000 up to 31 December 2016. Hence, the said expenditure is observed as fruitless expenditure.
- (iii) Two properties obtained on lease basis in Chilaw and Anamaduwa had remained idle for more than 19 years and 9 years respectively due to delays in preparing plans.

(b) Non Performing Investments

Although a sum of Rs.47.25 million had been invested by the Bank in shares of the “Vanik Incorporation Ltd” during the period of 1999-2003, the Bank had failed to recover even the value of investment.

4.4 Human Resources Management

The following observations are made.

- (i) The Bank had not taken action to fill 8 vacancies in the post of Assistant General Managers as at 31 December 2016.
- (ii) Fifty seven excess cadre in the post of Office Assistants and allied grades and 15 vacancies in the post of Drivers and 362 vacancies in the category of chief Manager and Banking Assistant level have been observed as at 31 December 2016.

4.5 Retirement Benefit Obligation

A sum of Rs.1, 278,903,024 had been provided in the accounts as at 31 December 2016 as retirement benefit obligations. However, the Bank had not taken actions to invest such amount to meet the future obligation.

4.6 Market Share of the Bank

The market share of the Bank based on Loans and Advances, and Deposits as compared with other banks for the year under review and preceding four years is given below.

Year	Market Share as a percentage of Deposits and Loans and Advances	
	Based on Deposits	Based on Loans and Advances
2016	12.65	20.27
2015	11.48	19.58
2014	10.22	14.33
2013	10.15	17.92
2012	9.69	17.59

The following observation is made in this regard.

Marginal increase in market share of the Bank had been observed as compared with previous years.

5. Accountability and Good Governance

5.1 Internal Audit

According to the Office Circular No.2015/65 dated 11 June 2015 issued by the Human Resources Department of the Bank, the approved cadre of the Internal Audit Department was 45. However, the actual cadre attached to the Internal Audit Department as at 31 December 2016 was only 34 and the Bank had not allocated adequate staff for the Internal Audit Department. Further, it was observed that no audit had been performed by the Internal Audit Department with regard to the activities of the Finance Department, Human Resources Department etc.

5.2 Budgetary Control

Significant Variances ranging from 1 per cent to 36 per cent had been observed between the budgeted and actual income and expenditure thus indicating that the budget had not been made use of as an effective internal control instrument of the Bank.

6. Systems and Controls

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

Areas of Control

Observation

Accounting

- Calculation of impairment provision
- Recognition of staff loans at amortized cost at the end of the year.

Loan Administration

- Strict compliance with the introduced procedures
- Written off loans

Human Resources Management

- Adherence to the regulations

Internal Control

- Expand the internal audit activities in all operations of the Bank
- Strengthening controls in the system of the Bank.
i.e. changes in interest rates, link deposit with the loan in loans against deposits