

Bank of Ceylon – 2016

The audit of the financial statements of the Bank of Ceylon ("the Bank") and the consolidated financial statements of the Bank and its Subsidiaries ("Group") for the year ended 31 December 2016 comprising the statements of financial position as at 31 December 2016, and the statements of profit or loss, statements of comprehensive income, statements of changes in equity and statements 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. In carrying out this audit, I was assisted by the firms of Chartered Accountants in public practice.

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

1.2 Special Statutory Provisions for Bank

The Bank has been exempted from the provisions of Part II of the Finance Act, No. 38 of 1971 by an order of then Minister of Finance published in the Government Gazette No. 715 of 14 May 1992 by virtue of powers vested in him by Section 5 (1) of the said Finance Act. The Bank is also exempted from all Treasury and Public Administration Circulars as decided by the Cabinet of Ministers and conveyed by the Secretary to the Treasury by his Circular No.EA02/BC/PB/01 dated 10 April 1992.

1.3 Board's Responsibility for the Financial Statements

The Board of Directors ("Board") is responsible for the preparation of these financial statements that give a true and fair view 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 misstatement, whether due to fraud or error.

1.4 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 assessments, the auditor considers internal control relevant to the Bank's preparation of the financial statements that give a true and fair view 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, so far as appears from my examination, the Bank maintained proper accounting records for the year ended 31 December 2016 and the financial statements give a true and fair view of the financial positions of the Bank as at 31 December 2016 its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

In my opinion, the consolidated financial statements give a true and fair view of the financial position as at 31 December 2016 and its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards of the Bank and its Subsidiaries dealt with thereby, so far as concerns the shareholders of the Bank.

2.2 Exemption

The Bank has been exempted from the provisions of Part II of the Finance Act, No 38 of 1971 by an order of then Minister of Finance published in the Government Gazette No. 715 of 14 May 1992 by virtue of powers vested in him by Sections 5(1) of the said Finance Act.

2.3 Comments on Group Financial Statements

2.3.1 Group's Financial Statements and Basis of Consolidation

The financial statements of the Bank comprised the consolidation of the financial statements of the Domestic Banking Unit, the Off Shore Banking Unit, Islamic Banking Unit and the Foreign Operations that are an integral part of the Bank. The Group financial statements comprised the consolidation of the financial statements of the Bank, its Subsidiaries and Associates in compliance with Sri Lanka Accounting Standards (SLFRS/LKAS).

The position of the investments of the Bank as at 31 December 2016 and as at the end of the preceding year in each Subsidiaries and Associates were as follows.

Name of the Company	Position of Investment		Ownership as a Percentage of Stated Share Capital	
	2016 Rs. Mn.	2015 Rs. Mn.	2016	2015
Subsidiaries	-----	-----	-----	-----

Quoted Companies

Property Development PLC	860	860	95.55	95.55
Merchant Bank of Sri Lanka & Finance PLC	2,255	2,255	74.49	74.49

Unquoted Companies

BOC Management and Support Services (Pvt) Ltd	1	1	100.00	100.00
BOC Property Development and Management (Pvt) Ltd	1,010	1,010	100.00	100.00
BOC Travels (Private) Ltd	2.5	2.5	100.00	100.00
Hotels Colombo (1963) Ltd	101	101	99.99	99.99
Bank of Ceylon (UK) Ltd	2,684	2,684	100.00	100.00

Total Investments in Subsidiaries**6,913.5** **6,913.5**

Less-Provision for Impairment

(700) (700)

Net Investments in Subsidiaries**6,213.5** **6,213.5****Associates****Unquoted Companies**

Transnational Lanka Records Solutions (Pvt) Ltd	20	20	24.69	24.69
Ceybank Asset Management (Pvt) Ltd	31	31	43.36	43.36
Southern Development Financial Company Ltd	25	25	41.67	41.67
Mireka Capital Land (Pvt) Ltd**	-	750	-	40.00
Lanka Securities (Pvt) Ltd	42	42	41.60	41.60

Total Investments in Associates**118** **868**

Less-Provision for Impairment

(25) (25)

Net Investments in Associates**93** **843****Total Investments****6,306.5** **7,056.5**

** Investment in shares of Mireka Capital Land (Pvt) Limited had been sold on 30 December 2016 for a sum of Rs.3.88 billion. The effects on this transaction have been adjusted in the financial statements.

2.4 Comments on Financial Statements of the Bank

The following observations are made.

Impairment on Loan Receivables

At a sample audit test checks, it was revealed that Bank's impairment process was ineffective due to several reasons. Such as when forecasting cash flows not having proper mechanism to determine the time and cash received through realization of property mortgaged, failed to justify prediction of cash flows, unavailability of adequate evidence to support future cash flows and in the case of mortgaged loans it was failed to assess the future recoverability. In addition, when determining probability of default, management does not use monthly bucket wise movements of Individual Significant Customer's (ISL) non-impaired loan balances. Further, state owned enterprises are considered non-impaired on the grounds those are attached to the Government without evaluating ability of Government to settle the dues.

Further, a sum of Rs.319,952 million or 31 per cent of total loans and advances of the Bank representing the receivables from Government authorities and state owned enterprises. Out of the above balance, a sum of Rs.30,998 million had been reasonably identified as significant loans and have objective evidence of incurred losses. These loan balances were receivable from the Urban Development Authority (UDA), Lanka Sathosa LTD, Paddy Marketing Board, Agarapathana Plantation Ltd and Sri Lanka Handicraft Board. Except Rs.4,651 million receivable from the Paddy Marketing Board, Agarapathana Plantation Ltd and Sri Lanka handicraft Board, all the above loan balances had not covered by Treasury guarantees or any other securities as at 31 December 2016. According to the management comments, due to subsequent settlement by the UDA in March 2017 the capital outstanding from them were reduced to Rs. 4,990 million.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Group had recorded a pre-tax net profit of Rs.30,117 million as compared with the corresponding pre-tax net profit of Rs. 25,476 million for the preceding year, thus indicating an improvement of Rs.4,641 million or 18.2 per cent in the financial results. The operations of the Bank excluding Subsidiaries during the year under review had resulted in a pre-tax net profit of Rs. 31,189 million as compared with the pre-tax net profit of Rs. 25,279 million in the preceding year, thus indicating an improvement of Rs. 5,910 million or 23.4 per cent in the financial results.

The main reason attributed for the improvement of operating profit was increase of interest income by Rs.21,940 million or by 19.5 per cent during the year 2016. In addition, the gain arisen from selling shares of Mireka Capital Land (Pvt) Limited, an Associate Company, amounting to Rs.3,130 million included under other operating income was also attributed to the above improvement.

Out of total profit of Rs.24.79 billion for the year 2016, the Bank has allocated a sum of Rs.17.35 billion or 70 per cent as dividend to the Government of Sri Lanka. However, the Bank had declared only Rs.6.35 billion or 36 per cent from the profit as dividend in the previous year. Hence dividend allocation had been increased by Rs.11 billion or 173 per cent when compared with previous year.

Although the net profit after tax of the Bank was Rs. 24,791 million, the value addition of the Bank for the year under review was Rs.78,561 million as compared with the previous year's value addition of Rs.70,237 million. As such, the value addition of the Bank had improved by Rs. 8,324 million.

3.2 Analytical Financial Review

3.2.1 Profitability

The following observations are made.

- a) Income earned by providing banking services shown a growth of 16.5 per cent to stand at Rs. 147,554 million and this was a considerable increase as compared with Rs. 126,664 million of the year 2015 as a result of increase of interest income by 20 per cent. However, cost of services shown an increase of 29 per cent to stand at Rs.71,164 million as compared with the previous year, as a result of increasing interest expenses backed by increase in time deposits.
- b) Non-banking income shown a growth of 35.8 per cent to stand at Rs. 6,568 million as compared with Rs.4,838 million for the previous year. The reason for this considerable growth was capital gain derived from the disposal of an Associate Company (Mireka Capital Land (Pvt) Ltd).
- c) Even though the profit after tax for the year 2016 had increased by Rs.7,433 million, the expansion and growth had decreased by 14.6 per cent during the year 2016 as compared with the year 2015 as a result of high dividend payout ratio of 70 per cent in the year under review.
- d) Value allocation to employees and providers of external funds had increased by 0.6 per cent and 3.6 per cent respectively during the year 2016 and this was a minor increase as compared with the year 2015.

3.2.2 Significant Accounting Ratios

The following observations are made in this regard.

- i) Return on Average Equity (ROAE) of the Bank has gradually decreased from 33.5 per cent in the year 2011 to 22.2 per cent in the year 2015 and increased to 28.4 per cent in the year under review. Hence, it was observed that the Bank had not taken satisfactory action to achieve an adequate return by managing the Bank capital since 2011. Although the Bank's reserves had gradually increased, the Bank had not achieve a higher ROAE value in 2016.
- ii) Liquidity Ratio of the Bank was very much closed to the minimum requirement of 20 per cent in the year under review and it was declined from 28.2 per cent to 21.6 per cent and become the lowest ratio achieved during the last five years.
- iii) The Capital Adequacy Ratio (Tier 1+2) of the Bank had been declined from 13.6 per cent in 2014 to 12.3 per cent in the year under review.
- iv) Cost to Income Ratio of the Bank has gradually decreased from 51.1 per cent to 43.0 per cent during last six years.

4. Operating Review

4.1. Loan Administration

4.1.1 Granting Loans

The total balances of Loan and Advance as at 31 December 2016 of the Bank was Rs.1,047,190 million and it was a 20 per cent increase when compared with the previous year balance of Rs.869,316 million. Even though, the Bank had shown a slow growth rate of 2 per cent and 5 per cent during the years 2013 and 2014 respectively, in last two years growth rate of loans and advances had been increased from 12 per cent in 2015 to 20 per cent in 2016. Product wise details of loans and advances in last two years are as follows.

Loan Category	Balance as at 31 December		Balance as a Percentage	
	2016	2015	2016	2015
	Rs.(Mn)	Rs.(Mn)	%	%
Term loans	391,237	350,153	37	40
Overdraft	171,518	141,974	16	16
Personal loans	160,171	107,540	15	12
Loans under schemes	81,145	50,702	8	6
Trade finance	68,038	45,357	6	5
Housing loans	48,852	42,804	5	5
Pawning	47,192	56,901	5	7
Lease rental outstanding	47,475	47,142	5	5
Staff loans and other outstanding	31,562	26,743	3	3
	-----	-----		
	1,047,190	869,316		
	=====	=====		

According to the above information, a sum of Rs.562,755 million or 53 per cent of total outstanding consists with term loans and overdrafts for the year under review. Further, personal loans, trade finance and loans under schemes had shown considerable improvements of 49 per cent, 50 per cent and 60 per cent respectively as compared with previous year. However, pawning outstanding had been decreased from Rs.56,901 million to Rs.47,192 million or by 17 per cent as compared with previous year.

4.1.2 Evaluation of Customers

In a test check, it was revealed that certain loans and advances had been granted without proper evaluation of securities mortgaged and credit worthiness of the customers. Further, Bank had not carry out an effective and timely monitoring of customer credit evaluation by obtaining audited financial statements and legal documents relating to establishment of the business from the corporate customers. In certain instances with related to mortgage properties, the insurance policies had not been obtained/ duly renewed and regular inspections had not been carried out. Further, correspondence files for advances had not been updated with relevant documents and information.

Even though the Bank uses different systems for recording loans and advances, an automated central liability report which captures all the facilities given to customers under different operating platforms was not available with the Bank. Hence, it was difficult to ensure proper aggregation of entire portfolio of each customer and evaluate those customers effectively and accurately.

4.1.3 Non-performing Loans and advances

The following observations are made.

- (a) The Bank was capable to reduced the non-performing loan ratio of 4.3 per cent in 2013 to 3.8 per cent as at the end of the year 2014 by transferring an amount of Rs.19,966 million from the non-performing loan account to an assets account. However, the non-performing loan ratio had increased once again to 4.3 per cent by the end of the year 2015 as compared with the year 2014 and it was an increase of 13.15 per cent. Nevertheless, the Non-performing ratio of the Bank has a favourable condition in the year 2016 due to decline from 4.47 per cent in the year 2015 to 2.98 per cent in the year under review. Decrease of total advance portfolio of pawning was the main reason attributed for this situation. Details are shown below.

Year	Balance of Loan and Advances	Non-performing Loans and Advances
-----	-----	-----
	Rs. Million	Rs. Million
2016	1,047,190	29,786
2015	869,316	36,978
2014	777,505	28,762
2013	755,385	31,754
2012	714,846	19,254

- (b) Non-performing Advances (NPA) of selected 06 Branches had reflected higher percentages in the year under review. Details are shown below.

Name of Branch -----	Total Advance ----- Rs.	Total NPA ----- Rs.	NPA as a Percentage of Total Advance -----
Atchuvely	737,607,225	484,517,589	65.69
Mawanella	2,155,725,522	857,364,829	39.77
Chunnakam	1,238,502,480	476,372,825	38.46
Fish Market	970,880,218	320,100,011	32.98
Panadura	2,111,391,534	332,884,112	15.76
Islamic Banking Unit	2,160,333,140	330,257,360	15.28

- (c) Non-performing loans and advance balances related to top ten customers under each product were totaling to Rs. 5,116 million. The product wise details of those balances are given bellow.

Type of Loans and Advances -----	NPA as at 31 December 2016 ----- Rs.	NPA as at 31 December 2015 ----- Rs.	Variance {Favourable /(Adverse)} ----- Percentage
Loans	3,679,419,339	3,669,994,752	0.26
Overdraft	1,204,476,621	994,818,508	21.08
Credit Card	11,525,217	11,495,724	0.26
Leasing	221,570,594	368,519,812	(39.88)
Total	5,116,991,771 =====	5,044,828,796 =====	

- (d) Five Branches of the Bank had recorded the highest non-performing percentages against the total overdrafts facilities provided by those Branches. The total overdraft balance as at 31 December 2016 was Rs.1,992 million and the total non-performing as at that date was Rs 1,532 million ranging from 34.93 per cent to 99.64 per cent as shown below.

Name of the Branch	Total Balance as at 31 December 2016	Overdraft	Total Non-performing Overdraft as at 31 December 2016	NP overdraft as a percentage of Total Overdraft
-----	-----	-----	-----	-----
	Rs.		Rs.	
Panadura	372,583,525		130,160,563	34.93
Mawanella	138,979,171		83,728,716	60.25
Regent Street	331,361,343		239,895,059	72.40
Fish Market Peliyagoda	311,273,703		243,866,990	78.34
Second Corporate	837,322,109		834,322,809	99.64
Total	1,991,519,851		1,531,974,137	
	=====		=====	

- (e) The Card Centre of the Bank had issued 88,620 credit cards as at 31 December 2016 and the total outstanding balances as at that date amounted to Rs. 3,229 million. Out of this, a sum of Rs.167 million or 5.18 per cent were categorized as Non-performing. The number of card holders who had not paid even a single installment since obtaining the cards up to 31 December 2016 stood at 94 and the total outstanding amount was Rs.3.7 million. Further, the capital and interest written off during the year under review were Rs. 986,488 and Rs.506,554 respectively.
- (f) The Bank had granted Rs. 47,475 million or 4.5 per cent as leasing facilities under the total loans and advance granted during the year 2016. Out of total leasing exposure, a balance of Rs. 19,333 million or 40 per cent represent the receivables from Government and State Owned Enterprises (SOE). Out of that a sum of Rs. 16,455 million or 85 per cent represents the receivable from Ministry of Finance with regard to 3,229 leasing facilities. Non-performing outstanding of the under mentioned Government Institutions were significant as at the end of the year 2016.

Name of the Institution	Number of Facilities	Value of the Leasing Facility	Total NPA Balance (Capital Outstanding)
-----	-----	-----	-----
		Rs. Million	Rs. Million
Ministry of finance	9	27,812	14
Ministry of Highways Ports and Shipping	7	216	35
Cooperative Wholesale Establishment	43	83	44
	59	28,111	93
	=====	=====	=====

Further, the following 10 Branches of the Bank had recorded the highest non-performing advances for leasing facilities totaled Rs.402 million as at 31 December 2016.

Name of the Branch -----	Total NPA ----- Rs. Million
Pettah	114
Union Place Super Grade	50
Corporate Relations	49
Dehiwala Super Grade	48
Kaduwela	34
Fish Market Peliyagoda	29
Kandy Super Grade Branch	24
Borella Super Grade Branch	19
Kiribathgoda Super Grade	18
Panadura Super Grade	17
Total	402 ----- =====

- (g) Non-performing pawning advances had been decreased from Rs. 6.4 billion to Rs.1.1 billion as compared with the previous year due to sale of majority of long outstanding pawning articles through auctioning during the year under review. Further, the gold in hand as at 31 December 2016 stood at Rs. 17.8 billion and provision for non-performing was amounting to Rs. 4.47 billion.

4.1.4 Loans Granted to Non-Government Institutions -----

The total balance of Loans and advances of the Bank as at 31 December 2016 was Rs.1,047,190 million. Out of the above total loan exposure, a sum Rs.727,237 million or 69 per cent representing the receivables from non-governmental entities. It included the identified individually significant loans amounting to Rs.235,458 million. Out of the above balance, a sum of Rs.42,512 million have reasonable evidence for incurring losses. It was observed that outstanding balance of Rs.6,934.9 million related to 16 significant customers including two customers of Maldives Branch had been impaired 100 per cent. (Annexure 01) At the sample audit examinations, it was revealed that the Bank had granted significant loan facilities to under mentioned customers of non-governmental sector which has a high risk of recoverability.

South Asian Institute of Technology and Medicine (Pvt.) Ltd - (SAITM) -----

A significant loan had been granted to South Asian Institute of Technology and Medicine (Pvt.) Ltd - (SAITM) by the Malambe Branch of the Bank. The total exposure and outstanding balance as at 05 June 2017 were Rs. 2,809 million and Rs. 2,161 million respectively.

The following observations are made in this connection.

- (a) As per the Government Gazette Notification dated 30 August 2011, the approval was granted to provide a construction loan of Rs.600 million for the purpose of constructing a Professional Unit of SAIMT. However, the Bank had granted a sum of Rs. 1,820 million for the construction of Teaching Hospital, Post Graduate Institution and Engineering Faculty and a sum of Rs.925.5 million for working capital requirement of both University and Hospital as at 05 June 2017.
- (b) As per the Office Instruction Circular No. 28/2015 maximum amount of loan that can be granted was restricted to 60 per cent of the total undertaking cost of the commercial property. However, the Bank had granted loans on 87.4 per cent and 94.81 per cent of the forced sale values of the properties of Hospital and University respectively.
- (c) A mortgage loan of Rs. 1,625 million had been granted on Hospital Property. However, this property consist a leasehold land with an extent of 5 acres and 28 perches obtained on lease basis from the Urban Development Authority (UDA) for a period of 30 years from 13 March 2012 onwards. Even though the leased rental paid to the UDA was Rs.130 million, the Bank had treated as this Rs.414 million in assessing the forced sale value of the above land.
- (d) On this ground the SAIMT was unable to pay loan installments since March 2017 and in the purpose of avoid to categorize these loans as non-performing, the Bank had further granted the following facilities to the SAIMT on the Board approval dated 02 May 2017.
 - i. Provide a grace period of 7 months from March to September 2017 for the existing term loans.
 - ii. Grant term loan of Rs.103 million and Rs.300 million to meet the interest portion of the existing loans and working capital requirement of hospital and the university respectively at a concessionary rate of 12.5 per cent per annum and with the grace period against personal guarantee of the Directors of the SAIMT
 - iii. Refund the loan installments amounting to Rs.27.17 million recovered in February 2017.
- (e) Forty six per cent of the loans granted by the Malabe Branch had represented the loans granted to the SAIMT.
- (f) Even though, the General Manager of the Bank had singed a Letter of Intent with the SAIMT and the Secretary to the Ministry of Health, Nutrition and Indigenous Medicine (MOH) on 17 July 2017 expressing willingness to enter into a formal agreement to handing over and taking over the Dr. Nevil Fernando hospital to the Government of Sri Lanka, a formal agreement had not been signed even by the end of September 2017.

Kaduwela Holdings (Pvt.) Ltd

Board of Directors of the Bank had approved various types of loan facilities totaling Rs.1,020 million for importing of vehicles and working capital requirement of the above company during the months of July and December 2016. The total exposure as at 07 September 2017 was Rs.1,216.7 million.

The following observations are made in this connection.

- a. By exceeding the approved permanent overdraft limit of Rs.70 million, the Metropolitan Branch of the Bank had granted Rs.136 million as overdraft facilities without proper approvals and a mortgaged bond.
- b. Board of Director had approved Letter of Credit (LC) facilities totaling Rs. 400 million for imports of 175 vehicles at once. However, the company had imported the vehicles in 12 instances during the period from 11 January 2017 to 03 July 2017 by utilizing Rs.426 million provided under these facilities. Further, without recovering even a part payment the Bank has released all documents related to 175 vehicles.
- c. The Board of Directors had initially approved hypothecation loan of Rs. 200 million for the payment of custom duty for the above mentioned vehicles and subsequently this loan amount had been extended up to Rs.450 million.
- d. There is no any securities available with the Branch to recover the total exposure of Rs.1,216.7 million as at 07 September 2017.

4.1.5 Written off Loans and Advances

Capital and interest written off during the last four years relating to outstanding loans and advances are given below.

Year	2016	2015	2014	2013
-----	-----	-----	-----	-----
Capital (Rs. Million)	30	19	34	45
Interest (Rs. Million)	53	36	61	101
Number of loans written off	2,842	456	415	146

The following observations were made in this connection.

- i) Total capital written off in the year 2016 was Rs.30 million and it represents 2,842 customers of the Bank. Interest related to above outstanding was Rs. 53 million.
- ii) Capital written off and Interest written off had been increased by 58 per cent and 47 per cent as compared with the previous year.
- iii) Out of total written off capital and interest balance of Rs.83 million relating to the year 2016, a sum of Rs.36 million or 43 per cent was receivables from two private companies.

4.2. Market Share of the Bank

Although, the Bank had owned the status of market leader in the banking sector, it was observed that the present market share of the Bank had not shown any increasing trend during the last five years under the current market condition. The Market Share of the Bank based on the loans and advances and deposits are shown below.

(a) Market Share based on Loans and Advances

	2016	2015	Year 2014	2013	2012
	-----	-----	-----	-----	-----
Total Loans and Advances of the Bank (Rs. Million)	1,047,190	869,316	777,505	755,385	714,847
Total Loans and Advances of the Market (Rs. Million)	5,540,751	4,715,290	3,894,545	3,426,558	3,149,326
Market share of the Bank (%)	18.90	18.40	20.00	22.00	22.70

(b) Market Share based on Deposits

	Year 2016	2015	2014	2013	2012
	-----	-----	-----	-----	-----
Total Deposits of the Bank (Rs. Million)	1,258,632	1,084,968	934,856	843,236	703,569
Total Deposits of the Market (Rs. Million)	6,295,559	5,403,131	4,686,306	4,169,520	3,625,374
Market share of the Bank (%)	20.00	20.10	19.90	20.20	19.40

4.3 Ratings

The position in ratings of the Bank in the banking sector in the year 2016 was as follows.

i) Global Rating

Fitch Ratings re-affirmed the Bank's International Long-term Issuer Default Rating as "B+ with negative outlook" while Moody's reaffirmed "B1 with negative outlook" during the year 2016. However, in the year 2015 Fitch rating and Moody's reaffirmed above rates as "BB- with stable outlook" and "B1 with stable outlook" respectively. Hence, it indicates an increase of default risk in 2016 as compared with the preceding year.

ii) Local Rating

Fitch Ratings Lanka Limited reaffirmed the Bank's National Long Term Rating as "AA+ (lka) with stable outlook" and ICRA Lanka Limited awarded a credit quality rating as "(SL) AAA with stable outlook" during the year 2016.

4.4 Management Activities

4.4.1 York Street Building

An extent of 163,890 sq.ft of a 6 storied building with a total extent of 261,610 square feet situated at York Street belonging to the Bank had been used by the Metropolitan Branch and Western Province North Office up to the year 2013 and the rest of floor areas are still being used by the Hotels Colombo (1963) Ltd. Hence, a considerable area or more than 60 per cent of the building is being idle since 2013. As per the valuation report dated 17 October 2016, the value of the land and building was Rs. 3,413 million. Subsequently, the Government has identified this as non-strategic business. Therefore, the matter now has been referred to PPP (Public Private Partnership) Unit of the Ministry of Finance.

Further, according to the structural assessment report issued by the Department of Civil Engineering of the University of Moratuwa in 2010, there were severe deteriorations of most of load carrying structural elements and proposed 15 recommendations regarding this building. However, still the Bank had not taken necessary actions to implement these recommendations.

4.4.2 Building Obtained on Rental Basis

The Bank has entered into an agreement with a private company to obtain a building at Hospital Road, Colombo 01 on rental basis for 5 years period for the purpose of functioning operation of the Metropolitan Branch. The Bank had spent Rs. 321 million as rental for this building since 2013.

The following observations are made in this regard.

- i) Although the rent agreement was signed on 16 September 2013, the Branch has been shifted to the building on 21 July 2014. Therefore the Bank had not used the building for 10 months period.
- ii) Even though the Bank has taken the entire building under the above rent agreement, only ground, first, second and third floors are being used. Hence fourth, fifth and sixth floors are remained idle since the year 2013. However, the management had not taken actions to make use of the remaining floors.
- iii) The above building is not in a good condition since concrete beams, slabs and walls of the building had been cracked. It was further noted that owner of this building has repaired cracked places in several times.
- iv) Even though this building was got caught by the bomb blast of the Central Bank in 1996, no any structural assessment had been conducted by a Structural Engineer, when entered into rent agreement.

4.4.3 Selection of Advertising Agencies

The Bank has selected 3 advertising agencies for the purposes of design and preparation of advertisements of the Bank. These agencies had been selected by calling quotations for a period of two years commencing from 10 July 2015.

The following observations are made in this regard.

- i) Before selecting the above agencies, the contracts of the existing agencies had been terminated by the Bank with the approval of the Board of Directors nine months prior to the contract period. However, the reason for the termination was not made available for audit.
- ii) The Technical Evaluation Committee (TEC) had evaluated 27 service providers who had fulfilled the expected requirements according to the marking scheme prepared by them. However, without considering the marks and ranks allocated by the TEC, the Board of Directors selected 10 agencies out of 27 at the first round by conducting interviews and finally selected 3 agencies by evaluating the presentations delivered by them.
- iii) Four months before the expiry of agreements entered into with the above three agencies, the Board of Directors had decided to extend the service period by another one year commencing from 9 July 2017.

4.4.4 Legal Actions Initiated Against the Bank

Hundred and eighty seven (187) legal cases had been filed by the outsiders against the Bank. Out of those, 06 cases filed by five customers had been identified as unfavorable to the Bank as at 31 December 2016. A judgment related to one case had already been delivered against the Bank. Hence, the Bank was unable to recover the capital outstanding of Rs.50 million and interest thereon from that person and remaining five cases are related to recovery of outstanding loans and devolved property.

4.4.5 Asset Management

The following observations are made.

- (a) The Bank does not possess legally binding lease hold agreements in respect of 16 properties obtained from the Government as at 31 December 2016. Even though this was pointed out in my report for the year 2015, the Bank had not taken necessary actions to rectify this. However, seventeen Branches and seven managers or staff quarters had been located in those properties.
- (b) Although the lease agreement of the property of Digana Branch had been expired on 02 April 2015, the Bank had not taken actions to renew the agreement even up to 31 December 2016.

- (c) Deeds for three freehold properties valued at Rs.229 million which Office of the Galle Province and Branches of Hakmana and Grandpas located had not been made available with the Bank.

4.4.6 Investments in Capital Market

The investment activities of the Bank should ensure the objectives of investment policy of the Bank such as liquidity, diversification and yield. However, the Bank had sustained a loss of Rs. 69.2 million and Rs. 427.3 million as result of investment of Rs. 4,936 million made in the shares of the quoted companies in the year 2015 and Rs. 4,809 million in the year 2016.

4.4.7 Employee Benefits

The Bank does not have an established Trust Deed for the Medical Fund of Pensioners' and Widows'/Widowers' and Orphans' Pensioners'.

4.5 Operating Weaknesses

4.5.1 Operations of Overseas Branches

(a) Chennai Branch

The following observations were made.

- i) As at 31 December 2016, 22 per cent of the total deposit portfolio represents the deposits of 3 customers and 38 per cent represents top 10 customers. Further, 25 per cent of credits represent the loans granted to top 4 borrowers and 53.5 per cent represents the top 10 borrowers. This indicates that this Branch dependent on very limited depositors and exposed to concentration risk.
- ii) An ATM machine in the Branch has not been working condition since 2013 and the Bank has not taken any action to repair the ATM machine.

(b) Seychelles Branch

The following observations are made.

- (i) Total deposit of the Branch was SCR 130 million as at 31 December 2016. Out of that 53 per cent representing deposits of 4 customers and 74 per cent of deposits representing ten depositors. In the meantime, out of the total loans and advances of SCR 84 million as at 31 December 2016, 46 per cent had granted to four borrowers and 69 per cent distributed among ten borrowers. Thus indicates that the Branch was more dependent on very limited depositors and exposed to high liquidity risk.

- (ii) As per the decision taken by the Cabinet of Ministers on 12 September 2012, the Bank had agreed to allocate credit facility of US Dollar 10 million to the Seychelles Government and Seychelles Development Bank; (one of the State Banks cooperating with the Bank of Ceylon in this regard). However, it was observed that the Bank had not implemented the said decision even up to 17 February 2017.
 - (iii) Presently there are nine public and private sector banks, two main insurance companies, a development bank and other non banking financial institutions offer their products and services to the market in Seychelles. The Bank could achieve only market share of 2 per cent due to the reasons of unavailability of ATM facilities in the Branch and capital constrain in order to meet emerging credit needs of their customers.
- (c) Even though, an additional capital had been infused during the year 2016 to open the Bangalore Branch, the approval for establishment of a new Branch had not be given by the Ministry of Finance of India.

4.5.2 IT Environment of the Bank

At the sample audit examination carried on Information Technology Environment of the Bank, following weaknesses were observed.

- (a) There was no an appropriate user termination related to systems of Bank Trade, Pawning, Inter Banking Smart Remit, Base 24, Skylease, CITS and ICBS.
- (b) Information Security Policy Manual (version 2.0) had not been updated by the Bank since December 2011. As a result the stakeholders were not aware the organisation's security policies and procedures which required to be followed with regard to information systems.
- (c) The Bank has not renewed the maintenance agreement with the vendor to ensure the maintenance and service of the Paymate System. Non-availability of a software maintenance agreement may result in difficulties and delays when maintaining and upgrading the Paymate application.

4.5.3 Apparent Irregularities

The following observations are made.

- (a) Assistant Manager of Gurugoda Branch of the Bank (Bodyline) had fraudulently removed Rs. 1 million from the ATM. However, no meaningful action had been taken against this officer.
- (b) A Junior Executive Officer of the Kandy 2nd City Branch had fraudulently taken a sum of Rs. 11.19 million from the ATM in three instances within two days of 6 and 25 March 2015. However, this cash shortage had not been identified until 20 January 2016, since the officer involved had change the available cash balance fraudulently in the system.

- (c) The Manager of Waikkal Branch had fraudulently taken Rs.40 million from the safe by cutting the cash safe of the Branch. As a result an amount of Rs.42.4 million had been lost to the Bank. In addition, it was revealed that the above Manager had also committed following frauds.
- i) Grant Rs. 500,000 to a customer against fake gold articles.
 - ii) Fraudulently remove the absolute ownership of two vehicles without recovering the balance of the leasing facilities. Total leasing facility and outstanding balance at the date of release of vehicles were Rs. 7.1 million and Rs. 6 million respectively.
 - iii) Obtain an amount of Rs.4.9 million from four customers' accounts by misusing their accounts.
 - iv) Grant a loan facility of Rs. 5 million and Rs.6.2 million to two customers instead of Rs. 4.5 million approved by the Top Management and against mortgage over deposit of Rs. 7 million belongs to another customer without sanction of account holder.

As per the management comments, the relevant manager had been bailed out and CID investigation is ongoing. Insurance claim is lodged to minimize the loss. Further, Internal disciplinary inquiry was commenced and decision pending.

- (d) The Manager of the Pemaduwa Branch had granted temporary overdraft facilities approximately Rs.9.25 million by exceeding his delegated authority limit and without prior or covering approval from the respective higher authorities. These facilities had been granted to 5 current accounts holders without their knowledge and aiding and abetting staff officer to withdraw money from their accounts using signed blank cheques obtained by such officer from respective current account holders with contravening the Office Instruction Circular No. 90/99.
- (e) The Manager of the Batapola Branch had fraudulently removed cash from the current accounts of customers by overdrawing their accounts with taken cheques from the above customers amounting to Rs.26 million.

4.6 Identified Losses

The following observations are made.

- (a) On 20 January 2017, a gang of robbers had entered into the Medagama Branch and taken away cash of Rs. 5.8 million from the Automated Teller Machine (ATM). Further, robbers had also taken away the DVR of the CCTV camera and the Router and Modem of ICBS network. The Police could have only found Rs.4. 8 million from the robbers. Insurance claim had not been still received on behalf of this loss.
- (b) It was revealed that, a sum of Rs. 1.6 million had been fraudulently withdrawn by a person by using 3 ATM debit cards issued against a savings account of the

Boralesgamuwa Branch. An insurance claim of Rs. 998,000 only had been received in this connection.

- (c) Three fraudulent Point of Sale (POS) machine transactions aggregating by Rs. 99,813 were taken place in a Branch at United States of America on 24 August 2016. The above transactions made by using a count felt card outside the country and the Bank had not identified hackers for this incident.

5. Accountability and Good Governance

5.1 Procurement Plan

Master Procurement plan had not been prepared by the Bank for the year under review in terms of section 4.2.1 (a) of the Procurement Manual of the Bank.

6. Systems and Controls

Deficiencies in systems and controls observed during the course of audit were brought to the notice of the Bank by my detailed reports issued to the Chairman of the Bank. Special attention is needed in respect of the following areas of control.

Areas of Control

Observations

(a) Loan Administration

- Non evaluation of customers' repayment ability
- Prevailing highest non-performing advance ratio and written off loans

b) Controls Over ATM

- Inadequate security and lack of internal controls on administration of ATM

c) Information Technology

- Inadequate controls over applications of IT systems, passwords and other controls

Annexure 01

Name	Number of Facilities	Granted Amount	Outstanding as at 31 December 2016
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		Rs. million	Rs. million
Sintesi Limited	11	1,064.6	1,724.5
Harcourts (Pvt) Ltd	79	210.1	216.8
Mr.N.S.Amarasekara	1	224.9	224.9
Ampara Ekabadda Govi Samithiya	11	178.1	181.2
Business Forms (Pvt) Ltd	6	108.8	109.7
Gunathilake Constructions	3	229.9	634.5
Dholiyadhoo investments (Pvt) Ltd.	1	749.2	786.4
MVK Maldives Pvt Ltd	1	354.0	374.7
Tristar Apparel Exports (Pvt) Ltd	75	296.8	680.7
Creations (Pvt) Ltd	5	226.4	278.2
Sea Services (Pvt) Ltd.	1	106.9	174.9
Mr.S.S.Croos	1	100.5	106.4
Pelawatte Suger Industries PLC.	1	150.0	170.8
Standard Trading Company (Pvt) Ltd	36	260.9	493.5
Mr.I.Shafeeg	Male Branch	102.4	157.5
Mr.INV Dholiyadhoo	Male Branch	443.7	620.7
Total		4,807.2	6,934.9
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