

Bank of Ceylon and its Subsidiaries – 2017

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 2017 comprising the Statement of Financial Position as at 31 December 2017 and the Statement of Profit or Loss, 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. To carry out this audit I was assisted by a firm 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 Board’s Responsibility for the Financial Statements

The Board of Directors (“Board”) is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards and for such internal control as the Board determines is necessary to enable the preparation of Financial Statements that are free from material misstatements, whether due to fraud or error.

1.3 Auditor’s Responsibility

My responsibility is to express an opinion on these Financial Statements based on my audit. I conducted my audit in accordance with Sri Lanka Auditing Standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the Financial Statements are free from material misstatements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Financial Statements. The procedures selected depend on the Auditor’s judgment, including the assessment of the 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 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 controls. 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.

1.4 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 Sections 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.

2 Financial Statements

2.1 Opinion

In my opinion, the financial statements of the bank and the consolidated financial statements give a true and fair view of the financial position of the Bank and the Group respectively as at 31 December 2017 and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Financial Statements

2.2.1 Comments on Group Financial Statements

The financial statements of the Bank comprised with 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 with the consolidation of the financial statements of the Bank, its Subsidiaries and Associates in compliance with Sri Lanka Accounting Standards (SLFRS/LKAS).

The Group comprises with seven Subsidiary Companies and four Associate Companies. Subsidiaries are engaging in diverse activities such as financial services, travel related services, hydro power generation, hotels & accommodation and property management activities. Some of the activities engaged by the associate companies include management of Unit Trust funds, stock brokering and property related activities.

The position of the direct investments of the Bank as at 31 December 2017 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	
	2017 Rs. Million	2016 Rs. Million	2017	2016
Subsidiaries				
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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	2	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	6,913		
Less-Provision for Impairment	(400)	(700)		
Net Investments in Subsidiaries	6,513	6,213		
Associates				

Unquoted Companies				
Ceybank Asset Management (Pvt) Ltd	31	31	43.36	43.36
Lanka Securities (Pvt) Ltd	42	42	41.60	41.60
Southern Development Financial Company Ltd	25	25	41.67	41.67
Transnational Lanka Records Solutions (Pvt) Ltd	20	20	24.69	24.69
Total Investments in Associates	118	118		
Less-Provision for Impairment	(25)	(25)		
Net Investments in Associates	93	93		
Total Investments	6,606	6,306		

2.2.2 Comments on Financial Statements of the Bank

2.2.2.1 Sri Lanka Accounting Standards

Sri Lanka Accounting standard 39

In accordance with paragraph 59(c) of the standard, objective evidence that a financial asset or group of assets is impaired includes; the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider. However, some customers who had significant financial difficulties and whose facilities had been restructured were neither identified on time in impairment assessment nor were a provision.

2.2.2.2 Lack of Evidence

Information such as detailed schedules were not made available for the provision of Rs.5,061,285 shown under the Work-In-Progress which had been brought forward over a number of years without being changed.

2.2.2.3 Unexplained Differences

Difference of Rs.385.8 million and Rs.408.9 million were observed between the statements of Lanka Pay System and the system of the bank relating to ATM payables and receivables respectively.

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. 30,815.5 million as compared with the corresponding pre-tax net profit of Rs. 30,117.0 million for the preceding year, thus indicating an improvement of Rs. 699 million in the financial result for the year under review. Even though, the interest expense for the year had increased by Rs.33.1 million increase of interest income by Rs.38 million had mainly affected to this improvement.

The operations of the Bank excluding Subsidiaries during the year under review had resulted in a pre-tax net profit of Rs. 30,343 million as compared with the corresponding pre-tax net profit of Rs. 31,189 million in the preceding year, thus indicating a decrease of Rs. 846 million in the financial result for the year under review. Even though the interest income for the year had increase by Rs.36.658 million, decrease of the other operating income by Rs.3.379 million and increase of interest expenditure by Rs.32.259 million had mainly affected to this decrease.

3.2 Analytical Financial Review

3.2.1 Profitability

The following observations are made.

- (a) Income earned from banking services had shown an increase of 26 per cent when comparing with the preceding year. Although the time deposits had been increased by 36 per cent, the cost of the banking services had increased by 44 per cent comparing with the previous year.
- (b) Income earned from non-banking services had shown a decrease of 42 per cent when comparing with the preceding year because, a sum of Rs.3.1 billion gain from sale of associate company of Mireka capital Land (Pvt) Ltd had included in the income from non banking service for the year 2016.

- (c) Out of the total income, 90 per cent was comprised with interest income and 73 per cent of the interest income had derived through the loans and advances.
- (d) Fee and commission income and net gains from trading and financial investments had contributed to the total income of the Bank by 5 per cent and 2 per cent respectively. Other operating income represented 3 per cent of the total revenue.
- (e) Other operating expenses had decreased by 21 per cent due to the fair value adjustment on gold in hand amounting to Rs. 3.3 billion.

3.2.2 Significant Accounting Ratios

The following observations are made.

- (a) Capital adequacy Ratio of the bank had increased from 8.7 per cent in the year 2016 to 10.8 per cent in the year 2017 and the liquidity ratio of the bank had increased from 21.6 per cent in the year 2016 to 27.2 per cent in the year 2017.
- (b) Return on Average Equity (ROAE) of the Bank had gradually decreased from 33.5 per cent in the year 2011 to 20.9 per cent in the year under review, which indicates that the Bank had not taken satisfactory action to achieve an adequate return by managing the Bank capital since the year 2011. Although, the Bank's reserves had been gradually increased, a higher ROAE value had not been achieved by the Bank.
- (c) Return on Average Assets (ROAA) of the Bank had gradually decreased from 2.1 per cent in the year 2011 to 1.7 per cent in the year under review
- (d) Cost to Income Ratio of the Bank had gradually decreased from 51.1 per cent to 38.4 per cent during last six years.

4 Operating Review

4.1. Performance

4.1.1 Planning

Although the Corporate Plan for the period of the year 2017 to the year 2019 had been prepared covering all aspects of the bank, action Plan had not been prepared annually. However, available action plan had been prepared for the period from the year 2016 to the year 2018.

4.1.2 Operating Review

The following observations are made

- (a) Loans and Advances granted by the Bank as at 31 December 2017 as Rs. 1,219,914 million compared with previous year balance of Rs. 1,047,189 million indicating an increase of 16 per cent. The main reason for the aforesaid increase is the rise of term loans during the year under review. Out of the above balance, a sum of Rs. 861,246 million or 71 per cent of total outstanding had consisted with term loans, overdrafts and personal loans. An increasing trend had shown in all loans and term loans had shown a 29.1 per cent improvement during the year 2017. Out of the above total loan exposure, a sum of Rs.346,809 million or 31 per cent had consisted with receivables from government institutions and remaining 69 per cent was receivable from non-governmental entities.
- (b) 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 carried out an effective and timely monitoring methods for customer credit evaluation by obtaining audited financial statements of corporate customers and legal documents relating to the establishment of the business. 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.
- (c) The total non-performing loans and advances as at 31 December 2017 was Rs.34,261 million as compared with the said value of Rs.31,754 million for the year 2014 and shown an increase of 7.89 per cent. Non performing ratio of the bank had declined in the year 2017 from 2.98 per cent to 2.80 per cent compared with 2016. Hence a favourable condition had indicated for the year under review.
 - (i) Further it was identified that four branches of Fish market Peliyagoda, Kalawana, Grandpass and Islamic Banking Unit had reported highest non performing ratio of 38 per cent, 29 per cent, 25 per cent and 17 per cent respectively. In addition to that Second corporate branch was handling total NPA of Rs. 5,570,078,818.
 - (ii) The Card Centre of the Bank had issued 99,670 credit cards as at 31 December 2017 and the total outstanding balances as at above date was Rs. 3,721 million. Out of this, a sum of Rs. 181 million or 0.05 per cent were categorized as Non-performing. Further, the number of card holders who had not paid even a single installment since obtaining the cards up to 31 December 2017 stood at 92 and the total outstanding amount was Rs.1.3 million. Further, the capital and interest written off during the year under review were Rs. 10 million and Rs.14 million respectively.
 - (iii) Out of the total loans and advances of the bank, a sum of Rs.48,436 million or 3.9 per cent had been granted under leasing facilities as at the end of the year under review. Out of the above total leasing exposure, a balance of Rs. 13,674 million or 28 per cent represents receivables from Government and state owned Enterprises (SOE) and the said amount represents 3,307 number of leasing facilities. Out of that, a sum of

Rs.12,134 million or 91 per cent represents the receivable from Ministry of Finance related to 2,278 leasing facilities.

Further, highest non performing leasing exposure had been identified in Dehiwala super grade and Pettah branches total of which was Rs.273 million.

At the end of the year 2017, Ebert Silva Touring, Ministry of Highways Ports & Shipping and Avro Travels (Pvt) Ltd had been identified as top 3 non performing lease customers and the number of leasing facilities granted to these institutions was thirty six.

Out of the total lease balance, a sum of Rs.4,368,906 represent two customers in Meegahakiula and Monaragala branches had been written off during the year 2017.

- (iv) Non performing pawning advances had decreased substantially from Rs. 1,185 million to Rs. 596 million compared with the previous year because the Majority of long outstanding pawning articles had been auctioned during the year.
- (d) The written off amount of capital and interest relating to outstanding loans and advances had been rapidly increased during the last four years and the total capital written off in the year 2017 was Rs.1,169 million and it represents 12,014 customers of the Bank. Interest related to above outstanding was Rs. 830 million and the Capital was Rs.1,143 million and interest of Rs.699 million relating to outstanding loans and advances had been written off by the recovery sales unit during the year 2017 and the number of loans written off was 11,661 and the number of overdraft written off was 310. Out of the written off amount, more than 50 per cent was done by Northern Province Branches specially by Atchchvely, Chunnakam and Kilinochchi branches. Above loans had been granted to refugees in IDP (Internally Displaced Person) camps after the war in 2009 as housing loans, self-employment loans, agriculture loans and even consumption loans. When granting above loans proper identifications, verification of addresses and other usual credit checks etc had not been carried out by the Bank.

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 acquired market share in the banking sector had not shown any increasing trend during the last five years under the current market condition. Details are shown below.

(a) Loans and Advances

	Year				
	2017	2016	2015	2014	2013
Total Loans and Advances of the Bank (Rs. Million)	1,219,914	1,047,190	869,316	777,505	755,385
Total Loans and Advances of the Market (Rs. Million)	5,791,214	5,007,522	4,258,330	3,453,875	3,079,441
Market share of the Bank (%)	21.06	20.91	20.41	22.51	24.53

(b) Deposits

	Year				
	2017	2016	2015	2014	2013
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Total Deposits of the Bank (Rs. Million)	1,511,409	1,229,573	1,066,341	916,421	819,891
Total Deposits of the Market (Rs. Million)	7,399,006	6,295,559	5,403,131	4,686,306	4,169,520
Market share of the Bank (%)	20.4	19.5	19.7	19.6	19.7

(c) Ratings

The position of the Bank in the banking sector in the year 2017 was as follows.

i) Global Rating

Fitch Ratings re-affirmed the Bank of Ceylon's International loan-term Issuer Default Rating as "B+ with stable outlook" while Moody's reaffirmed "B1 with negative outlook" during the year 2017.

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 2017.

4.3. Management Activities

(a) Human Resource Management

Although the Bank of Ceylon is the leading government bank of Sri Lanka, there was no a Scheme of Recruitment (SOR) which includes basic qualifications, method of selection, methods of interview and evaluations criteria's etc for each posts. The Board of Directors (BOD) of the Bank had granted approval to recruit 600 number of trainee staff assistants at its meeting held on 25 May 2015. However, the said number of recruitments had been increased 4 times up to 1500 since 25 January 2015 to 25 October 2017.

As per the memorandum dated 06 October 2017, the available number of vacancies as at the end of the year 2017 was 980 for the above post. However, the board had decided to recruit 520 excess staff without considering bank funding requirements to maintain the above excess. Although initially the Board of directors had decided the interview ratio as one for per four passed candidates (1:4), finally 11520 number of all success candidates had been interviewed and members of interview panels had been paid sitting allowance of Rs. 4,099,050 on the basis of number of candidates faced to the interview and bank had spent Rs. 3,389,160 as other expenses.

(b) Asset Management

Fixed assets had not been labeled and information in relation to the locations of the fixed assets had not been included in the fixed assets register. It was difficult to conduct the physical verifications due to unavailability of above information. Further, fire arms purchased had not been recorded in the fixed Assets Register.

(c) ATM Managements

A separate account had been maintained by the Bank under the other assets for ATM shortage. The balance of this shortage had increased over the years and it was Rs. 6,804,908, Rs. 19,232,292 and Rs. 27,083,541 in the years 2015,2016 and 2017 respectively. A provision of Rs.12 million had been made as at 31 December 2017 without doing any reconciliation for the said shortage.

(d) Defined Benefit Plan

According to the IFRIC 14, the surplus of Rs.8.7 million as at 31 December 2017 on the Widows, Widowers and Orphans Pension Fund should be recognized as defined benefit assets. However, such surplus had not been recognized in the financial statements as defined benefit asset as per IFRIC 14.

(e) Investment Property Management

An area of more than 60 per cent of 6 storied building at York Street 261,610 square feet in had been remained idle since the year 2013. As per the valuation report dated 17 October 2016, the value of the land and building was Rs. 3,413 million.

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

(f) Non-economic transactions

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 had been signed on 16 September 2013, the Branch had shifted to the building on 21 July 2014. Therefore, the building had not been used for 10 months' period.
- (ii) Even though the entire building had been rented out 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) Even though this building was got caught to the bomb blast in 1996 and concrete beams, slabs, and walls of the building was cracked. No any structural assessment had been conducted by a structural engineer when entered in to the rent agreement.

(g) Provision for Impairments

In the process of impairment, following ineffectiveness were observed with effect to the impairment provision for the year.

- (i) 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 is 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. As a result, the management could not be identified customers as Individually Significant Customers (ISL) at their preliminary impairment calculation.
- (ii) When evaluating customers for impairment purpose, the bank uses credit review sheets for each customer. However, in the test sample examination, it was observed that some credit review sheet had not been taken into account. Latest financial statements of customers had not been reviewed when filling above sheets. Further, some sheets were incomplete without including security details, CRIB statements etc.
- (iii) Due to the low probability of recoverability of cash flows pertaining to the fully impaired customers, the management's current practice is to discontinue accrual of interest from the date the customer is identified as fully impaired. However, the said treatment is not consistently applied across all the branches of the Bank especially in respect of the fully impaired customers in Maldives.
- (iv) Facilities given to some customers had been restructured or given grace periods continuously without taking into the impairment assessment. However, recoverability and the adequacy or validity of securities of those customers as at 31 December 2017 is questionable.
- (v) The bank had not considered individually significant government loans and advances for individual impairment even though they have objective evidence for incurring losses. As an example the bank had not considered State Engineering Corporation and Mihin Lanka under individually significant customers for impairment process. Even though the State Engineering Corporation has a huge loss of Rs.650 million for the 2015/2016, negative equity position, huge reduction in sales turnover and adverse position of key financial ratios, bank had granted loans of Rs. 992 million under the security valued at Rs. 167 million Further Mihin Lanka has discontinued their operation since 30th October 2016 and bank has granted loan based the letter of comfort issued by the treasury which expired on 31st December 2017. Outstanding amount of Capital loan was Rs.2,433 million as at 31st December 2017 with the unsecured outstanding of Rs. 14 million.

- (vi) Total loan exposure to non-government sector as at 31 December 2017 was Rs. 843,104 million. In connection with this, impairment provision of Rs.9,632 million had been made relating to the customers who had exceeded the loan amount of Rs.100 million. Further a sum of Rs.8,760 million related to 22 customers who had impaired 100 per cent had included in the above balance and out of this amount 64 per cent represented by the Kaduwela holdings, Gunathilaka Constructions, Doliyadhoo Investment and Tri star apparal.

4.4 Operating Activities

4.4.1 IT Environment of the Bank

In the sample audit examination carried out on Information Technology Environment of the Bank, it was observed that actions had not been taken to terminate the default passwords which were being activated in the OS400 system. Further, Password configurations in the “OS400 System” were not up to the general standard of IT security best practices and the user profiles were available in the “OS400 system” with no password expiry and there were instances of absence and delays of terminating resigned employees from the above mentioned systems.

4.4.2 Losses due to frauds reported during the year

The following observations are made.

- (a) Out of the loss of Rs.10 million occurred due to a fraud taken place in the Diyabeduma branch, 99 per cent had been covered subsequently by the Bank.
- (b) A sum of Rs. 15,025 million had been obtained from Anuradhapura super grade branch as personal loan by 15 customers providing forged documents. Attention had not been paid by the bank to confirm the accuracy of evidence submitted by customers before issuing such loans.
- (c) The Kandy Super Grade Branch had issued a performance bond in favour of Central Province Road Development Department on behalf of its customers for 18 months and it was extended for further 6 months without requests made by customer’s written request. Subsequently a customer had deviated payment of remaining dues of Rs.50 million and as per the judgment of the case which had been filed by the bank against to the customer the bank could not claim for a guarantee because the customer had not requested to extend the validity period of performance bond. Due to negligence of the staff and poor internal control the Bank had incurred the above mentioned loss.
- (d) Two instances were observed in Vavuniya Kachcheri Extension office that a sum of Rs. 150,000 had been withdrawn from dormant accounts without knowing account holders and providing false information.

- e) A sum of Rs. 1,203 million had to be impaired as at 31 December 2017 as outstanding balance of Metropolitan branch relating to Kaduwela Holdings (Pvt.) Ltd due to unavailability of proper tangible security which is mandatory to obtain for an overdraft facility.
- f) According to the office instructions circular No. 46/2010 (7) the authorized officer should have satisfied with the genuineness of the articles pawned. However, a sum of Rs.103,000 had been granted from the Hemmathagama branch for false gold articles.

5. Accountability and Good Governance

5.1 Procurement Plan

Procurement plan had not been prepared by the bank in line with the action plan for the year under review.

5.2 Audit Committee

Eleven audit committees were held during the year 2017 compared with fifteen Audit Committee meetings held in 2016.

6. Systems and Controls

Definiences in systems and controls observed during the cause of audit were brought to the notice of the bank from time to time. Special attention is needed in respect of the following areas of systems and controls.

Areas of Control	Observation
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(a) Loan Administration	- Evaluation of Customer repayment ability - Non Performing Advance Ratio - Highest Non Performing Customers and Branches - Written Off Loans
(b) Controls against ATM machines	-Adequacy of security of ATM machine - Internal controls on administration of ATM machines
(c) Information Technology	-Controls against using IT systems -Passwords and other controls
(d) Human Resource Management	- Continuous frauds done by internal staff of the Bank - unavailable of Scheme of Recruitments
(e) Asset Management	- labelling of fixed assets for identification purposes -maintaining records on the Firearms