

Central Bank of Sri Lanka - 2017

1. Financial Statements

1.1 Opinion

The audit of the financial statements of the Central Bank of Sri Lanka (“the Bank”) which comprise the statement of financial position as at 31 December 2017, and the statement of income and 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 respects, the financial position of the Bank as at 31 December 2017, 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 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.

Those charged with governance are responsible for overseeing the Bank’s financial reporting process.

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

2. Non-Compliance with Laws, Rules, Regulations and Management Decisions

The Bank had paid Pay As You Earn tax (PAYE) and tax on tax aggregating Rs. 355 million and Rs. 363 million for the year under review and for the preceding year respectively from its own funds instead of being recovered from respective employees in terms of Public Enterprises Circular No.03/2016 of 29 April 2016.

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.50,194 million as compared the pre-tax net profit of Rs. 24,014 million in the preceding year, thus indicating an improvement of Rs. 26,180 million in the financial results. Increase of gain from unrealized price revaluations by Rs.14, 261 million and increase of interest income from foreign currency financial assets by Rs.8,045 million were the main reasons 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. 60.6 billion including net foreign exchange revaluation loss of Rs. 3.8 billion as compared with the total net operating income of Rs. 36 billion, (including net foreign exchange revaluation loss of Rs. 6.8 billion) in the preceding year, thus indicating an improvement of 68 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. 10.4 billion as compared with that of Rs. 12 billion in the previous year, thus indicating a decrease of 13.3 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.

	2017	2016	Variance	
	Rs. Bn.	Rs. Bn.	Rs. Bn.	percentage
			(Favourable)/(Adverse)	
Income from Foreign Currency Financial Assets	49.7	26.4	23.3	88.3
Interest Income	22.9	14.9	8	53.7
Gain/(Loss) from Unrealized Price Revaluations	24.0	9.7	14.3	147.4
Gain from Realized Price Changes	2.8	1.8	1	55.6
Expenses on Foreign Currency Financial Liabilities	3.0	3.9	0.9	23.1
Interest Expense	3.0	3.9	0.9	23.1
Net Foreign Exchange Revaluation Gain/(Loss)	(3.8)	(6.8)	3	44.1
Total Net Income/(Expense) from Local Currency Financial Assets	16.1	18.8	(2.7)	(14.4)
Other Income	1.6	1.5	0.1	6.7
Operating Expenses	10.4	12	1.6	13.3
Withholding Tax	1.8	1.8	0	0.0
Net Profit/(Loss) for the year after Tax	48.4	22.2	26.2	118.0

The income from foreign currency financial assets had increased by 88.3 per cent as compared with the preceding year and the total net income from local currency financial assets had decreased by 14.4 per cent.

4. Operating Review

4.1 Performance

The following observations are made.

(a) Developing a new Mechanism for Collection of Coins and Distribution

According to the Strategic Plan (2016-2018), the Expressions of Interest (EOI) had been called from cash collecting companies to facilitate the coin collection process of the Bank on 23 March 2016 as per the instruction given by the Monetary Board at its meeting held on 24 November 2015. After the evaluation of EOI received from the five companies, the Evaluation Committee had decided to reject the EOIs due un-obtained a required minimum marks by those companies. Accordingly, the Bank had not implemented a strategic action for developing a new mechanism for island wide coin collection other than coin distribution.

(b) The Financial Sector Consolidation Programme

The Bank had unveiled the Master Plan on Financial Sector Consolidation on 17 January 2014 with the objective of developing a strong Banking/ Non-Banking Financial Institutions sector with enhanced resilience to internal and external shocks in order to cater to the growing demands of the economy. Accordingly, the Consolidation Plans with 17 institutions including Banks, Financial companies and Leasing companies had been completed as at 30 April 2017 by spending Rs.68 million. However, the Consolidation Plans with 16 institutions had not been completed even up to the end of April 2018, though the Bank had incurred a sum of Rs.59 million in this regard. In addition to the above expenditure, the Bank had incurred an additional sum of Rs. 59 million for preparing Information Memorandum, Due Diligence, Valuation reports and other matters relating to 20 Institutions which were not included in the above Consolidation Plans.

(c) Regulating and Supervision of Financial Companies

Financial Companies are regulated and supervised under the Financial Business Act, No.42 of 2011 by the Monetary Board of Sri Lanka. As per the Section 12 (1) of the Finance Business Act, the Monetary Board may give directions to finance companies regarding the manner in which any aspect of the business and corporate affairs of such finance companies are to be conducted. However, it was observed that any directions had not been made with regard to following matters referred in Section 12 (1) of the Finance Business Act even up to the end of April 2018.

Clause No	Matters
B	<ul style="list-style-type: none">- The maximum rates of interest that may be charged on loans, credit facilities or other types of financial accommodation granted by such companies.- The maximum periods for which any such loan, credit facility or other type of financial accommodation.
J	Conditions which should be applicable to withdrawal by depositors of deposits before maturity.
L	Fixing the limits to the rate at which the amount of any loans, investments or financial accommodation made or granted by such companies may be increased within specified periods.
N	The maximum percentage of the share capital in a finance company which may be held by the persons specified in this clause.
O	The margins to be maintained by such companies in respect of secured accommodations.
Q	The payment to directors or employees of such companies by way of salary, allowance, perquisites, reimbursement of expenses, terminal benefits, gratuity and other superannuation payments.

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|---|--|
| W | Terms, conditions and procedures to be followed by such companies in the acquisition of real estate, and pricing thereof. |
| Y | Submission of a bank guarantee by a finance company for such value and on such terms as may be determined by the Board to ensure the payment of any penalty that may be imposed by the Board under this Act. |

In this connection the Secretary to the Monetary Board of the Bank had informed me that *“there are situations where it is not prudent to issue directions on business operations of finance companies by adopting a generalised approach. The decision taking authority has been given to the Board of Directors of the respective companies as they operate with different risk management frameworks and business models.”*

4.2 Transactions of Contentious Nature

A Consultant was appointed during the month of January 2015 for obtaining Consultancy and Project Management Services to implement the Central Counter Party Mechanism (CCP) in order to mitigate the settlement risk and strengthen the clearing and settlement process in the financial market. According to the tripartite agreement entered into between the Bank, the Colombo Stock Exchange and the Security & Exchange Commission, the cost of the project including the consultancy fee will be equally shared among them. Accordingly, the Bank had spent Rs.22.2 million for the consultancy fee of the first phase of the project as a share of the Bank. However, the Bank had withdrawn from this tripartite agreement in 2015 and the tripartite agreement was terminated without completing other four phases of the project.

4.3 Procurement and Contract Process

4.3.1 Properties purchased by the Bank in USA and Brazil

“The Select Committee of Parliament to look into and report on the expenses incurred by the Central Bank of Sri Lanka for the purchasing of the Office for the Sri Lankan Embassy in Brazil and the Office for the Permanent Representative of Sri Lanka to the United Nations, New York, USA, separately in respect of each premises” was appointed on 23 May 2017 as per the Motion Passed in Parliament on 09 February 2017.

The Committees instructed the Auditor General to submit a report on the land value of the above properties separately and accordingly the report was submitted to the Committees on 20 September 2017. Subsequently the Committees instructed the Auditor General to submit another report on the specified matters in relation to the above subject and that report was also submitted to the Committees on 24 November 2017. The major observations included in the above reports are as follows.

- (a) It was observed that the approval of the Monetary Board for purchase of properties had been granted after the written request of the Secretary to the Ministry of External Affairs by considering the possibility of purchasing premises abroad and renting out to the diplomatic missions of Sri Lanka UN in New York and obtaining the recommendation from the appointed team for purchase of the premises.

- (b) Provision of Section 117 of the Monetary Law Act prevents the Central Bank from engaging in trade or otherwise having 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. Decision of the Monetary Board for purchasing of building properties suitable for offices in selected international cities with a view to renting out such buildings to the Diplomatic Missions of Sri Lanka at market rates until such time the Central Bank requires such buildings for its own use in future was remained contrary to the above requirement since renting out properties are necessarily have characteristics of a commercial undertaking.
- (c) The Attorney General, by his letter dated 25 February 2016 has informed, that the Monetary Board has the powers to purchase immovable property under provisions in Section 5,9(2) and 10(d) of the Monetary Law Act, No. 58 of 1949 (MLA). However, it had been further stated that, renting such properties would fall within the prohibition stipulated under Section 117 of MLA.
- (d) It was observed that a separate valuation report on the property in New York at the time of purchase had not been obtained from an independent valuer, even though the team comprising Government Chief Valuer had recommended that purchasing the above property with existing partitioning and furniture at an offer of not more than US\$ 5.25 million.
- (e) The report of the Committee had included the recommendations made by the Sri Lanka Permanent Representative to UN in New York by his letter No.ADM/57 dated 10 September 2010 relating to the property in New York. According to the recommendations, the floor was in an excellent condition and it would not require any internal refurbishment except construction of two additional toilets. However, in contradict to above recommendations, the Deputy Permanent Representative to the UN, New York from his letter No. NY/ADM/57 dated 19 April 2011 had requested an additional amount of approximately US\$ 400,000 for some improvements such as three additional toilets, re carpeting of the floor and some partitioning works. Accordingly, a sum of US\$ 395,000 had been incurred for the improvements and more works in addition to construction of two additional toilets had been done. (Cost for constructing of two (2) new toilets was US\$39,500).

The Bank had transferred the properties in Brazil and New York to the Ministry of Foreign Affairs on 03 May 2018 and 30 May 2018 respectively. An actual cost of Rs.734.3 million had been recovered thereon from the profit appropriation to the General Treasury for the year 2017 on 28 March 2018.

4.3.2 Procurement for Provision of Janitorial Services and Cleaning Services

 The following observations are made.

- (a) Previous contract agreement entered into with a cleaning service company in this regard had been extended for another two years from 01 October 2015 to 30 September 2017 subject to an increase of 7.5 per cent of the previous contract price (excluding VAT) of Rs.35,404,073. In addition to that, the contract for cleaning and janitorial services to the Multi Storey Car Park belongs to the Bank was also awarded to the said company for

above mentioned two years period for an annual contract price of Rs.983,446 (excluding VAT). Accordingly, the total annual contract price (excluding VAT) was Rs.36,385,519.

The following observations are made in this regards.

- (i) Although a Procurement Committee and a Technical Evaluation Committee had been appointed under the approval of the Governor on 21 July 2015 for calling bids and to select a new contractor for this purpose, the existing contract agreement for cleaning services with the previous company had been extended without calling bids to select a new contractor.

In this connection the Secretary to the Monetary Board of the Bank had informed me that "the previous contract agreement contained the provision of extending the same contract at the expiry, on the mutually agreeable conditions to both parties. The Bank was of the view that the applied increase of 7.5% was reasonable based on the increasing rate of wages, chemicals and other resources involved with the contracts of this nature during the contract period of two years."

- (ii) The above contract had been further extended up to 31 March 2018 on a contract price (excluding VAT) of Rs.18,193,760.
- (b) Bids had been invited through open competitive bidding procedure and after the evaluation of bids, the contract for the Provision of Janitorial Services to the Head Office Buildings of the Bank, Bank House, Car Park and Clock Tower had been awarded to a private company who submitted second lowest bid price (excluding VAT) of Rs. 129,188,389 for a two years period commencing from 01 April 2018.

The total cost estimate per year for providing janitorial services for the Head Office premises of the Bank, Car Park at CBSL Head Office, Chatham Street Clock Tower and Bank House was Rs.41.46 million. However, annual cost of awarded contract was Rs.74.28 million (including VAT). Hence, an abnormal cost increase of Rs.32.82 million or 79 per cent was observed in audit.

4.3.3 Minting of Currency Coins for 2016

The Cabinet of Ministers at the meeting held on 27 June 2012 had vested the authority to the Monetary Board for taking final decision with regard to mint coins by either calling International Bids or to place orders with existing suppliers to.

In considering the stock levels as at 31 October 2015 and the lead time constraints to meet the high demand of coins, the Monetary Board at its meeting held on 24 November 2015 had approved for placing of orders with the existing suppliers/mints for a total of 255 million pieces of coins and orders to be placed at prices negotiated taking into consideration that commodity prices had declined significantly from the price levels prevailed in 2013.

The following observations were made in this regards.

- (a) An International Bids had been called in 2012 for minting and supplying of 550 million pieces of coins for the Bank for the period 2013 – 2015 and awarded the contract to the three mints. Procurement process to call International bids for the coins requirement for

the year 2016 and onwards could have been commenced at the possible time since the awarded contract was only for the period 2013 – 2015. However, the approval of the Monetary Board for placing currency coins minting orders for 2016 with the existing suppliers at negotiated prices based on the prices quoted in 2013 had been sought on 11 November 2015 highlighting the stock levels as at 31 October 2015 and lead time constraints to meet the high demand of coins.

- (b) As higher prices quoted by an existing supplier for Rs. 1 and Rs. 5 coins, the prices for minting Rs. 5 coins for 2016 had been increased by 5.25 USD for 1000 pieces of coins significantly as compared with prices of 2013. Hence, the Monetary Board had decided that not to place order for minting Rs. 1 coins and reduce the orders for Rs. 5 coins up to 40 million.
- (c) As stated in Monetary Board decision dated 24 November 2015, the commodity prices had been declined significantly as compared with the price levels prevailed in 2013. However, more gain from this price decreases had not been received to the Bank since prices for minting coins had been requested from the existing suppliers only. In other hand, opportunity for generating competitive between suppliers had been lost to the Bank since prices for minting coins had been requested from the existing suppliers only. It was further observed that the cost of the coin represent the metal cost which range from 42 per cent to 68 per cent generally.
- (d) It was observed that quoted prices for Rs. 2 and Rs. 10 coins of the selected bidder (on the new quotation called from the all existing suppliers for the balance part of the coins requirement of 2016 on 08 March 2016) had significantly decreased as compared with the prices quoted by the existing suppliers on 02 December 2015 as shown above. Decrease in prices for Rs. 2 and Rs. 10 were USD 5.21 and USD 1.13 respectively.

4.4 Un-resolved matters pointed out in the Previous Audit Reports

Some matters pointed out in my previous audit reports had not been resolved even up to the end of the year under review. Details are given below.

(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 it’s 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. 476,418,155 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 2016 to 26 November 2017	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 April 2016 to 31 December 2017	Department of EPF	Rs. 6,752,500
Central Point Building – 4 th and 5 th Floors	01 December 2016 to 30 November 2017 and 01 November 2018	CHEC Port City Colombo (private) Ltd	Rs.5,540,658 (1 st year) Rs.5,956,218 (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 30 June 2018	Special Task Force – Sri Lanka	Rs. 220,000
Part of Anuradhapura Regional Office	03 September 2016 to 02 March 2018	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 March 2018	AB Securities (pvt) Ltd	Rs. 265,816/ Rs. 332,270 from 15/09/2017
Property in Brazil	01 February 2015 to 31 December 2017	Ministry of Foreign Affairs	USD 9,000
Property in New York -USA	01 June 2015 to 31 December 2017	Ministry of Foreign Affairs	USD 68,000

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. The Deed of Transfer of building property in Brazil and New York was signed on 3 May 2018 and 30 May 2018 respectively. Total actual cost of Rs.734.3 million had been recovered from the profit appropriation for the year 2017 on 28 March 2018.

(b) 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 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. After the examination, the Committee had arrived to the conclusions of there was supervisory forbearance over the period and prudent investment decisions had not been taken consistently at all levels of the reporting line in certain instances.

5. Achievement of Sustainable Development Goals

Every public institution should act in compliance with the United Nations Sustainable Development Agenda for the year 2030. However, the Bank had not taken actions to identify the sustainable development goals under purview of Bank's scope and targets relating to the activities thereof, along with the milestones in respect of achieving those targets, and the indicators for evaluating the achievement of such targets.

In this connection the Secretary to the Monetary Board of the Bank had informed me that “the Bank neither has the legal mandate nor instruments available to help achieve Sustainable Development Goals (SDGs) directly. It may also be noted that, as the funds of the Bank cannot be used for the achievement of SDGs.

6. 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 dealers.
(b) Maintenance of Treasury Bills Portfolio	Maintaining the treasury bills portfolio included under Sri Lanka Government Securities in manually by using excel sheets instead of being used properly designed system functionality.
(c) Control over Inventory	(i) Use of manually designed Weighted Average Method for valuation of inventories which was susceptible to high human errors. (ii) Un-availability of approved policy with regard to identifying the slow moving and obsolete inventory items.
(d) Cyber Security Governance Framework	The Bank not documented/defined any cyber security governance framework.
(e) Accounting	Possibility to deactivate ledger accounts with balances in the iGLAS system by Admin and not picked deactivated accounts to the trial balance.