

1.1 Opinion

The audit of the Financial Statements of the Bank of Ceylon (the “Bank”) and the Consolidated Financial Statements of the Bank and its subsidiaries (the “Group”) for the year ended 31 December 2018 comprising the Statement of Financial Position as at 31 December 2018 and the Statement of Profit or Loss, Statement of Comprehensive Income, Statement of Changes in Equity and Statement of Cash Flow 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 provisions of the National Audit Act No. 19 of 2018. 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. My comments and observations which I consider should be report to parliament appear in this report.

In my opinion, the accompanying Financial Statements of the Bank and the Group give a true and fair view of the financial position of the Bank and the Group as at 31 December 2018, and of their financial performance and their cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

1.2 Basis for Opinion

I conducted my audit in accordance with Sri Lanka Auditing Standards (SLAuSs). 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 believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation of Financial Statements that give a true and fair view in accordance with Sri Lanka Accounting Standards and for such internal control as management determine 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, management 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 unless management either intend to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

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

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Bank is required to maintain proper books and records of all its income, expenditure, assets and liabilities, to enable annual and periodic Financial Statements to be prepared of the Bank.

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

My objective is 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 Sri Lanka Auditing Standards 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 Sri Lanka Auditing Standards, I exercise professional judgment and maintain professional skepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the management.
- Conclude on the appropriateness of the management'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.

The scope of the audit also extended to examine as far as possible and as far as necessary the following;

- Whether the organization, systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of the presentation of information to enable a continuous evaluation of the activities of the Bank and whether such systems, procedures, books, records and other documents are in effective operation;
- Whether the Bank has complied with applicable written law, or other general or special directions issued by the governing body of the Bank;
- Whether the Bank has performed according to its powers, functions and duties; and
- Whether the resources of the Bank had been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws.

1.5 Financial Statements

1.5.1 Internal Control over the preparation of Financial Statements.

Audit Issue	Management Comment	Recommendation
a. It was observed that some portfolios such as Treasury Bonds Infinity & Abimana, Restructuring Bonds, Debentures & Trust Certificates, Treasury Bonds Vishrama and Securities in Other Countries are maintaining manually.	All the operations and reporting under each of these portfolios are being carried out accurately without any delay with the current system. However, Investment Banking Division (IBD) is in the process of acquiring a software solution (IT System) and expected to transfer the manually maintained portfolios.	It is recommended to insert these manually maintaining portfolios in to the proposed IT system promptly.
b. 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.	Comment Noted, The Bank is using a workaround solution in order to capture the total exposure of the customers. With the implementation of the SLFRS solution, Bank would be in a position to have a fully automated solution to capture the central liability information. Until that, the Bank will continue the present workaround to capture the ISL information from the different environments. Target date :- 31.12.2019	It is recommended to introduce a system which can generate central liability report which captures all facilities given to a customer.

c	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 2018 is questionable.	Comment Noted, Facilities had been restructured considering the cash flow of the business and adhering to the existing policies of the bank. The policy has been approved and system modification is in process to capture restructured facilities due to credit deterioration.	In the impairment assessment, recoverability and the adequacy or validity of securities of those customers should be considered.
d	The bank had not considered individually significant loans and advances granted to government organizations for individual impairment assessment even though they have objective evidence for incurring losses.	The Bank is considering all aggregate exposure of customers, if the aggregate balance is over Rs.100 Mn as ISL, irrespective of ownership of the facilities that is including SOEs and direct government.	Loans and advances granted to government sector which has objective evidence for incurring losses should be considered by evaluating past experiences of recoverability.

1.5.2 Non-Compliance with Sri Lanka Accounting Standard

Non-Compliance with reference to particular Standard	Management Comment	Recommendation
<p>a SLFRS 09</p> <p>According to SLFRS 09, Treasury bills under Financial Assets Measured at Amortized Cost should be measured at Effective Interest Rate (EIR) method. However, the bank had valued Treasury Bills on simple interest method through the Financial System instead of Effective Interest Rate (EIR). Due to that the value of treasury bills has been overstated by Rs. 61,068,907 as at the end of the year under review.</p>	<p>The Bank does not apply EIR adjustments for the Treasury Bills which are less than 1 year. Further, when applying the EIR calculation, adjustment to the opening balances also should be considered, so the EIR impact is immaterial.</p> <p>Similarly, there is no any interest difference at the maturity of the investments under both simple and EIR interest rate calculations.</p>	<p>It is recommended that the bank should comply with the SLFRS 9 when valuing Treasury Bills.</p>
	<p>Industry practice is also to apply simple interest calculation method to treasury bills which have maturity period less than 1 year.</p>	

1.5.3 Accounting Policies

Audit Issue	Management Comment	Recommendation
<p>a. Accounting policy of the bank stated that amortization or depreciation of assets should be started when the asset is available for use. However, some instances were observed that,</p> <ul style="list-style-type: none"> • The Bank had started to amortize Intangible Assets when entering in to purchasing agreements and • The Bank had depreciated Property Plant and Equipment in full amount for the month of acquired. 	<p>The Bank has opened a new General Ledger Account named "Work In Progress - Software A/C" to record the intangible assets until the asset is available for use.</p>	<p>Bank should adhere with the accounting policies.</p>

1.5.4 Suspense Accounts

Audit Issue	Management Comment	Recommendation									
<p>a Suspense accounts balances were identified in other assets and other liabilities accounts which have been in existence for a considerable number of years.</p> <table border="1"> <thead> <tr> <th></th> <th>Amount (Rs.)</th> <th>Year</th> </tr> </thead> <tbody> <tr> <td>Other Liabilities- Suspense Account Lease (Maharagama Branch)</td> <td>1,045,001</td> <td>2013</td> </tr> <tr> <td>Other Assets- Suspense A/C ATM</td> <td>38,833</td> <td>2005</td> </tr> </tbody> </table>		Amount (Rs.)	Year	Other Liabilities- Suspense Account Lease (Maharagama Branch)	1,045,001	2013	Other Assets- Suspense A/C ATM	38,833	2005	<p><u>Suspense Account lease</u> According to the report of Sky Lease General Ledger Suspense A/C Lease – Maharagama Branch (22310085) is balanced as at 16.08.2019.</p> <p><u>Suspense A/C ATM</u> This Amounts will be cleared before 31.12.2019</p>	<p>It is recommended that management should take actions to reconcile and clear the Suspense Accounts balances within a reasonable time period.</p>
	Amount (Rs.)	Year									
Other Liabilities- Suspense Account Lease (Maharagama Branch)	1,045,001	2013									
Other Assets- Suspense A/C ATM	38,833	2005									

1.6 Accounts Receivables and Payable

1.6.1 Receivable

Audit Issue	Management Comment	Recommendation
a A sum of Rs. 6,614,072 worth of long outstanding balances in 25 branches was in “Claim Voucher Accounts” under other assets. Those balances were outstanding since 2014, 2015 and 2016.	Since no records available in Mankulam, Mulliyawalai & Kilinochchi Branches due to the war before 2009, we are in the process of clearing the items. Other amounts will be cleared before 31.12.2019. Branches/ Divisions have been properly instructed on write off of long outstanding balances through Office Instruction Circulars (OCIs).	Bank should take actions to identify and settle the long outstanding balances.

1.7 Non-compliance with Laws, Rules, Regulations and Management Decisions etc.

Reference to Laws, Rules Regulations etc.	Non-compliance	Management Comment	Recommendation
a (i) Section 7(1) and 7(2) of the Financial Transaction Reporting Act no 6 of 2006	Where Bank has reasonable ground to suspect that any transaction or attempted transaction may be related to the commission of any unlawful activities or any other criminal offence or has information that it suspects may be relevant the Institution shall, as soon as practicable, after forming that suspicion or receiving the information, but no later than two working days there from, report the transaction or attempted transaction or the information to the Financial Intelligence Unit(FIU) of the Central Bank. Information regarding fund transfer amounting USD 1,103,980 credited to account no. 8066387 maintained by Mr. J C Nammuni on 04 October 2017 and withdrawn Rs. 30,000,000 on the same date has not been reported to Financial Intelligent Unit on time and subsequently reported on 10 October 2017. Hence FIU has imposed a penalty payment to the Bank amounting to Rs. 1,000,000 in term of section 15(1)(e) read with section 18(1) of the Financial Transaction Reporting	Said lapses have now been rectified with the implementation of the Clari5 system which is the new Anti – Money laundering and countering the Financing of Terrorism (AML/CFT) transaction monitoring system of the bank. Smart Remit System, which perform SWIFT transaction processing is now integrated with Clari5 and it generates STR alerts automatically. Further, Compliance division makes sure of the submission of the STR on timely manner to the FIU of the Central Bank of Sri Lanka. Employee concerned has resigned from the Bank’s service. Hence, disciplinary action could not be executed. Awareness programs in this regard are being conducted on regular basis by the	Bank should comply with the relevant Act.

Act, No. 6 of 2006.

- (ii) Section 29 (1) No Financial Institution shall without the prior written approval of the Central Bank of Seychelles extended one or more credits to any one customer or a group of closely-related customers for amounts aggregating more than 25 per cent of such financial institution's core capital.

Bank has failed to comply with the aforesaid section, as bank has not requested prior approval from the Central Bank of Seychelles for the credit facility granted to Mr. Cyril Serge Bonnelame.

Hence Central Bank of Seychelles has imposed a penalty of SCR. 300,000 (Rs. 3,300,000) in term of section 63(2)(m) of Financial Institution Act 2004.

Compliance Division to educate the staff on strict adherence to all regulations, with the assistance of FIU. Online compliance certification system has been introduced for all the staff members to ensure the effectiveness of the training programs.

Seychelles branch granted a term loan facility of USD 549,450 to the borrower – Mr. Cyril Serge Bonnelame on 13.10.2017. The facility was disbursed in two stages. Subsequently, based on the monthly returns to the Central Bank of Seychelles informed the bank that the said facility exceeded the single borrower exposure limit and liable to monetary penalty for violating the prudential regulations as per section 63 of the Financial Institution Act.

Foreign branches of the Bank should comply with the Financial regulations of relevant country.

Credit concentration of SCR 7.8 million was calculated as 25 per cent of capital base of SCR 31.3 million (Tier I 28.3 million +Tier II 2.9 million).

However, when considering the Tier I capital it was only SCR 7,096,500.

According to the guidelines of large exposures, credit concentration, and connected lending issued by the CBS in February 2017, "Core Capital" has the same meaning as "Tier I Capital". As such 25% of the core capital as at 30.09.2017 should be SCR 7.09 million

instead of SCR 7.84 million.

1. Despite breaching section 29 (1), we acted diligently and we have obtained immovable property worth SCR19.12 million as second way out of secure the repayment.
2. After the year ending audit the said credit facility has come down to below the credit concentration limit.
3. According to the said breach, we immediately informed the Central Bank of Seychells seeking of the covering approval.
4. Actually, the facility has been exceeded the single borrower exposure limit being the miscalculation of core capital factor or else the purpose was not dealt with any fraudulent transaction. However, we undertake not to repeat such offences in future.

Further, a memorandum dated 18.04.2018 submitted to the Board and the covering approval of the Board of Directors has granted for having paid a sum of SCR 300,000 to the Central Bank of Seychelles being a monetary penalty imposed by the Central Bank of Seychelles on the explanation provided by the General Manager that this happened due to a genuine mistake.

(iii) Section 4 of the Operating Instructions to Authorized Dealers, Ref No. EC/9/93 dated 29.12.1993 of the Exchange Control Act No. 24 of 1953.

A national of a foreign country who was a citizen of Sri Lanka prior to the acquisition of such nationality, should open Non Resident Foreign Currency accounts (NRFC) in Sri Lanka.

Hydepark branch of bank has opened a Non-Resident Rupee Account (NRRA) bearing No 75470621 on 24 December 2013 in the name of Mrs. C S N Dharmaratne who was a Sri Lankan national emigrant.

Hence Exchange Control Department of the Central Bank imposed a penalty of Rs.154,317 in terms of the provision of above Act.

This penalty has been imposed due to the execution of credit transaction amounting to Rs. 10,851,407.89 and debit transactions amounting to Rs. 4,380,340.79 during the period of 24.12.2013 to 31.07.2014.

Bank should monitor the specific transactions getting approvals from relevant authorities and comply with the Operating Instructions issued by the Central Bank relating to foreign exchange.

Controller of Exchange has requested to furnish if any cause to show not having committed offences in terms of section 51 of the ECA on the above incident.

Accordingly, bank has replied by its letter dated 06.11.2017 informing the details of the incident and an investigation has been carried out in this regard.

However, the explanations given in the letter had not been accepted by CBSL as valid reasons to determine that BOC has not committed offences in terms of section 51 of ECA due to following reasons.

- As per the paragraph 2(c) of the operating instructions to Authorized Dealers bearing EC/79/93/(D) issued on 29 December 1993, clearly has stated that Authorized Dealers are permitted to open and maintain NRRA, without reference to the Exchange Control Department, for Sri Lanka Nationals Resident outside Sri Lanka excluding emigrants.
- As per the paragraph 2 (d) of the above given act, clearly has stated that credits of local arising from capital

transactions and debits for outward remittances require prior approval of the Exchange Control Department.

In view of the above, CBSL conclude that BOC has violated the operating instructions to authorized dealers bearing Ref. No. EC/79/93 – D dated 29.12.1993 issued by the CE by opening Nonresident Rupee Accounts and operating such account, by crediting of Rs.10,851,407.89 and debiting sum of Rs. 4,380,340.79.

In order to avoid future occurrence of such lapses, continuous training and awareness have been given to the staff involve in handling foreign exchange related transactions. Further, the bank has arranged a special training program in 2017 with the assistance of CBSL educate employees who involved in such transactions. Further continues training programs are conducted by compliance division to update knowledge of the staff. Office Instructions Circular no. 18/2017 dated 26.07.2017 with recent changes in Foreign Exchange Transactions has been issued and communicated to the branches.

Staff involved on this incident has been strictly advised to act in accordance

with regulations, when opening and maintaining accounts, which are governed by ECR of CBSL. Employee concerned in this incident has retired for the Bank's service. Hence, disciplinary action could not be taken.

(iv) Section 4 of Foreign Exchange Act No. 12 of 2017. In terms of the existing foreign exchange regulations, Authorized Dealers shall obtain prior permission from the Department of Foreign Exchange (DFE) to open Special Foreign Currency Accounts (SFCA) in the name of respective entities. Borella Super Grade branch of the Bank has opened a SFCA bearing No. 82412063 in the name of ETI Finance Ltd on 19.03.2018 without obtaining prior permission of DFE.

CBSL had informed that the branch has opened a SFCA bearing no 82412063 in the name of ETIFL and inform remittances to a Sri Lanka Rupee account maintained in the name of ETIFL on 19.03.2018 without obtaining prior permission from the Department of Foreign Exchange.

Bank should monitor the specific transactions getting approvals from relevant authorities and comply with the Foreign Exchange Act.

Accordingly, they informed to close the above account with immediate effect and credit the funds held in that account as well as any future inward remittances to a Sri Lanka Rupee account maintained, in the name of ETIFL and inform the same to the department.

Director- Department of Foreign Exchange has requested explanation from the branch stating that the branch has violated section 4 of Foreign Exchange Act No 12 of 2017.

Disciplinary actions had been implemented against the responsible staff members as per the disciplinary process of the bank.

(v) Foreign Exchange Act No 12. Foreign exchange buying and selling should be reported to the Central Bank using Form I and Form II. However, the Bank had not reported to following

During that period Bank has used two systems to report foreign currency buying and selling to the Central Bank of

Bank should monitor the specific transactions, getting approvals from

of 2017 remittances received in foreign currency and credited to following rupee accounts.

Name	Account No.	No of Remittances	Total amount (Rs.)
Batticaloe campus (Pvt) Ltd	78495137	6	21,697,753
Sri Lanka Hira Foundation	1631952	11	313,184,756
A.M.A. Lanka pvt ltd	80961953	5	144,978,158
Malik Abdulla Bin Abdul Aziz University Collage Batticaloa	74791337	6	24,849,903

Sri Lanka as follows.

Period	System
March 2016- February 2019	File upload by login to CBSL
February 2019 onwards	Online Reporting to CBSL

relevant authorities and comply with the Foreign Exchange Act.

The task of Form II reporting to CBSL is given priority by the bank and we have therefore assigned staff to submit reports to CBSL regularly. Proper systems and procedures too were put in place for smooth reporting of same. However, we have no mechanism to review the reported transactions due to the Central Bank of Sri Lanka has discontinued the system of uploading files by logging in to CBSL from February 2019. We have referred the matter to our Chief Internal Auditor (CIA), for an internal investigation to find out the circumstances under which such a lapse has occurred. Therefore, we will give a proper explanation, once the investigation is concluded.

1.8 IT General Controls

Audit Issue	Management Comment	Recommendation
<p>a During the sample examination, under the Information systems general controls, it was observed that Existence of Dormant accounts, Absence of password policy enforced to user accounts, User accounts without direct ownership, Unresolved service requests in application vendor portals, Insecure Password Configurations, Insecure web access to internal, Absence of Disaster Recovery Service for an application, Application integrations through insecure links, Absence of adequate backups and Sharing of user accounts.</p> <p>In addition, under the audit of Application security controls, it was observed that Absence of secondary validations, Single instance of miscalculated interest rate due to delayed process, Absence of validations in system parameters.</p>	<p><u>ICBS Core Banking System</u></p> <ul style="list-style-type: none"> • <u>Existence of dormant accounts</u> - Status is shown as active, users unable to login since these are get expired in 3 months. However, application manager had disabled the application access for the sample accounts given. Since password auto forced to change after 3 months, there is no possibility of login to the system without the intervention of the application manager. • <u>Absence of password policy enforced password</u> - User password renewal has been setup for 3 months and actual renewal happens only when user logged in after 3 months. Until such time status is shown as active. • <u>User accounts without password ownership</u> - However there are specific user accounts assigned to specific roles to be used in case of a specific purposes. • <u>Unresolved service requests in application portals</u> - Numbers of cases were high at that time because those were deliveries mainly for Internet Banking project which was being implemented. Now this is being cleared. <p>There are only 15 open cases in vendor portal as at 07/10/2019</p> <ul style="list-style-type: none"> • <u>Insecure password configurations</u> - Password length setup done. Other parameter setting will be done with the support of the vendor. IBM Minimum password age will be implemented by 30/11/2019. <p><u>Pawning Subsystem</u></p> <ul style="list-style-type: none"> • <u>Insecure password configurations</u> - Existing dormant users are revoked manually. Further proper mechanism is being implemented to identify and revoke the dormant accounts on timely basis. <p><u>Human Resources Management Application – HCM</u></p> <ul style="list-style-type: none"> • <u>Insecure web access to Internal</u> - The bank is in the process of doing a feasibility study of implementing the same with the vendor. Will be implemented by 30/06/2020. 	<p>Bank should continuously monitor the systems, identify the weaknesses and solutions should be implemented immediately.</p>

- Absence disaster recovery to one application - This had not been under the initially identified list of systems that require disaster recovery facilities. Disaster Recovery service will be implemented next year – 31/03/2020.

Application integrations through insecure links - SFTB will be implemented by 31/12/2019.

Sky-lease Leasing System

- Absence of Disaster Recovery Service for an application - DR setup has been completed and currently given for UAT.
- Application integrations through insecure links - Bank is in the process of doing feasibility study of this matter with the vendor. The said process will be initiated after the outcome of the same.
- Insecure Password Configuration - This requirement will be implemented with the Vendor support upon the vendors response over feasibility of doing it by 31.03.2020

Smart Remit – Inward Remittance.

- Absence of adequate backups - Day end back up and Real time mirrored copy of Smart Remit systems is already in place. Total backup solution will cover VM backups.

Trade Finance

- Insecure Password Configurations - Bank is in the process of procuring new trade finance solution which will address the said issues. (30.09.2020) because of failures of the existing system.

Loan Subsystem

- Absence of secondary validations

B class Officer should obtain the loan granting function in the system from the Manager of the branch. Also One function can be used to create only one loan. It is the responsibility of the Manager and Credit Officer to check the loan account in the system immediately as the loan is granted (It is stated in the user guides of Loan subsystem).

Additionally, the bank has introduced new workflow to branch network named as "DMS Workflow" to originate Personal/Home Loans and it covers Loan application,

Appraisal, Approval and Document Printing / Save /Retrieval.

DMS workflow has given facility to manager/A class officer to view the details of the loan created by B class officer before granting the permission to create loan in ICBS fed into the system. Once approved, loan account will be created in ICBS automatically by pushing information already captured in appraisal from DMS Workflow.

Instructions have been issued to Manager & credit officer to check the loan details soon after granting loan.

ICO should check the day end report on the following day.

- Single instance of miscalculated interest rate due to delayed process

The above mentioned loan account 72670849 is granted under SMEDEF PROJECT loan category which subject to change interest rate in every six months time. The list of SME loans to change the interest rate is generated by Development Banking Division. However there was a slight delay in receiving instructions from the said division. Subsequently, interest rates have been changed accurately in the system. As per the instructions received from the Development Banking Division.

DBD has been informed to notify back office before 1st of January and 1st of July each year in order to change interest rate in the system to avoid the repetition of the same in the future.

Deposits

- Absence of validations in system parameters.

Since the bank has numerous deposit products, giving products codes for different tenure period of same product is not practically feasible. Hence the bank has limit one product code for each tenure period for foreign currency denominated accounts and CTRA accounts. At the time of opening, the relevant term limit should be selected for such accounts.

Payment cycle/ frequency parameter remain editable since it is a business decision requirement.

To maintain accuracy of interest accrued on deposited amount, the "next payment date" and "next renewal date" parameters should be equal. Hence, when the next renewal date is a holiday, the system automatically select the next working date as the renewal date and accordingly, the interest payment date also selected as same as renewal

date.

Currently the DMS system used for accounts creation and it does not allow users to change the payment period from months to days.

This has been introduced to branch network and around 95% branches follow the DMS for FD creation. ICO should check all opened FD accounts with the account opening report on the following day.

2. Financial Review

2.1 Financial Result

The operating result of the year under review amounted to a profit of Rs. 19,479 million and the corresponding profit in the preceding year amounted to Rs. 21,312 million. Therefore, a deterioration amounting to Rs. 1,833 million of the financial result was observed. The reasons for the deterioration are increasing of operating expenses, impairment charge; taxes on financial services and income tax expense.

2.2 Trend Analysis of major Income and Expenditure items

Profit after tax of the Bank has decreased by Rs. 1,833 million or 9.4 per cent as compared with the previous year. Impairment charges for loan and other losses increased by Rs.5,700 million or 61 per cent due to converting impairment provision method from incurred loss approach to expected credit loss approach . Further, other operating expenses increased by Rs. 5,085 million or 18.6 per cent. Personal expenses of the Bank has increased by Rs. 1,879 million or 11.05 per cent due to salary increments granted to employees as per the collective agreement with effect from 1 January 2018.

2.3 Ratio Analysis

Following observations are made on some important accounting ratios of the Bank for the year under review as compared with sector ratios in this regard.

- (i) The Return on Equity (ROE) ratio and Return on Asset Ratio (before tax) of the bank had been decreased by 4.2 per cent and 0.2 per cent respectively in 2018 as compared with previous year mainly due to low profitability during the year under consideration.
- (ii) Statutory Liquid Asset Ratio of the Bank indicated as 24.47 per cent as at the end of the year 2018, comfortably above the regulatory requirement of 20 per cent and in line with the industry level of 24.5 per cent.
- (iii) Total Capital Adequacy Ratio of the Bank reported as 14.6 per cent as at 31 December 2018 which is higher than the minimum statutory requirement of 12.875 per cent.
- (iv) The net interest margin of the Bank in 2018 had reduced by 0.1 per cent as compared with the previous year.

3. Operational Review

3.1 Identified Losses

Audit Issue	Management Comment	Recommendation
a Fraudulent Loan of Rs. 1.1 Million – Maradana Branch	<u>Current Position</u>	
Loan officer of the Maradana branch had fraudulently created a loan account for Rs. 1.1 million in the system and loan funds had been used to settle other loan accounts through the system without following the formal procedures and bank circulars. Further, a sum of Rs. 19 million deposited as bank guarantees had been transferred to the relevant customer's savings account without a written approval from the customer in the aim of increasing the savings account balances as at the end of the year.	• Based on the preliminary investigation, the credit officer was interdicted from the bank service	Bank should periodically evaluate and strength the internal control system which avoid fraudulent activities.
Further, Temporary overdraft facilities relevant to 02 accounts totaling Rs. 7.3 million had been granted exceeding the authority limit of the Manager - Maradana branch and contravening the bank circulars. Permanent overdraft facilities relevant to 07 accounts totaling Rs. 36.97 million had been granted in the aim of fulfilling deposit targets of the Maradana branch without obtaining a proper approval and recommendations.	• Disciplinary actions are in progress against the credit officer of Maradana Branch and other staff members involved for their negligence	
	• The fraudulent loan of Rs. 1.1million created by the credit officer of Maradana Branch is	

The sources of receiving funds and information relevant to deposits should be written on the deposit slip when deposits are made to the accounts of bank's employees through the counter. However, deposits totaling Rs. 150,000 had been credited to a current account maintained by the Loan Officer- Maradana branch without specifying the sources of funds.

not paid off yet and it is in the regular section. The balance to be recovered as at 06.07.2019 is Rs. 690,042.

b Misplacement of Credit Files and Fraudulently Issuance of Loans and Advances amounting of Rs.14 Mn - Anuradhapura Super Grade Branch

Loan officer of BOC Anuradhapura branch has misguided his bank officers and granted Loans and Overdrafts to his relatives in several occasions without any collateral. Also, he has overdrawn such customers' current accounts by using Branch Manager's Personal access with exceeding the authority of the Manager and misplaced even mandate relevant to the customers. Further, covering approval for aforesaid overdraft facility was not taken. That current account also has fraudulently transferred from another branch through the ICBS by using Branch Manager's Personal access. In this regard, the officer concerned act contrary to the provisions of bank circulars. Further, he has misplaced 86 loan files and due to that the recovery process of the relevant loans is pending and out of the granted amount of Rs.14 Mn, Rs.6.8 Mn is in the financial risk without taking any recovery action due to the aforesaid reason. Further, Rs.13 Mn Loans were transferred to Non-Performing Category.

Current Position

- The credit officer was interdicted from the bank service
- Disciplinary actions are in progress against the credit officer who committed the frauds and against 8 staff members for their negligent.
- Loss of Rs.14Mn to the bank is to be recovered by bank

Bank should periodically evaluate and strength the internal control system which avoid fraudulent activities.

c Fake account creation and forces made to the staff in Norochhole Branch

Branch Manager of the above branch has done many irregularities in the operation of Deposits, Loans and Pawning transactions.

A fake loan account has been created and approved by Branch Manager on the name of his brother and father for the amount of Rs. 2.5 Mn and Rs. 490,000 respectively by using unauthorized access and fund also was released fraudulently. Further he has opened Senior Citizen Fixed Deposit Accounts on behalf of his Mother and Mother in law for Rs. 2.7 Mn committing several frauds and closed aforesaid accounts in the system without a request of customer and finally he avoided giving relevant interest to such customers.

Current Position

- The branch manager was interdicted from the bank service.
- Disciplinary actions are in progress against the Branch Manager who committed the frauds and other staff members for their negligence.
- Loss to the bank was fully recovered in all stated cases.

Bank should periodically evaluate and strength the internal control system which avoid fraudulent activities.

Said Manager has forced an officer at the pawning section to accept low karatage gold articles value of which was Rs. 899,280. Also, he has withdrawn money amounting of Rs 2.5 Mn from the counter fraudulently. In addition to that, he cancelled the crossing of a Pay in order for purchasing a Motor Vehicle which cost of Rs. 1,715,000 and made withdrawal from the counter without a written permission of the customer. In this regard, Mortgage Bond also has not been registered within 21 days.

d Kandy Super Grade Branch 1 – Poor Evaluation of the Customer

A loan facility of Rs. 146 million (disbursed amount- Rs. 131 million) had been approved to M/S New Polgolla Auto Service under small and medium scale enterprises. This SME facility had been designed as four loans for the settlement of outstanding balance at Hatton National Bank and constructions (Rs. 51 million), purchase of machinery (Rs. 75 million), solar power system (Rs. 5 million) and for working capital (Rs. 15 million). However, the customer had defaulted the loan. It was observed that the conditions imposed by the credit committee had not been followed by the responsible officers of the bank and many irregularities were observed when disbursing the loan. The following observations are made in this regard.

- Pay order of Rs. 26 million had been issued to settle the HNB outstanding without getting customer contribution of Rs. 07 million.
- Funds for machineries had been issued prior to completion of the construction of building. Machineries had not been mortgaged to bank and most of the machineries were not available in the service station at the time of inspection by the internal auditors.
- Loan for the construction of building and the loan for purchase of machinery had been released within a very short period (01 week) which is not justifiable.
- Loan Proceeds for the purchase of solar power system had been released without customer contribution and before the completion of the building construction works.
- Even though there were significant differences between the account sets submitted by the customer and the audit firm, they had not been verified during the financial evaluation.

Current Position

- Disciplinary actions are in progress against the staff members concerned for their negligence.
- Parate execution was performed and the property was devolved to the Bank.
- Planning to file a case to obtain an ejection order and ejection notice has already issued.

Bank should periodically evaluate and strength the internal control system which avoid fraudulent activities.

3.2 Operational Inefficiencies

Audit Issue	Management Comment	Recommendation
<p>a Loans and Advances</p>		
<p>(i) Gross loans and advances granted by the bank as at 31 December 2018 was Rs. 1,510,534 million compared with previous year balance Rs. 1,219,914 million indicating as increase of 23.8 per cent. The main reason for the aforesaid increase is the rise of overdrafts during the year under review. Out of the above balance, a sum of Rs. 1,136,530 million or 75 per cent of total outstanding had consisted with term loans, overdrafts and personal loans. An increasing trend had shown in all loans and overdrafts and it was 64 per cent improvement during the year 2018.</p>	<p>Comments Noted.</p>	<p>When granting of loans, Bank should evaluate recoverability of the customer.</p>
<p>(ii) Top twenty total loans and advance portfolio exposures as at 31 December 2018 was Rs. 778,698 million. Out of above balance Rs. 735,377 million or 94 per cent represents government institutions. Further, highest portfolio exposure of Rs. 296,977 million has been granted to Ceylon Petroleum Corporation (CPC) and it was 20 per cent of the total loans and advances of the Bank as at the year under review.</p>	<p>Comments Noted.</p>	<p>When granting of loans, Bank should evaluate recoverability of the customer.</p>
<p>(iii) The total non-performing loans and advances as at 31 December 2018 was Rs. 53,753 million as compared with the said value of Rs. 34,261 million for the year 2017 and shown an increase of 57 per cent. Non-performing ratio of the Bank had increased from 2.9 per cent to 3.6 per cent in year 2018 compared with the previous year. Hence, unfavourable condition had indicated for the year under review.</p>	<p>Comment Noted. The bank has identified following major causes for the NPA position experiencing now.</p> <ol style="list-style-type: none"> 1. Adverse impact of the changes in economic condition and external factors 2. Impact of the adoption of new Accounting Standards i.e. SLFRS 09 & CBSL Guidelines <p>The Bank's internal policies and procedures have been revisited and strengthened</p>	<p>When granting of loans, Bank should evaluate recoverability of the customer.</p>

prudently and proactively to control and reduce the growth in NPLs/impaired loans.

Strategies Identified to control NPAs are discussed at the weekly Corporate Management Meeting as a permanent agenda item. The Board and its subcommittees pay special attention to NPAs and discuss strategies to minimize the same on regular basis.

Further, regular NPA meetings are held where collection efficiency ratio is closely monitored by the corporate management.

In addition credit quality assurance units have been established to cover entire credit portfolio in order to strengthen the credit evaluation and documentation.

(iv) It was identified that K.D. Ebert and Sons Holdings (Pvt) Ltd, Kaduwela Holdings and Dholhiyadhoo Investment (Pvt.) Ltd had reported highest customer's non-performing amounts of Rs. 1,105.97 million, Rs. 1,532.48 million and Rs. 1,455 million respectively as at the end of the year 2018 and it is a 15 per cent of the total non-performing loans and advances of the Bank.

Kaduwela Holdings

Has initiated legal action for all the facilities & summary of the actions taken are given below.

Short Term Loan:

Case No. DDR/398/18 & DDR/399/18 next calling dates 05.11.2019 and 31.10.2019

Over Draft:

CHC/160/18/MR

Ex party Trial on 08/10/2019,

Import Loan:

CHC/45/19/MR Calling on 07/10/2019,

LC Bills CHC/457/19/MR Calling on 23/01/2020

Bank should take appropriate actions to strength the recoverability process.

Dholhiyadhoo Investment (Pvt.) Ltd

NPA balance of Dholhiyadhoo Investment (Pvt) Ltd as at 30.09.2019 is Rs. 2,448 Mn.

Maldivian government has planned to acquire the assets under toxic assets rehabilitation program. Under which Male government has sent a letter to State Bank of India with this concern and our action is getting delayed until finalization of the acquiring procedure.

K. D. Ebert and Sons Holdings (Pvt) Ltd

NPA balance has reduced to Rs. 2,716 million as at 30.09.2019. The Bank has financed for several projects of the customer including 10 i road projects, Manampitiya Aralaganwila Road Project, 25 Bridge Package and Ambatale Water Project and out of those projects, the Road Development Authority has terminated 07 I

road projects and claimed Rs. 2,845.8 million for the Letter of Guarantees issued by the Bank. Enjoining orders have been served restraining the Bank from making the payment on guarantee claims.

The Bank has received the following payments and used to settle the Bank liabilities.

Project	Date & Amount Received (Rs. Million)
Thalduwa Meewitigamma Road	16.08.2019 34.59
Ambatale Water Project	26.09.2019 520.8

The recovery actions and negotiations are being taken against the said companies in order to recover the dues.

b Written off loans & advances

The total capital written off in the year 2018 was Rs. 40 million and it represents 2,843 customers of the Bank. Interest related to above outstanding was Rs. 53 million.

After taking every possible action to recover facilities, the balance portion of the facilities had been written off with the approval of the Board of Directors in line with the Bank's write off policy.

Bank should take actions to minimize the written off amounts with following of appropriate recovery actions.

3.3 Idle or Underutilized Property, Plant and Equipment

Audit Issue	Management Comment	Recommendation
<p>a An extent of 163,890 square feet of a 6 storied building out of 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. 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.</p>	<p>Based on the structural assessment report of the York Street Building, the Bank has decided to commence the structural strengthening of the building and the approval of the BOD had been obtained on 29.08.2019 to proceed with the works. A paper advertisement has been published on 27.09.2019 calling proposals from consultants for structural strengthening of the building. The Bank is planning to renovate the building after the completion of structural strengthening and the consent of the Ministry of Finance has been given for the matter.</p>	<p>After renovating the building, the Bank should take actions to utilize the idle area properly.</p>

3.4 Procurement Management

Audit Issue	Management Comment	Recommendation
<p>a The Bank has entered into an agreement with a private company on 16 September 2013 to obtain a building at hospital road, Colombo 01 on a rental basis for 5 years' period for the purpose of functioning operation of the Metropolitan Branch. The Bank had spent Rs. 321 million as initial rentals. Bank has not used building for the period of first 10 months from the date of agreement. This building was got caught to the bomb blast in 1996 and concrete beams, slabs, and walls of the building was cracked. However, when entered in to agreement structural assessment has not been done by the bank. Further, bad condition of the building had been noted by the Deputy Chief Security Officer on 18 September 2014 and by Deputy</p>	<p>The Bank managed to obtain Equity two building on rent and entered into an agreement on 16.09.2013 for a period of 05 years. Since the Bank had to refurbish the building to suit for the Banking operations with proper procurement procedure, it took about 10 months to commence the Banking operations at equity two building. Even though the Bank had planned to establish its "Call Centre" at equity two building, the proposal was abandoned and the Western province north office could not be shifted back due to the commitments of the agreement. Also the Bank did not wish to occupy a third party in the building due to the security reasons. The Bank was satisfied with the building and decided to enter into an agreement for 05 years based on the assurance of the structural engineer. According to the report of the structural</p>	<p>Bank should utilize its funds effectively and efficiently through a proper procurement process.</p>

General Manager (Support Service) on 13 July 2016. Although the Bank has rented out entire building, under the above rent agreement, fourth, fifth and sixth floors are remained idle since the year 2013.

Even though this matter was mentioned in the last year audit report, management had entered in to a new lease agreement on 07 December 2018 for a period of five years from the date of 16 September 2018 to 15 September 2023 related to this Building. Under the said agreement Bank has taken floors of ground, first, second, third and fourth on rental basis. Bank has agreed to pay Rs. 345,129,984 for the period of 5 years under this agreement.

engineer obtained on 17.08.2018, the structure of the building was in a stable condition and concrete core testing was not required at that stage. The Bank considered renewing the agreement for further 05 years commencing from 16.09.2018 without 5th and 6th floors with proper security arrangements. This decision was based on the time consume for the renovation of the York street building.

3.5 Human Resources Management

Audit Issue	Management Comment	Recommendation
a The Bank does not have a Schemes of Recruitment (SOR) which includes basic qualifications, method of selection, and methods of interview and evaluations criteria's etc for each position. Board of Directors grants approvals for each recruitments or promotions occasionally.	The bank has prepared the Scheme of recruitment (SOR) for the Bank and has forwarded it to the Human Resources policy Committee (HRPC) for its perusal and initial approval: Once it is finalized, it will be submitted to the BOD for its final approval.	Bank should maintain Scheme of Recruitment to facilitate proper recruitment and promotion process.