Central Bank of Sri Lanka - 2012

1. Financial Statements

1.1 Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Central Bank of Sri Lanka as at 31 December 2012**,** and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

1.2 Comments on Financial Statements

1.2.1 Accounting Deficiencies

The following observations are made.

(a) Two suspense account balances amounting to Rs. 3,535,285 had not been reconciled and cleared in the accounts.

(b) The value of a land where the White Aways building is situated had been accounted for as work-in-progress instead of being accounted for as land according to the LKAS 16. The land value of the White Aways building was Rs. 400 million.

(c) As per Section 39 of the Monetary Law Act (MLA), the profits earned by the CBSL after the appropriations and making settlement of dues from the Government of Sri Lanka should be transferred to the General Treasury within 60 days after the closure of the financial year. However, a sum of Rs. 33 billion had been remitted to the General Treasury in June, October and December 2012 as advance payments from the profit for the year under review, contrary to the provisions made in the MLA. As per financial statements a profit of Rs. 66.2 billion had been earned by the CBSL after taking into account of the net foreign exchange revaluation gain of Rs.25.2 billion. In addition, a sum of Rs. 1.35 billion had remained as recoverable from the Government as at 31 December 2012. The Assistant Governor of the CBSL had informed me that,

(i) "the profit transfers were made with the advice of the Hon. Attorney General and there is no specific bar in the Monetary Law Act for transfer of realized audited profit during the year.

(ii) they will arrange an specific external audit on realized profit on a quarterly basis and effect advanced profit transfers to be in line with such realized audited quarterly profits, subject to finalization of total profit transfer in the audited annual financial statements for the year."

(d) In terms of Section 39 (b) of the Monetary Law Act, the total shareholders' equity as a percentage of the difference between the total assets and assets in gold and foreign currencies should not be less than 15 per cent. Subsequently, in order to strengthen the CBSL's Balance Sheet and considering the economic condition of the country the Monetary Board had decided to increase this ratio to 100 per cent on 13 December 2010. However, the above ratio which was decided by the Monetary Board had not been maintained by the CBSL during the year under review. The ratio maintained by the CBSL, were ranging from 51 per cent to 60 per cent throughout the year under review against the 100 per cent requirement. The CBSL had explained that, "these capital ratios were determined by the Monetary Board from time to time as voluntary benchmarks for internal monitoring of the capital adequacy in addition to the ratio of 15 per cent as stipulated in the Monetary Law Act. However, in view of the enhancement of capital of the Central Bank to Rs. 50 billion as proposed in the Government Budget 2014, the Monetary Board has now decided to rescind the above stated voluntary ratio and to consider prescribing such a ratio annually at the time of approving of the financial statements each year if additional capital would be necessary due to new circumstances on prudential grounds. Draft amendment to the Monetary Law Act to implement the above budget proposal has already been submitted to the Ministry of Finance."

1.2.2 Accounts Receivable and Payable

The following observations are made.

(a) A sum of Rs. 480.8 million paid by the CBSL as the legal fees to foreign lawyers during the preceding years, upon the request made by the Attorney General, on behalf of the Ceylon Petroleum Corporation (CPC), had not been recovered for over two years. Assistant Governor of the CBSL had informed me that, “the amount recoverable as at end of 2013 was Rs. 333.1 million."

(b) It was observed that the refundable tender deposits, sundry creditors and contract retention amounting to Rs. 2,739,898 had remained for over 05 years in a control account. However this balance had neither been claimed by the suppliers nor transferred to the income account by the CBSL up to the end of the year under review.

2. Financial Review

2.1 Financial Results

According to the financial statements presented, the operations of the CBSL for the year under review had resulted in net profit of Rs.66,209 million as compared with the corresponding net profit of Rs. 46,830 million in the preceding year, thus indicating an increase of Rs. 19,379 million in the financial results. The net foreign exchange revaluation gain of Rs.25,182 million as compared with the gain of Rs.3,577 million in the preceding year and the net income from local currency financial asset of Rs.24,866 million as compared with the net gain of Rs. 227 million in the preceding year had been the reasons for the increase in net profit for the year under review.

2.2 Analytical Financial review

The net total operating income of the CBSL for the year under review was Rs. 75.9 billion including net foreign exchange revaluation gain amounting to Rs.25.1 billion as compared with Rs.53 billion, including net foreign exchange revaluation gain amounting to Rs. 3.5 billion in the preceding year representing an increase of 43 per cent in the net total operating income. Whereas the operating expenses including depreciation and amortization expenses during the year under review was Rs. 7.1 billion as compared with Rs. 5.5 billion of the previous year. Thus indicating an increase of 29 per cent. The changes of the revenue and expenditure of the CBSL during the year under review, as compared with the preceding year are shown below.

	2012	**2011**	**Change**	
	Rs.(Bn.)	Rs.(Bn.)	Rs.(Bn.)	%
Income from foreign currency financial assets	28.6	52.4	(23.8)	(45)
Expenses on foreign currency financial liabilities	3.7	3.9	(0.2)	(5)
Foreign exchange revaluation gain	25.1	3.5	21.6	617
Income from local currency financial assets	24.8	0.2	24.6	12,300
Operational expenses	7.1	5.5	1.6	29
Net profit for the year	66.2	46.8	19.4	41

It was observed that, the income from foreign currency financial assets had decreased by 45 per cent as compared with the preceding year and despite the fact that significant increase of income from local currency financial assets as compared with the preceding year.

3. Operating Review

3.1 Activities on Maintenance of Financial System Stability in Sri Lanka

3.1.1 Actions Taken Against the Unauthorized Financial Businesses

The following observations are made

(a) Since the year 2008, the Supervision of Non-Banking Financial Institutions (SNBFI) had been conducted through the investigations relating to the unauthorized Financial Businesses, based on the directions given by the Monetary Board and the Committee on Public Enterprises (COPE). Out of the total of 65 investigations carried out so far , following progress were reported.

(i) Forty six investigations have been concluded.

(ii) Three investigations are remaining for further action referring 01 investigation was referred to Attorney General for legal action.

(iii) Additional 06 cases had also been completed. The advice of the Attorney General was received and further clarifications have been sought in this regard.

(iv) Twenty four cases remained under investigation.

Investigation of most of the cases had been commenced in the years 2008 and 2009 and 37 per cent were being continued. The slow investigation progress had negatively affected to preclude the possible actions that would have been taken against the unauthorized financial institutions. Thus, the ongoing investigation process seems to be ineffective.

(b) Further, the Director of SNBFI had directed to publish the name and registered address of the company as an institution doing financial business in contravention of the provisions of the Finance Companies Act in the newspapers and initiate legal action against the company. Nevertheless, it was revealed in audit that the SNBFI had not taken further action against the said company even though the company had not complied with the directions issued by the Monetary Board up to end of September 2013.

(c) Having recognized the role of Micro Finance Institutions (MFIs) for the stability of the financial system in Sri Lanka and the need to establish a regulatory and supervisory mechanism for the micro finance sector, the Monetary Board had decided at its meeting held on 07 February 2006 to approve a draft Micro Finance Institution Regulatory Act formulated for the purpose of providing a legal framework for the supervision of MFIs. Further, the Monetary Board had approved at its meeting held on 17 August 2009 to establish an independent regulatory and supervisory authority to regulate and supervise MFIs in Sri Lanka. Based on the above decisions, a draft Micro Finance Bill was finalized and the draft Bill was furnished to the Cabinet of Ministers in order to submit the Bill to the Parliament.

Subsequently, on September 2013, due to the suggestions made by the Cabinet sub Committee on legislation and discussions held with CBSL, the CBSL had decided to hold the Bill without being enacted until implementing of alternative regulatory framework. According to the information made available for audit, the reason to hold the Bill was that more difficulty for the CBSL to maintain the stability of NBFIs sector if MFIs also come under the purview of the CBSL. However, according to the Monetary Law Act, the CBSL is responsible to take necessary actions in order to maintain financial system stability in the country. Also, it was observed in audit that the Department of SNBFI had temporally suspended the investigations conducted against some of the unauthorized financial businesses entities, with a view to regularize such businesses under the proposed Micro Finance Bill. Further, the Department of Rural Development of the CBSL is more emphasis on development of micro financing systems in the rural areas and there was an increasing trend relating to initiate micro Finance businesses in the country. In such a ground, the proposed Bill had been withheld without enacting, after being reached to the final stage over a period of 07 years, is questionable. However, the CBSL informed that “the legal process of such new Bills takes its normal course through the relevant authorities and the Central Bank does not have a specific control at this stage to pass the legislation."

3.1.2 Supervision on Failed Finance Companies

The following observations are made.

(a) The Monetary Board had granted the approval on 21 March 2011 to write off the outstanding loans and refinance facilities given to 13 defaulted finance companies during the period of 1998-2000, amounting to Rs. 6.1 billion. Subsequently, the Monetary Board also decided on 01 September 2011 to claim from liquidation proceeds from six failed companies which were in liquidation process, when those companies make the distributions. However, only a sum of Rs. 18.4 million had been received by the CBSL until end of September 2013. Further, even though the Committee on Public Enterprises directed to take disciplinary actions against the

Directors of those Companies, such action had not been taken up to end of September 2013.

The Assistant Governor of the CBSL had informed me that, " the Central Bank submitted due diligence reports on failed finance companies to the Attorney General and reminders were also sent. In 1988/89 there was no specific legal framework for regulatory mechanism for finance companies. The Central Bank took several measures including refinance facilities to crisis-hit finance companies in the national interest in view of conventional wider financial/economic stability responsibilities of a Central Bank to prevent adverse contagion of crisis and loss of depositor confidence across the financial and economic system, given specific circumstances / reasons that prevailed at that time. The Finance Companies Act did not have specific powers to take legal action against the Directors of those failed finance companies .Since there was no prior regulatory mechanism, legal action should be taken under normal laws. Therefore, legal documentary evidence required for taking such legal action even by the Attorney General may not be available. Further, those Directors as well as the officials involved in this subject may not be alive now or not traceable. Attorney General not taking legal action could be due to such legal impediments. Therefore, pursuing for taking legal action could not be viable at this stage and such attempts could be a cost to public funds.”

(b) A finance company having liabilities to depositors’ amounting to Rs. 3.5 billion was bankrupt during the year under review. According to the information made available to audit, following observations are made with regard to supervision of the company.

(i) In the year 2009, an investigation was conducted by the Department of Supervision of Non-banking Financial Institutions (DSNBFI). However, the files relating to the investigations had been misplaced by the DSNBFI and evidence with regard to report to the Monetary Board had not been furnished to audit.

(ii) Another investigation was conducted in the year 2011. Matters relating provision for bad and doubtful debts, maintaining of required liquid assets, taking of accrued interest as income, violation of the single borrowing limit and the reporting requirements, reporting of incorrect cash and bank balances, etc. had been reported to the Monetary Board. However, the details of actions that were taken against the company had not been furnished to audit.

(iii) Subsequent investigation was also made during November 2012 and serious irregularities were reported to the Monetary Board. Particularly, in maintaining of negative assets base, related party transactions amounting to Rs. 632.38 million, utilization of the funds obtained from the initial public offer amounting to Rs. 48.45 million to purchase the shares on behalf of the Group Chairman, accounting of fictitious assets around Rs.228.6 million, payment of excessive fixed deposits interest amounting to Rs.18.28 million etc. were reported.

(iv) Based on the above matters, the Monetary Board had directed to take number of actions, giving particular attention, to lodge a complaint at the Criminal Investigation Department against the Chief Executive Officer on suspected misappropriation of the funds, to inform the responsible parties to take action to transfer the assets that have been acquired by the parent company and its related parties, to reduce remunerations of all Directors and appointed new Directors based on their willingness to infuse capital, and to appoint another finance company as a Managing Agent under Section 25(1) (F) of the Finance Business Act of 2011.

(v) Before reporting the above matters by the DSNBFI in November 2012, the independent auditors had also reported a number of instances of deviation from the directions given by the DSNBFI since the year 2009. Particularly, in investment in the Parent company over Rs. 1,500 million and payments made to the Directors and other related parties, non-compliance with liquid assets requirement and requirement to invest in Sri Lanka Government Treasury Bills and Securities and the CBSL Securities, and provision for bad and doubtful debts etc. were highlighted.

3.2 Regional Development Activities

The Regional Development Department (RDD) of the CBSL continues in providing refinancing facilities to the Participating Credit Institutions (PCIs) through Revolving Funds and Credit Schemes established in the various regional development sectors such as agriculture, micro and medium level enterprises and micro finance etc. According to the financial statements presented, 24 Revolving Funds / Credit Schemes had been completed during the preceding years granting Rs.28.4 billion and there were 20 ongoing Revolving Funds/ Credit Schemes. Allocated funds for the ongoing Revolving Funds / Credit Schemes up to end of the year under review was Rs. 18.8 billion. Separate financial statements had been prepared annually for each of the Revolving Fund / Credit Scheme.

(a) Even though separate Revolving Funds/ Credit Schemes had continued, outcome of the Projects had not been evaluated in order to monitor the Projects performance as in expected manner. However, the Assistant Governor of the CBSL had informed that, "the outcome of the project is evaluated only for donor funded projects upon completion of projects if such a condition is imposed in the Agreement. Outcome evaluation involves a separate cost to undertake socio-economic surveys of beneficiaries."

(b) The actual financial performance of 20 revolving funds/ credit schemes for the year under review, as compared with the budgeted allocations, some of the Revolving Funds/credit schemes had not shown satisfactory progress on disbursements of refinance loans to the intended parties. Details of such revolving funds/ credit schemes are given below.

Revolving Fund/ Credit Scheme	Budgeted allocation for the year 2012 Rs.(Mn)	Amount disbursed as at 31 December 2012 Rs. (Mn)	Variance Rs. (Mn)	%
Provincial Development Loan Scheme	530	340	190	36
Poverty Alleviation Microfinance Project II	904	652	252	28
Mandatory Lending to Agriculture Sector (Viskam) Loan Scheme	744	524	220	30
Tea Development Project Revolving Fund (TDP-RF)	300	131	169	56

3.3. Currency Management

The following observations are made.

(a) The Currency Department (CD) of the CBSL had launched a Project for recycling of old high valued coins in denominations with Rs. 5 and Rs. 2 in 2007 and 2008 in view of earn income from recycling of high valued coins. However, out of 10.75 million coins, 3.25 million pieces and 2.39 million pieces of high valued coins in denomination with Rs. 5 and Rs. 2 respectively had remained unsold as at 31 December 2012.

The Assistant Governor of the CBSL had informed me that “a decision had been taken not to recycle until the international metal prices increase to high level.”

(b) It was observed that the movement of the stock of several commemorative coins were very slow, thus indicating that lower public demand thereon. The stock position of such commemorative coins remained in the vaults as at 31 December 2012 are given below.

Description	Year of issue	Face Value Rs.	No.of coins minted	No. of coins remained in the Vaults as at 31 December 2012
2500 Buddha Jayanthi	1957	5	500,000	20,168
3rd Anniversary of Induction of President R. Premadasa	1993	1	2,500	803
50th Anniversary of UNO	1995	5	5,000	3,959
50th Anniversary of Independence of Sri Lanka	1998	1,000	25,000	6,685
Cricket World Cup- 1996	1999	1,000	25,000	10,164
2550 Buddha Jayanthi	2006	2,000	10,000	8,444
2550 Buddha Jayanthi	2006	1,500	20,000	18,697
Cricket World Cup- 2007	2008	1,000	10,000	8,007

3.4 Human Resources Management

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The following observations are made.

(a) The CBSL Employees and Pensioners Distress Relief Fund (EPDRF) had been established for the purpose of granting financial assistance to the employees and the pensioners of the CBSL who are member of the Fund facing financial difficulties due to sudden terminal illness, major surgeries and prolonged illness where the cost of such treatments in excess of the benefits which such employee or pensioner entitled to claim under other three medical benefit schemes of the CBSL. The collection for the EPDRF is made through proceeds of the sale of immovable assets of the CBSL under the Monetary Board approval to transfer of such funds, sale of unusable items, donations, enrollment fees of the members and the investment income. The Director of Welfare shall maintain separate accounts for the Fund. Total contribution of the Fund as at 31 December 2012 was Rs. 40.18 million and number of members stood at 846 in service and 874 pensioners. Following matters were observed in this regard.

(i) According to the Rules of the EPDRF, the Director of Welfare should have to prepare annual financial statements and it should be audited by the Director of Management Audit of the CBSL and the audited financial statements should be submitted to the Monetary Board. It was observed that the financial statements for 2012 had been prepared and not submitted the audited financial statements to the Monetary Board.

(ii) Funds had not been utilized for the intended purposes since inception of the Fund and total contribution of Rs. 40.18 million had been invested in the government securities.

Assistant Governor of the CBSL had informed me that "the specific reason for not utilizing the Fund is that, as per the decision of the Monetary Board dated 15 th June, 2006, the funds should not be utilized until the size of the Fund reaches Rs. 100 million. However, the Monetary Board has now (in 2013) decided to reduce this limit to Rs.30 million to preserve the capital and to increase the fund periodically with new members and other sources. Therefore, the Fund now exceeds Rs. 30 million and financial assistance now could be granted to eligible members. The outstanding fund is invested in Govt. securities to earn interest income to the Fund with safety of funds."

(b) The CBSL had paid the PAYE Tax liability of its staff members during the year under review too, as a practice, contrary to the direction given by the Committee on Public Enterprises (COPE) and the provisions in the Inland Revenue (Amendment) Act, No 24 of 1997. It was observed that PAYE Tax aggregating Rs. 138.9 million and Rs. 108.8 million had been paid for the year under review and for the preceding year respectively by the CBSL on behalf of its employees. The employees of the CBSL during the year under review were 1,495 in service and 1,983 retired employees.

3.5 Contract Administration

The following observations are made.

(a) In order to renovate the Central point Building, the Expression of Interest (EOI) had been called from the consultancy firms and in response, 14 firms had expressed their interest out of which 9 firms had been selected as qualified firms. Contrary to the selection procedure, a firm which was not submitted an EOI had been selected as a consultant of the renovation works without having reasonable ground to the selection. Further, a sum of Rs.12,014,920 had been paid to the firm up to March 2013. The selected consultancy firm was responsible to prepare the cost estimate for the renovation works, and their cost estimate was Rs. 571 million. However, the estimate had later been revised and reduced to Rs. 300 million. Hence, the accuracy of the cost estimate and professionalism of the selected firm may be questionable. Subsequently, the estimated cost of Rs. 300 million had exceeded by Rs.175 million. However, details of the cost estimates had not been made available to audit.

(b) Fixing tiles to the floor of the Lloyds building had been carried out for Rs. 5,078,514 without being called for tenders and without being prepared cost estimates and bills of quantities.

(c) A circuit bungalow had been constructed by the CBSL in the Somawathi National Park in Polonnaruwa District. According to the memorandum of understanding with the Wildlife Conservation Department, it was agreed to collaborate with each other construction, establishment and maintenance of the bungalow. Sums of Rs. 59.8 million and Rs. 6.2 million had been spent by the CBSL for the bungalow and wildlife office respectively. After 30 years of lease period, the building has to be transferred to the Wild Life Conservation Department. However as per the records maintained by the Facilities Management Department of the CBSL, the bungalow had been occupied only in 52 occasions during the year under review and earned only Rs.386,500 as occupancy charges.

3.6 Matters of Contentious Nature

The following observations are made.

(a) The CBSL had entered into an agreement for Currency Swap arrangement with the Central Bank in Malaysia (Bank Negara, Malaysia) in order to mitigate the risks on depleting condition of the foreign reserves of the country and a facility of USD 200 million had been obtained in February 2009 and during the year under review. According to the agreement, the SWAP transaction would be renewed within a period of three months by mutual consent and interest based on London Interbank Offered Rate (LIBOR) to be paid on the transactions taken place quarterly. It was observed in audit that the CBSL had spent a sum of Rs. 824.6 million as interest up to end of the year under review on Currency SWAP transactions from the year 2010 without considering to terminate the agreement though the foreign reserves of the CBSL had been increased since the year 2010. The Assistant Governor of the CBSL had informed me that, " this agreement would expire on 9 February 2013"

(b) The CBSL had acquired the leasehold right on 133.98 perches of the Transworks Square Land for a period of 99 years, by spending a sum of Rs. 100,485,000, with effect from 02 June 2000 for the use of the Land as a vehicles park for the vehicles of the CBSL and staff officers. Subsequently, the block of the land was re-possessed by the Urban Development Authority (UDA) with a view to implement a development project with a foreign investor, without canceling lease agreement signed in the year 2000. Further, the UDA had not entered into a new agreement with the CBSL in order to settle the lease consideration. The book value of the leasehold land as at end of the year under review was Rs. 88,558,750. According to the CBSL's estimate market value of the land was about Rs. 1,200 million.

Nevertheless, the recoverability of receivable amount from the UDA or from the investor is doubtful due to the uncertainty of the negotiations made by the CBSL.

(c) The CBSL had purchased a building in Baron Jayathilaka Mawatha, Colombo-1 (White Aways Building), for Rs. 500 million based on the valuation made by the Government Valuer, from the Ministry of Public Administration and a sum of Rs. 13.67 million had been spent for the renovation of the building. However, legal ownership of the building had not been transferred to the CBSL up to end of October 2013 even after lapse of over one year from the date of the purchase. According to the decision made by the senior management of the CBSL, the purposes of the acquisition of this building were to have additional premises at separate locations as a risk management measure and to facilitate the expansion of some Department of the CBSL. Nevertheless, on the ground of available extra building spaces to the CBSL in the main building premises as well as at two separate buildings which were already acquired, the decision to acquire another building for the purpose of risk management measures may be a questionable matter. The Assistant Governor of the CBSL had informed me that "the building was acquired to meet the medium and long term expansion of the CBSL"

(d) Based on the approval granted by the Monetary Board on 10 January 2011, the CBSL had purchased a building in New York for US$ 5,807,116 and a sum of US$ 400,000 had also been spent for refurbishment work of the building. However, contrary to Section 117 of the Monetary Law Act, this building had been rented out to the Ministry of Foreign Affairs for a three years period commencing from 01 June 2012 at a monthly rental of US$. 68,000.