

**1.1 Opinion**

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The audit of the financial statements of Central Bank of Sri Lanka (the “Bank”), which comprise the statement of financial position as at 31 December 2019, and the statements of income, statement of 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 provisions of the National Audit Act No. 19 of 2018, Section 13(1) of the Finance Act, No. 38 of 1971 and Section 42(2) of the Monetary Law Act (Chapter 422). My comments and observations which I consider should be report to Parliament appear in this report. To carry 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 2019, 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**

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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 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 and Those Charged with Governance for the Financial Statements**

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Monetary Board 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 unless management either intends 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.

### 1.3 Auditor's Responsibilities for the Audit of the Financial Statements

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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 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's 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.

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.

## 2. Financial Review

### 2.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year under review had resulted in a net profit of Rs.55.6 billion as compared with the net profit of Rs. 137.9 billion in the preceding year, thus indicating a deterioration of Rs. 82.3 billion in the financial results. Decrease of foreign exchange revaluation gain by Rs.161.4 billion was the main reason attributed for this deterioration in the financial results.

### 2.2 Trend Analysis of major Income and Expenditure items

Analysis of major income items and major expenditure items of the Bank during the year under review, as compared with the preceding year are shown below.

	2019	2018	Variance [Favorable/(Adverse)]	
	Rs. Bn.	Rs. Bn.	Rs. Bn.	percentage
<b>Income from Foreign Currency Financial Assets</b>	<b>76.9</b>	<b>3.2</b>	<b>73.7</b>	<b>2,303.1</b>
Interest Income	32.9	25.5	7.4	29.0
Gain/(Loss) from Unrealized Price Revaluations	42.9	(18.2)	61.1	335.7
Gain/(Loss) from Realized Price Changes	1.1	(4.1)	5.2	126.8
<b>Expenses on Foreign Currency Financial Liabilities</b>	<b>8.5</b>	<b>5.4</b>	<b>(3.1)</b>	<b>(57.4)</b>
Interest Expense	8.3	5.3	(3)	(56.6)
Expected Credit Losses	0.2	0.02	(0.18)	(900.0)
<b>Net Foreign Exchange Revaluation Gain/(Loss)</b>	<b>(14.6)</b>	<b>146.8</b>	<b>(161.4)</b>	<b>(109.9)</b>
<b>Total Net Income/(Expense) from Local Currency Financial Assets</b>	<b>14.0</b>	<b>6.2</b>	<b>7.8</b>	<b>125.8</b>
<b>Other Income</b>	<b>1.7</b>	<b>1.7</b>	<b>-</b>	<b>-</b>
<b>Operating Expenses</b>	<b>13.6</b>	<b>13.5</b>	<b>(0.1)</b>	<b>( 0.7)</b>
<b>Tax</b>	<b>0.3</b>	<b>1.1</b>	<b>0.8</b>	<b>72.7</b>
<b>Profit/(Loss) for the year</b>	<b>55.6</b>	<b>137.9</b>	<b>(82.3)</b>	<b>(59.7)</b>

(a) As per Section 41 of the Monetary Law Act, foreign exchange revaluation gain or loss shall not be included in the computation of the annual profits and losses of the Bank. Therefore, the profit for the year under review was Rs.70.2 billion (excluding net foreign exchange revaluation loss of Rs. 14.6 billion) as compared with the loss of Rs. 8.9 billion (excluding net foreign exchange revaluation gain of Rs. 146.8 billion) in the preceding year, thus indicating an improvement of Rs.79.1 billion in the profit. Increase of income from foreign currency financial assets by Rs.73.7 billion and increase of net income from local currency financial assets by 7.8 billion were the main reasons attributed for this improvement in the profit.

(b) The distributable profit for the year under review as determined in terms of Sections 38 and 41 of the Monetary Law Act and profit distribution policy of the Bank approved by the Monetary Board (effective from 2018) was Rs.25.4 billion as compared with no any distributable profit in the preceding year. Accordingly, a sum of Rs.24 billion had been distributed to the Consolidated Fund out of the distributable profit for the year under review as compared with no any amount had been distributed to the Consolidated Fund in the preceding year.

### 3. Operating Review

#### 3.1 Operational Inefficiencies

Audit Issue	Management Comment	Recommendation
<p><b>a. The Financial Sector Consolidation Programme</b></p> <p>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 21 institutions including Banks, Financial companies and Leasing companies had been completed as at 30 June 2020 by spending Rs.78 million. However, the Consolidation Plans with 12 institutions had not been completed even up to the end of June 2020, though the Bank had incurred a sum of Rs.49 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 Plan.</p>	<p>With the changes in Government Policy after 2015, the Monetary Board decided to suspend the involvement of the Bank in the consolidation Programme.</p> <p>Currently, 4 Licensed Finance Companies (LFCs) which have already initiated the consolidation plan in 2014 are in the process of completing the transaction.</p>	<p>To take possible actions to complete the incomplete Consolidation Plans.</p>

**b. Regulating and Supervising of Finance Companies**

- i. Finance Companies are regulated and supervised under the Finance Business Act, No.42 of 2011 by the Monetary Board of the Bank. 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 directions had not been issued with regard to cover the eight matters completely as referred to in Section 12 (1) of the Finance Business Act even up to the end of October 2020.
- General Directions on business operations of the LFCs so far have been issued depending on the requirements of the entire Non-Bank Financial Institutions sector. However, when conducting statutory examinations/ off-site surveillance, if the Bank observes that companies are not applying proper risk management practices and do not have proper business conducts, specific company related Directions are issued based on the findings, on case by case basis.
- To take necessary actions to issue directions which are important for regulation and supervision of finance companies before issues happened.
- It was further observed that directions on the above matters especially directions on maximum interest rates charged on loans, credit facilities or other types of financial accommodation granted by such companies, directions on the payment to directors or employees of such companies and directions on the maximum percentage of the share capital in a finance company which may be held by the persons are important for regulation and supervision of finance companies.
- In addition, the Monetary Board had issued a direction to the licensed commercial banks and licensed specialized banks to reduce interest rates on credit card advances and pawning advance given by them with effect from 24 August 2020. However, direction had not been issued to finance companies registered under Finance Business Act No. 42 of 2011 which are providing credit card advances and pawning advances though such an authority is given under the said act.
- ii. Winding up process of the three finance companies which licenses were cancelled by the Monetary Board of the Bank in the year 2018 and 2019 have not been initiated (Liquidators have not been appointed) even up to 31 October 2020. A direction was
- The Bank is waiting for court orders relating to the two finance companies in order to proceed the liquidation process.
- The license issued to a LFC
- To take necessary actions to expedite the winding up process.

made to a finance company which license was cancelled with effect from 05 March 2018 to initiate winding up process within 30 workings days from the date of cancellation and the said company failed to initiate winding up process within the said time frame. In such a situation, action for winding up can be filed as per the Section 37 (6) of the Finance Business Act, No.42 of 2011 by the Director of Department of supervision of non bank financial institutions. However, applications for winding up had been filed at Colombo Commercial high court on 03 December 2019.

was cancelled by the Monetary Board in 2019 and directed the Board of Directors of the company to initiate winding up process of the company, within 30 days from the date of 09.10.2019. Accordingly, the company filed a winding up application in Commercial High Court on 08.11.2019 and the same is currently being heard.

Also, a direction was made to another finance company which license was cancelled with effect from 25 July 2018 to initiate the winding up process within 30 workings days from the date of cancellation and the said company failed to initiate the winding up process within the said time frame. However, applications for winding up had been filed at Colombo Commercial high court on 07 October 2020.

**c. Regulating and Supervising of Leasing Companies**

i. Leasing Establishments are regulated and supervised under the Finance Leasing Act, No.56 of 2000 by the Monetary Board of the Bank. As per the Section 34 of the Finance Leasing Act, the Director of the Department of Supervision of Non-Banking Financial Institution shall have the power to issue such general directions, as he may consider necessary for the purpose ensuring that registered establishments maintain efficient standards in carrying out their duties. However, it was observed that directions had not been made with regard to cover the four matters completely as referred to in Section 34 of the Finance Leasing Act even up to the end of October 2020.

General Directions on business operations of the Leasing Companies are issued as and when necessary. However, when conducting statutory examinations/ off-site surveillance, if the Bank observes that companies are not applying proper risk management practices and do not have proper business conducts, specific company related directions are issued based on the findings, on case by case basis.

To take necessary actions to issue directions which are important for regulation and supervision of leasing companies before issues happened.

It was further observed that directions on the above matters especially directions on maximum rate of payments to be levied by

registered establishments are important for regulation and supervision of leasing companies.

- ii. As per the Finance Leasing Act, No.56 of 2000, duties of lessors, lessees and supplier are described from the clause number 11 to 31. As per the clause number 11, only right of the Lessee is the undisturbed and peaceful possession of the equipment provided to the lessee under a finance lease. As per the clause number 15, upon the expiration of the period of a finance lease, the lessee shall return the equipment to the lessor in the condition in which it was delivered to the lessee subject to fair wear and tear and to any modifications agreed to by the parties to the finance lease. As per the clause number 20, at any default of the lessee, the lessor has right to recover possession of the equipment provided and recover such damages as would place the lessor in a position the lessor would have been if the lessee had complied with the provisions of the finance lease.

As per the provisions included in the Act, the all benefits such as possession of the equipment, recovered money and if any recovered damages whether or not the lessee has paid the due amount as scheduled under finance lease are entitled to the lessor and overall responsibilities under finance lease are assigned to the lessee. Therefore, it may be required to review the Act for identifying the necessity to do any amendments to the Act.

- d. **The Licensing, Regulation and Supervision of Companies carrying on Microfinance Business**

The Licensing, Regulation and Supervision of Companies carrying on Microfinance Business are carried out by the Monetary Board of the Bank under the Microfinance Act, No 06 of 2016 with effect from 15 July 2016. Companies which are accepting deposits and providing financial services mainly to low income persons and micro

The Bank will examine provisions in the Finance Leasing Act and will amend, if necessary.

To expedite the process of amending the Finance Leasing Act, if necessary.

In order to license, regulate and supervise entities engaged in the businesses of microfinance and moneylending, it has been proposed to establish a Credit Regulatory Authority through an Act of Parliament namely Microfinance and Credit Regulatory Authority Act (the Proposed Act). Approved draft

To take necessary actions to regulate and supervise the micro finance companies which are not coming under the purview of the existing Microfinance Act.

enterprises (Micro Finance Business) should obtain a license under the Act. Accordingly, only four companies had obtained the licenses to carry on microfinance business from the effective date of the aforesaid Act to the end of August 2020. Companies which are not accepting deposits but providing financial services to low income persons and micro enterprises in the country do not require to obtain a license under the Act. Therefore, those companies are not regulated and supervised by the Monetary Board of the Bank under the Act.

‘Microfinance and Credit Regulatory Authority Act’, has been forwarded for the consideration of the Ministry of Finance on 26.09.2019 in drafting of the Proposed Act.

e. **Public Debt Management**

i. The objective of the Public Debt Department of the Bank is to ensure that the government’s financing needs are met at the lowest possible cost consistent with a prudent degree of risk. However, Treasury bills, Treasury bonds and Sri Lanka Development Bonds issued during 2018 could not be issued in some instances at the lowest possible cost consistent with a prudent degree of risk. It was observed that the accepted yield rates of 14 Treasury bill issuances in 2018 were above the yield rates determined in the secondary market for similar maturities ranging from 05 basis points to 71 basis points. It was further observed that accepted yield rates of 16 bonds out of the 22 Treasury bonds issuances in 2018 were above the yield rates in the secondary market for similar maturities ranging from 4 basis points to 84 basis points. It was further observed that the accepted yield rates of 10 bonds out of the 16 Sri Lanka Development Bonds issuances in 2018 were above the yield rates determined in the secondary market for similar maturities of the Sri Lanka Sovereign Bonds ranging from 24 basis points to 126 basis points.

All Tender Board decisions are taken after giving due consideration to macroeconomic environment, Treasury’s funding requirement, bidding pattern, market conditions and market developments that prevailed at the time of the auction.

To take all efforts to raise fund to the government at the lowest possible cost consistent with a prudent degree of risk in all instances.

The Treasury’s tight funding requirement too drives the Tender Board decisions with regard to the amount to be accepted from a particular auction and the corresponding cut-off and Weighted Average Yield Rates (WAYRs). In the prevalence of Treasury’s tight financing environment, the required funding needs to be raised even at a higher cost to facilitate Treasury’s cash flow management.

Developments in international capital markets have an effect on the rate expectation for Sri Lanka Development Bonds (SLDBs), thus it is not advisable to compare International Sovereign Bond (ISB) secondary rates only



with that of the SLDB yields. SLDBs are mainly a domestic debt instrument whereas ISBs are external debt instrument.

Domestic foreign currency liquidity, exchange rate behaviour and domestic market developments also drives SLDB cost of financing.

In 2018, particularly towards latter part of 2018, all government securities yield rates have increased including SLDBs where even the volume offered could not be accepted due to market developments/ conditions.

- ii. At the situation where bids were presented at the yield rates more than the yield rate determined at the previous auction with similar maturities, the yield rate determined in the secondary market for similar maturities and two way quotes for similar maturities, it was observed that the savings / advantage (avoidable loss) which could have been obtained by accepting 60 percent or more under the phase I and issuing the remaining balance under the phase II and phase III instead of accepting full offered amount under phase I according to the new Treasury Bond Auction System, had not been obtained. Accordingly, a detriment / loss of Rs. 1,661 million could have been avoided in three Treasury bonds issuances in 2018.

Having deliberated the arrangement among stakeholders, it was agreed at that meeting to mandate the Tender Board to accept all reasonable market bids within the offered amount at Phase I notwithstanding issuances to be made under Phase II or III of the issuance process.

To utilize the all available options to raise funds to the government at the lowest possible cost consistent with a prudent degree of risk.
- iii. For the phase III (mandatory allocations to the primary dealers at weighed average yield rate determined in phase I) of the Treasury bond auction to take effect, 60 percent from the offered amount must have been accepted under the phase I. This clause had been revised to 70 percent in force from 09 July 2019 by the Superintendent of Public Debt. It was observed that raising the 60 per cent limit to 70 per cent would further limit the

The Monetary Board at its meeting held on 04.06.2019 approved the rationale for enhancing the minimum acceptance level at Phase I to trigger Phase III, from 60% to 70% was to further enhance the establishment of a market cleared price/ yield under Phase I as well as considering

To take all efforts to raise fund to the government at the lowest possible cost consistent with a prudent degree of risk.

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| availability of fund raising to the government at the lowest possible cost consistent with a prudent degree of risk.  | the feedback from the market participants on activation of Phase III.  |  |
| iv. It was not verified the transparency in the final pricing of Sovereign bonds due to lack of maintenance of documents and / or audio recordings to reviewing the role played by the Steering Committee and the Governor of the Bank in determining the final price of the Sovereign bonds at the International Sovereign bonds Auction.  | Cabinet of ministers authorize the Governor to make pricing decisions for the bond issuance. In practice, the Steering Committee/ Tender Board and the Ministry of Finance (MoF) are also represented in the pricing decisions made during the conference calls. | To take necessary actions to ensure the transparency in the final pricing of Sovereign bonds.  |
| v. According to Section 113 of the Monetary Law Act (MLA), the Central Bank of Sri Lanka is responsible for the management of public debt. However, the Monetary Law Act or any other written law does not define the types of debt that public debt includes, or the definition of public debt, the purposes and functions of public debt management.  | An appropriate response for this observation could be obtained from the MoF as the principle of public debt. The Bank performs an agency function with respect to public debt management as per the MLA.   | To take necessary actions to define the types of debt that public debt includes, or the definition of public debt, the purposes and functions of public debt management. |
| vi. Cash requirement for borrowing and the sources of borrowing are determined by the Department of Treasury Operations. Based on the said cash requirement including sources of borrowing, monthly borrowing program is recommended by the Domestic Debt Management Committee of the Bank and it is approved by the Governor of the Bank. Accordingly, the Public Debt Department of the Bank conducts the auctions for issuances of Treasury bills, Treasury bonds, Sri Lanka Development bonds and International Sovereign bonds. The Bank reports the outstanding Central Government debt using the loan information on the said issuances of government securities and the loan information received from the Ministry of Finance and the Departments of the Bank on the other loans which are obtained on behalf of the government by the respective parties. However, it was not observed that the Bank got confirmed the accuracy of bank | Central Bank compiles details of public debt directly from its own sources and through secondary sources.  | To take necessary actions to confirm the accuracy of bank overdraft balances and outstanding foreign loans other than outstanding international sovereign bonds.         |

overdrafts balances and outstanding foreign loans other than outstanding international sovereign bonds.

## vii **Unsound Practices of a Primary Dealer**

Through the examinations conducted by the Public Debt Department (PDD) since 2011 to 2015 on a particular Primary Dealer Company (PD), many violations of laws and regulations/directions which are mandatory to be followed by any PD had been observed. Major violations of the said PD observed by PDD are as follows.

- Most of the reverse repos (lending by the said PD) are with the holding company of the said PD.
- Failed to obtain adequate securities against reverse repo lending.
- Non availability of a contingency funding plan while maintaining high negative overnight mismatch.
- No signed Master Repurchase Agreements with customers.
- Inadequate securities provided for repo borrowing from customers

Violations such as inadequate securities provided for repo borrowing from customers had been repeated due to not taking serious actions against the said PD by the Bank.

Finally, the Bank had entrusted the management of the said PD to a Government Bank on 04 January 2016. Unrecoverable amount of investment with accrued interest to the Customers due to Security shortage for repo borrowing was Rs.7.2 billion as at 04 January 2016. Out of total irrecoverable amount, Rs. 2.1 billion was appeared to be irrecoverable to the four departments of the Bank which handle internal funds.

Any amount of the above mentioned unrecoverable amount of investment had not been recovered by the customers including

The Bank has initiated following measures to improve the safety of investors in government securities.

- Supervision of PDs assigned to the Department of Supervision of Non-Bank Financial Institutions
- The laws and regulations relating to supervision of PDs are being reviewed to strengthen the regulatory framework of PDs.
- System of sending SMS and e-mail notification to investor when there is a movement in the securities account.
- Issued a direction on mandatory allocation of Government Securities for Repo and Re-repo transactions incorporating penalties for non-compliances.

To take possible actions to recover the loss to the Investors and take necessary actions to prevent such incidents in future.

the four departments of the Bank even up to the end of October 2020.

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| viii | <p>Limitations of Lanka Settle System which is facilitated for the fund settlements; scripless securities settlement and recording the ownership of the Government securities transactions observed during the audit are as follows.</p> <ul style="list-style-type: none"> <li>• Securities held in CSL security account (Outright Purchase) can be removed by a primary dealer without having the consent of the customer (No any restriction in Lanka Secure System is introduced).</li> <li>• Difficulty in identifying the owner of the securities which are recorded under CRP security account.</li> <li>• Difficulty in identifying the beneficiary of coupon proceeds and maturity proceeds paid by the Bank on the securities recorded under CRP security account.</li> <li>• Not being recorded relevant information such as expected amount, return date and return price of Repo transactions between the primary dealer and their customers in Lanka Secure System.</li> <li>• No any restriction in Lanka Secure System to avoid removing allocated securities without substituting another security for Repo transactions.</li> </ul> | <p>PDD has introduced a real-time notification of movement of scripless government securities from 25.03.2019 onwards.</p> <p>Web based access to their securities account, is also made available to the customers in order to view the activities related to their securities account during any time (24x7).</p> <p>Imposing restrictions in the LankaSecure system for unauthorized removal of security allocations is technically not feasible as the system is not sensitive to recognize unauthorized removal vis-à-vis authorized removal.</p> | <p>To take necessary actions to mitigate violations that could be made by any PD for the purpose of protection the Investors.</p> |
| ix   | <p>Section 2.2 of Lanka Settle System Rules Version 2.1 (2013) which was issued for the operations of the Lanka Settle System by the Bank stated that fines can be imposed against Primary Dealers when a Primary dealer violates rules and regulations that they are required to follow. Further, as per the Section 8 of the Registered Stock and Securities Ordinance and Local Treasury Bills Ordinance Direction No. 01 of 2019 dated 20 December 2019 (Repurchase and Reverse Repurchase Transactions), penalties can be imposed against Dealer Direct Participants (DDP) for non-compliance with the said direction. However, fines/penalties had not been imposed against any Primary Dealer or</p>   | <p>The Legal and Compliance Department (LCD) has raised concerns over the legality of imposing penalties through subordinate legislation (i.e. Regulation and Direction issued based on the Acts under reference) in the absence of explicit empowerment to impose such penalties directly through the said Acts. In this regard, The Bank will consider alternative arrangements to address the said matter. Amendments to this effect have been included in the</p>  | <p>To take necessary actions to address the said matter.</p>  |

- DDP as the Bank was unable to enforce the said provisions.
- proposed Registered Stock and Securities Ordinance amendments (RSSO).
- x The Monetary Board instructed the PDD in September 2015 to develop an appropriate framework to impose fines against Primary Dealers who act against the interest of customer. However, such appropriate framework had not been developed even up to the end of October 2020.
- A committee prepared amendments to Regulations issued under RSSO and Local Treasury Bill Ordinance and these have been referred to the Attorney General's Department.
- To develop appropriate framework to address the said matter.
- xi As per the Section 4 of the Registered Stock and Securities Ordinance No. 07 of 1937 as amended, the Minister in charge of the subject of Finance shall, in respect of each loan (issuance of treasury bonds) to be raised under this Ordinance, specify by Order published in the Gazette. However, such kind of order for the year 2018, 2019 and 2020 had not been published in the Gazette even up to the end of June 2020. Further, order for the year 2008 to 2017 had been published in the Gazette in the immediately succeeding year based on the actual results of the issuance of Treasury Bonds in contrary to the Section 4 of the Ordinance.
- Relevant amendments to RSSO have been proposed.
- To comply with the said provision of the Ordinance or to take necessary actions to amend the Ordinance.
- f. The Asian Clearing Union (ACU) is a mechanism to settle, on a multilateral basis of payments for intra-regional transactions among participating Central Banks of Asia and Pacific region. Net settlement position of each ACU participant is calculated based on the daily outstanding balance held over the two months period and settlement will take place within four working days of the following month. Interest rate was spread between 1.6 percent and 2.51 percent during the year under review (2018 – 1.45 percent and 2.28 percent). All credits to accounts of the Bank relating to the settlement under ACU mechanism should be made on the respective value dates by the licensed commercial banks in Sri Lanka and the Bank invests holding amounts to be settled at the end of the two months. Accordingly, the Bank had paid a sum of USD 9.17 million
- In terms of the ACU procedure rules, the Bank as the borrower is required to pay for the borrowed funds at one month USD deposit rate published by the Inter-Continental Exchange (ICE). The rate of interest applicable for the settlement period will be the closing rate on the first working day of the last week of the previous calendar month. However, the investments of these funds occur throughout the settlement period at the deposit rate available in the market from highest rated counterparties. This creates
- To take possible actions to reduce the additional interest expense on the ACU.

(Approximately Rs.1,638.8 million) for the year under review and a sum of USD 5.98 million (Approximately Rs.992 million) for the preceding year as interest expense to ACU. However, investment income earned using holding amounts for the year under review and for the preceding year was USD 5.19 million (Approximately Rs. 929.9 million.) and USD 3.22 million (Approximately Rs. 534.5 million.) respectively. Therefore, the Bank had incurred an excess expense amounting to USD 3.98 million (Approximately Rs. 708.9 million.) for the year under review and USD 2.76 million (Approximately Rs. 457.5 million.) for the preceding year under ACU mechanism.

inherent disparity in interest paid and received due to market conditions.

It does not operate with a profit motive. In addition, accumulation of ACU balances in two-monthly cycles provide some additional short-term liquidity and enhance levels of external reserves during the period.

- g. 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. However, the Bank had not specified situations where orders can be placed with existing suppliers.

The approval of Cabinet of Ministers has been granted for the Monetary Board with discretionary power to decide most appropriate procedure for the procurement of coins and to decide whether to call for international tenders or to place orders with existing supplier when minting of coins.

To take necessary actions to address the said matter.

h. **Projects managed by the Regional Development Department**

It was observed that aggregate retained earnings amounting to Rs. 1.4 billion as at the end of the year under review relating to the 8 projects which had been funded by the Bank (as per the Note No. 56.7 to the financial statements for the year ended 31.12.2019) were not reflected in the financial statements of the Bank.

The board decision dated 16/03/2020, the Monetary Board decided that the Bank does not own the loan schemes maintained by Regional Development Department (for which the initial seed funds were provided by the Bank) and the Bank only acts as the custodian for the said loans. Accordingly, the respective assets, income and expenses related to these loan schemes are only recorded in the individual financial statements of the respective schemes and not in the Bank's financial statements.

To take necessary actions to address the said matter.

**i. Investments made by the departments of the Bank which handle internal funds**

The special audit report on the investments in Reverse Repurchase Transactions (Re-repo investments) with a Primary Dealer (PD) by the four departments of the Bank which handle internal funds (That is, Regional Development Department, Bank Supervision Department, Finance Department and Staff Services Management Department) had been submitted to the Governor of the Bank on 30 September 2019. The common and main observations relating to the said four departments of the Bank included in the special audit report are summarized as follows.

As per the guidelines for investments approved by the Monetary Board at its meeting held on 19 August 2010, security allocations for Re-repo investments shall be checked in the Central Depository System (CDS) by the investor on confirmation of investments. However, it was not observed any evidence that the said departments had checked the security allocations for Re-repo investments made with the said PD in the CDS on confirmation of investments.

ii As per the guidelines for investments referred to above, a haircut of 15 per cent shall be required on security allocation for Re-repo investments by the PDs. However, it was not observed any evidence that the said departments had checked the security allocations in the CDS with the haircut of 15 per cent for Re-repo investments made with the said PD. Further, any clause on the haircut of 15 per cent had not been included in Master Repurchase Agreement (MRA) entered between the said departments and the said PD.

A “Centralized Investment Unit” was established in Finance Department in March 2016 by centralizing the investment function in order to mitigate the overall investment risk of the Bank internal Funds.

Some measures have also been taken to ensure that securities are allocated to the relevant beneficiary account at CDS including the appointment of a custodian.

The possibility of the counterparties to remove securities without replacing another security before the maturity of the reverse repo transaction without informing the investor still prevails in the CDS.

Moreover, removing outright purchased Govt. Securities without investor’s knowledge by the Banks/Primary Dealers, is also still possible in the CDS.

At present, the haircut requirement is defined in the Direction No. 01 of 2019 on Repurchase and Reverse Repurchase transactions of dealer direct participants in Scripless Treasury Bonds and Scripless Treasury Bills issued under the Registered Stock and Securities Ordinance and Local Treasury Bills Ordinance.

To comply with the present procedures properly to prevent such incidents in future.

To comply with the present procedures properly to prevent such incidents in future.

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| iii | <p>Non-compliance with MRA of the said PD (Not allocating sufficient securities as per the clause 2 and 6 of the MRA) had not been observed by the said departments before October 2015. However, the said departments could have been observed the said violations as they had received the monthly transaction statements and security holding statements generated through CDS and they had obtained online viewing facility in CDS other than Staff Services Management Department.</p>   | <p>At present, real time notifications on security settlements are received via e-mail from the Scripless Securities Settlement System (SSSS). Further, availability and adequacy of securities kept as collaterals are checked weekly by the relevant fund administrative departments and reported to the Department Head through the reporting line. Moreover, ad-hoc verifications are also carried out.</p> | <p>To comply with the present procedures properly to prevent such incidents in future.</p> |
| iv  | <p>As per the guidelines for investments referred to above, investing officers should be vigilant on the market conditions and PD's good standing when deciding on the counterparties. However, the said departments had not complied with the said guideline since they had not observed the non-compliance with MRA by the said PD. (such as not allocating sufficient securities)</p>  | <p>Currently, in terms of the applicable Investment Guideline (IG) approved by the Monetary Board, Risk Management Department, the Front office of FD and all administrative departments are being vigilant on the market conditions and creditworthiness of Primary Dealers.</p>   | <p>To comply with the present procedures properly to prevent such incidents in future.</p> |
| v   | <p>As per the Investment Policy approved by the Monetary Board at its meeting held on 19 August 2010, 100 per cent capital protection of the funds should be maintained. Capital protection of the investment in Re-repo of Treasury Bills and Treasury Bonds is questionable as primary dealer has the ability to remove allocated securities without replacing another security before the maturity of the Re-repo. Accordingly, it is required to pay more attention on the capital protection of the funds in making decision to invest in Re-repo. Also, security allocations for Re-repo investments should be checked often in the CDS as a way of reducing risk associated with funds invested. However, it was not observed any evidence that risk on investment (including capital protection of the funds) had been measured by the said departments in making decision to invest in Re-repo with the said PD.</p> | <p>At present, investments are carried out in accordance with the provisions of Investment Policy Statement approved by the Monetary Board on 18.12.2019 and IG approved by the Monetary Board on 23.05.2018 which has clearly defined investment objectives and product and counterparty limits.</p>   | <p>To comply with the present procedures properly to prevent such incidents in future.</p> |



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| vi  | The said departments had observed since October 2015 that no securities had been allocated by the said PD on their Re- repo investments and they decided to recall investments. However, due to a tight liquidity issue faced by the said PD, they were unable to return entire investments made with the said PD. Hence, they had to roll over the remaining investments without having securities. Accordingly, outstanding amount of the investment with accrued interest (It can be considered as a loss) as at 04 January 2016 (the date where management of the PD was entrusted to the National Saving Bank by the Bank due to serious violations and liquidity issues of the PD) was Rs. 2.1 billion and It was Rs. 2.9 billion as at 18 September 2020. | Agreed.   | To take necessary actions to recover the loss. |
| vii | The said departments had not performed properly in accordance with the approved investment policy and guidelines for investments relating to the investments in Re-repo with the said PD. If they had properly complied with the said approved investment policy and guidelines for investments, the above mentioned loss to the funds managed by the said departments due to investment in unsecure Re-repo with the said PD could have been avoided or mitigated.  | The investing departments are not in agreement with the fact that the loss could have been avoided or mitigated by complying with the investment policy and guidelines.<br><br>At present, the Bank has initiated legal actions to recover the due amount from the said PD. | To take necessary actions to recover the loss. |

### 3.2 Transactions of Contentious Nature

	----- <b>Audit Issue</b> -----	----- <b>Management Comment</b> -----	----- <b>Recommendation</b> -----
a.	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 its claims”. In contrary to this provision, several buildings 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. 346.8 million during the year under review.	The Monetary Board of the Bank decided on 05.10.2017 to terminate the lease/rent agreements pertaining to the local properties except that of the Employees’ Provident Fund Department by extending the current agreements for the further period.	To comply with the said provision of the Act.

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| b.  | In term of Section 90 (2) of the Monetary Law Act, the Bank shall have regard to the need for maintaining adequate holdings of short-term securities in order to enable the bank more readily to contract its credit if such contraction becomes necessary in conducting open-market operations in Government securities. In contrary to this provision, Treasury Bonds which are considered as long-term securities were acquired and maintained for the purpose of open market operations by the bank. Accordingly, Treasury Bonds amounting to Rs.50.2 billion as at the end of the year under review was maintained by the bank. | The Bank conducted outright purchase of Treasury bond auctions in the secondary market with the approval of the Monetary Board considering the need for injecting permanent liquidity to the domestic money market in order to ensure interest rate stability and not for the purpose of accumulating stock government securities in its holding. | To comply with the said provision of the Act.                              |
| <b>c. Decline in value of the Building Properties</b>   |  |   |  |
| i   | The White Aways Building was purchased for a sum of Rs. 100 million on 01 September 2014 and it was renovated incurring a sum of Rs.325.42 million up to 31 December 2016. A revaluation loss of Rs.232.12 million was incurred as at that date after revaluation of the said building at Rs.187 million as at 31 December 2016. Accordingly, value of the building had declined significantly within a short period of 28 months.   | Some significant expenditure involved with the structural strengthening of this building which is more than 100 years old may not be reflected fully in the valuation.  | To take proper care in acquiring and constructing the Buildings in future. |
| According to the valuation received from the Department of Government Valuation on 07 September 2020, the White Aways Building has been valued at Rs. 202.25 million which was higher than previous valuation by Rs.15.25 million only. |  |   |  |
| ii  | Construction of the Kilinochchi Building Complex was completed on 31 May 2016 capitalizing a sum of Rs. 167.93 million and it was improved incurring a sum of Rs.100.84 million up to 31 December 2016. As revaluation value of the Kilinochchi Building Complex was Rs.169.5 million as at 31 December 2016, revaluation loss was Rs.96.87 million. Therefore, value of the newly constructed building had declined significantly within a short period of 7 months.  | No comment on the decline in value.   | To take proper care in acquiring and constructing the Building in future.  |

According to the valuation received from the Department of Government Valuation on 07 September 2020, the Kilinochchi Building Complex has been valued at Rs. 172.3 million which was higher than previous valuation by Rs.2.8 million only.

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| iii | Construction of the Sovereign Study Centre was completed on 30 September 2016 and capitalized a sum of Rs. 212.2 million. As revaluation value of the Sovereign Study Centre was Rs.170 million as at 31 December 2016, A revaluation loss of Rs.40.79 million was incurred. Therefore, value of the newly constructed building had declined significantly within a short period of 3 months. | No comment on the decline in value. | To take proper care in acquiring and constructing the Building in future. |
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According to the valuation received from the Department of Government. Valuation, the Sovereign Study Centre has been valued at Rs. 131 million which was lower than previous valuation by further Rs.39 million.

### 3.3 Underutilization of Funds

----- <b>Audit Issue</b> -----	----- <b>Management Comment</b> -----	----- <b>Recommendation</b> -----
The Bank had not performed any transaction from the funds of Rs. 35.8 million (EURO 175,789) available in Nostro Account with Banca Nazionale Del Lavarò (BNL) for many years.	The Monetary Board has approved the closure of the account.  However, when informed of the above decision BNL informed that the said account is linked with the commodity aid granted by the Italian government to the Sri Lankan government and managed by the Italian Ministry of Foreign Affairs. Hence, specific approval is needed from the Italian Ministry of Foreign Affairs to close the account.	To take necessary actions to address the said matter.

### 3.4 Human Resource Management

<b>Audit Issue</b>	<b>Management Comment</b>	<b>Recommendation</b>
A Monetary Board approved cadre was not available for the positions of Staff class grade I to III (1), Management Assistant class grade I to V and Office Assistant class grade I to III. Actual cadre for the above positions as at 14 September 2020 was 477, 570 and 155 respectively.	The said positions are not defined due to the possibilities of changing of scope of each department with the prioritizing of strategic objectives of the Bank which depends on the prioritizing of requirements from time to time.	To determine an approved cadre for the said positions since it can be revised considering the requirements from time to time.

### 4. Achievement of Sustainable Development Goals

<b>Audit Issue</b>	<b>Management Comment</b>	<b>Recommendation</b>
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 the 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.	<p>The Bank is not a direct implementation agency with regard to Sustainable Development Goals (SDGs), but a facilitator by ensuring economic and price stability, and financial system stability. Hence, the major functions of the Central Bank would support an enabling environment to ensure economic progress which would eventually support the achievement of SDGs.</p> <p>The Director, Policy Review and Monitoring Department was appointed by Governor to coordinate with the respective departments and to formulate Strategic and Action Plans of the Bank to facilitate progress towards achieving SDGs.</p>	To take necessary actions to ensure whether the Bank is in compliance with the said Agenda.