

People's Bank - 2013

The audit of consolidated financial statements of the People's Bank (Bank) and its subsidiaries for the year ended 31 December 2013 comprising the statements of financial position as at 31 December 2013 and the statements of income, statements of comprehensive income, statements of changes in equity and cash flow statements for the year then ended and a summary of significant accounting policies and other explanatory information, was carried out under my direction in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with Section 34 of the Peoples' Bank Act, No.29 of 1961. To carry out this audit I was assisted by a firm of Chartered Accountants in public practice. At the meantime 50 firms of Chartered Accountants in public practice assisted to audit of 50 Branches of the Bank. The financial statements of the Subsidiaries were audited by firms of Chartered Accountants in public practice appointed by the members of the respective Subsidiaries. Detailed audit reports in respect of the Branches were furnished to the Bank from time to time between 21 February to 22 April 2014. Some of the comments and observations contained in those reports are summarized in this report.

The Bank has been exempted from the provisions in Part 11 of the Finance Act, No. 38 of 1971 by an order of the Minister of Finance and Planning published in the Government Gazette No.715 of 14 May 1992 by virtue of powers vested in him by Section 5(1) of the said Finance Act. The Bank is also exempted from all Treasury and Public Administration Circulars as decided by the Cabinet of Ministers and conveyed by the Secretary to the Treasury by his Circular No. EA 02/BC/PB/01 dated 10 April 1992.

This report is issued in terms of Article 154(6) of the Constitution of Democratic Socialist Republic of Sri Lanka.

1.2 Management's Responsibility for the Financial Statements

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

1.3 Auditor’s Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risk of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Bank’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank’s internal control. An audit also includes evaluating the appropriateness of Accounting Policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

2. Financial Statements

2.1 Opinion – Bank

In my opinion, so far as appears from our examination, the Bank maintained proper accounting records for the year ended 31 December 2013 and the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2013 and its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Opinion – Group

In my opinion, the consolidated financial statements give a true and fair view of the financial position of the Bank and its Subsidiaries dealt with thereby as at 31 December 2013 and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.2 Comments on Group Financial Statements

The financial statements of the Bank comprised the consolidation of the financial statements of the Domestic Banking Units, the Offshore Banking Unit and the foreign operations that are an integral part of the Bank. The Group financial statements comprised consolidation of the financial statements of the Bank, its Subsidiaries and Associates in compliance with Sri Lanka Accounting Standards (LKAS). The Bank had owned 99 per cent of the share capital of the People’s Travels (Pvt) Ltd., 75 per cent of the People’s Leasing and Finance PLC., 26.13 per cent of the People’s Merchant Bank PLC and 37.3 per cent of the Smart Net Lanka (Pvt) Ltd at the balance sheet date.

The ownership of the Bank as at 31 December 2013 as compared with the preceding year in respect of each Company is as follows.

	Direct Investments			
	2013	%	2012	%
	Rs.000		Rs.000	
Name of the Subsidiaries				
People’s Travels (Pvt) Ltd	4,950	99	4,950	99
People’s Leasing and Finance PLC	1,240,958	75	1,248,484	75.17
Total investment in Subsidiaries	1,245,908		1,253,434	
Name of the Associates				
People’s Merchant Bank PLC	273,100	26.13	273,100	26.13
Smart Net Lanka (Pvt) Ltd	25,000	37.3	25,000	37.3
Total investment in Associates	298,100		298,100	
Less – Provision for impairment				
People’s Merchant Bank PLC	(65,532)		-	
Smart Net Lanka (Pvt) Ltd	(25,000)		(25,000)	
Net investment in Associates	207,568		273,100	

2.3 Comments on Financial Statements of the Bank

2.3.1 Sri Lanka Accounting Standards (LKAS)

The following observations are made.

LKAS 16 - Property, Plant and Equipment – According to the standard, if an item of a property, plant or equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued. However, during the revaluation of land and building, the Bank had not revalued 08 lands and buildings shown as a net book value of Rs. 118,294,512 as at 31 December 2013.

LKAS 39 - Financial Instruments: Measurement and Recognition – The Bank had recognized the value of financial assets held to maturity based on the simple interest method, instead of being amortized the same by using Effective Interest Rate (EIR). Hence, there was a difference of Rs. 36,960,694 between the amortized value and the value which had been recognized in the financial statements.

Further, the Bank had recognized the interest income for Sri Lanka Development Bonds (SLDB) on a simple interest base instead of being recognized by using Effective Interest Rate (EIR).

2.3.2 Deficiencies in the Impairment Calculation

The following observations are made;

- (i) The Bank had not maintained a checklist when evaluating objective evidence to identify any impairment triggers of a customer identified as individually significant, in the process of impairment calculation.
- (ii) The Bank's threshold for selecting individually significant customers is an aggregate loan portfolio of more than Rs. 25 million. However, it was noted that in the Branch network, the Bank had not considered the aggregate loan portfolio of the customers, instead of that had considered customers with individual loans of more than Rs. 25 million due to the limitation in existing system. Further, the impairment provision of Rs. 13,716 million may not be adequate due to non-consideration of the aggregate loan portfolio of the individual customers in the Branch network.

2.3.3 Accounting Deficiencies

The Bank had not updated the cancellation of leases to the accounting records in turn to the financial statements. Hence, the lease valued at Rs. 13,312,241 had been shown in the financial statements as lease hold lands and buildings.

2.3.4 Unreconciled Differences

The following unreconciled differences were observed in audit.

- (a) A difference of Rs. 4,894,797 was observed between the market value of investments in National Equity Fund shown in the financial statements and the confirmations received.
- (b) The following differences were observed between the balances shown in the general ledger and the system generated reports. Details are given below.

	Item	Amount as per (computerized) System Generated Report	Amount as per General Ledger	Difference
		Rs.	Rs.	Rs.
i	Opening balances			
	-Furniture	625,302,656	620,898,129	4,404,527
	-Machinery and Equipment	2,492,280,340	2,485,853,790	6,426,550
ii	Loans and receivables	490,938,334,000	490,915,750,000	22,584,000
iii	Interest in suspense	34,408,120,000	36,208,611,000	(1,800,491,000)
iv	Pawning	195,768,359,000	197,128,579,000	(1,360,220,000)

2.3.5 Unexplained Differences

The following observations are made in this regard.

- (a) An unexplained difference of Rs. 56,015,643 was observed between the amount shown in the payroll and the financial statements.

- (b) The following differences were observed between the letter of credits, guarantees acceptances shown in under the general ledger balances and the respective portfolio balances as at 31 December 2013. The reasons for the differences had not been explained to audit.

	Balance as per General Ledger	Portfolio Balance	Difference
	Rs.	Rs.	Rs.
Letter of Credit	73,766,374,264	72,744,232,512	1,022,141,752
Guarantee	27,157,319,254	26,734,131,683	423,187,571
Acceptances	49,864,088,462	50,220,224,671	(356,136,209)

2.3.6 Suspense Accounts

A sum of Rs. 227,254,000 had remained in 09 loan suspense accounts as at 31 December 2013 without being cleared.

2.3.7 Lack of Evidence for Audit

The evidence indicated against each item below had not been furnished to audit.

Item in the Account	Amount	Evidence not made Available
	Rs.	
(a) Investment Property	15,771,000	Relevant Agreement
(b) Leasehold Properties (08 properties)	24,432,000	Lease Agreements

2.4 Non compliance with Laws, Rules, Regulations and Management Decisions

The following non compliances were observed in audit.

Reference to Laws, Rules, Regulations and Management Decisions	Non-compliance
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(a) People's Bank Act, No. 29 of 1961	Authorized share Capital of the Bank was limited to 20,000,000 ordinary shares. Although the Bank had issued only 999,960 shares, the capital

pending allotment amounting to Rs. 7,152 million was equal to 143,040,000 shares which exceeds the authorized share capital as mentioned in the Act. However, a sum of Rs. 7,152 million was held in a capital pending allotment account as authorized share capital which is yet to be increased by amending People's Bank Act.

(b) Guidelines of the Central Bank of Sri Lanka
No.02/17/402/0073/001 of
12 April 2005

All Licensed Commercial Banks were required to increase their capital up to Rs. 2,500 million by the end of 2007 in terms of guidelines of the Central Bank. However, the Central Bank of Sri Lanka has permitted to few Banks who have not achieved that required capital, to enhance the amount at least by 50 per cent by end of the year 2006 and to completely reach Rs. 2,500 million by end of 2007. However, the Bank had not reached the required capital and the deficiency that existed as at 31 December 2013 amounted Rs. 2,450 million.

3. Financial Review

3.1 Financial Results

According to the consolidated financial statements presented, the operations of the Bank and the Group for the year ended 31 December 2013 had resulted in a pre-tax net profit of Rs.10,304 million and Rs. 13,412 million respectively as compared with the corresponding pre-tax net profit of Rs. 15,249 million and Rs. 17,671 million of the Bank and the Group respectively for the preceding year, thus indicating the decreases in the financial results of the Bank and the Group by Rs. 4,945 million and Rs. 4,260 million respectively. The increase of total impairment on the loans and other losses for the year by Rs. 9,842 million as compared with the previous year was mainly attributed for these decreases in the financial results of the year.

3.2 Analytical Financial Review

3.2.1 Summary of the Financial Results

The following table gives a summary of the financial results at various stages for the year under review and the preceding year.

	Year ended 31 December			
	2013		2012	
	Bank	Group	Bank	Group
	Rs. million	Rs. million	Rs. million	Rs. million
Interest Income	110,440	129,205	85,241	100,844
Interest Expenses	(73,791)	(84,245)	(51,324)	(60,211)
Net Interest Income	36,649	44,960	33,917	40,633
Other Income	9,880	10,616	9,392	8,985
Operating Income	46,529	55,576	43,309	49,618
Impairment for Loans and Other Losses	(13,716)	(14,822)	(3,874)	(4,575)
Net Operating Income	32,813	40,754	39,435	45,043
Operating Expenses	(20,803)	(25,249)	(21,721)	(24,559)
Operating Profit Before Value Added Tax	12,010	15,505	17,714	20,484
Value Added Tax On Financial Services	(1,706)	(2,016)	(2,465)	(2,745)
Operating Profit After Value Added Tax	10,304	13,489	15,249	17,739
Share of Profit/ (Loss) of Associates	-	(77)	-	(67)
Profit Before Tax	10,304	13,412	15,249	17,672
Tax Expenses	(2,816)	(4,248)	(4,355)	(5,775)
Profit for the Year	7,488	9,164	10,894	11,897

3.2.2 Significant Accounting Ratios

Certain significant ratios for the year under review and the preceding four years as compared with the Central Bank of Sri Lanka norms are given below.

	CBSL Norms	Actual				
		2013	2012	2011	2010	2009
		%	%	%	%	%
a) Capital Adequacy Ratio (Tier 1)	5.00	10.4	9.8	9.6	7.9	7.7
b) Capital Adequacy Ratio (Tier 1+Tier 2)	10.00	15.0	14.0	14.5	12.8	13.4
c) Return on Assets	-	1.1	2.0	2.6	1.7	1.4
d) Non Performing Advances to Total Advances	-	5.3	2.8	3.4	5.0	6.7
e) Liquidity Ratio- Domestic Banking Unit	-	25.2	21.8	21.5	23.4	29.9
Foreign Currency Bank Unit		22.3	21.8	24.0	22.3	24.6

4. Operating Review

4.1 Branch Performance and Profitability

According to the information made available, out of 345 Branches 295 Branches had been able to record a total profit of Rs. 10,826 million before reallocated expenditure, while 50 Branches had been recorded a total loss of Rs. 532 million for the year under review. Accordingly the net profit of 345 Branches was Rs. 10,294 million before the reallocated expenditure over the preceding year net profit of Rs. 17,688 million (including total loss of Rs. 23 million of 09 Branches of the year), thus indicating a decrease of Rs.7,394 million or 42 per cent in the financial results.

According to the zonal wise profit/(loss) for the year 2013, the Bank had recorded a loss of Rs. 2,593 million after reallocated expenditure over the preceding year profit

of Rs. 3,933 million after reallocated expenditure, thus indicating a decrease of Rs. 6,526 million or 166 per cent in zonal wise profitability.

The zonal wise Branch network of the Bank and their profitability for the year ended 31 December 2013 are given below;

Zone	Number of Branches	Profit/ (Loss)	
		2013	2012
		Rs. million	Rs. million
Central Zone	43	851	1,678
Eastern Zone	29	118	1,031
North Central Zone	27	282	807
Southern Zone	41	748	1,273
Sabaragamuwa Zone	32	833	1,225
Western Zone I	58	4,569	5,798
Western Zone II	38	1,452	2,672
Wayamba Zone	31	951	1,664
Northern Zone	21	39	724
Uva Zone	25	450	815
Total	345	10,293	17,687
Less:			
Reallocated Expenditure		(12,887)	(13,755)
Profit/(Loss) After Reallocated Expenditure		(2,594)	3,932

4.2 Loan Administration

4.2.1 Non- performing Loans

The following observations are made in this connection.

- (a) The under mention Branches had granted loans and overdraft facilities aggregating Rs. 404,870,562 to customers during the year and subsequently these had been categorised as non performing loans without being taken timely or proper actions to recover the outstanding balances. The total outstanding balances as at 31 May 2014 (including capital, interest and other charges) were Rs. 394,462,592. Details are shown below.

Branch	Number of Loan/Overdraft Facilities Given	Period	Total Amount Granted	Amount Outstanding as at 31 May 2014 (including capital and interest)
			Rs.	Rs.
Moratumulla	05	2007-2011	4,955,608	5,106,787
Udawalawe	08	2006-2012	2,254,324	2,757,209
Duke Street	09	1981-2011	141,666,959	143,721,574
Homagama	07	2003-2011	6,358,081	5,445,287
Piliyandala	12	2005-2012	249,635,590	237,431,735
Total	41		404,870,562	394,462,592

The following observations are also made in this regard.

- i. As per the valuation report dated 14 March 2013 given by panel of valuers relating to 02 loans given by the Homagama Branch in 2013 the forced sale value of the mortgaged property was only Rs. 5,250,000. The total outstanding balance as at 28 May 2014 was Rs. 11,276,498 which exceeds the forced sale value (fsv) of the property by Rs. 6,026,498.
- ii. When granting a permanent over draft by the Piliyandala Branch to a customer, the same customer had defaulted the payments of on another permanent over draft and loan facility with a total outstanding balance of Rs. 6,025,526 (including capital of Rs. 2,870,967 and interest of Rs. 3,154,559) as at 16 July 2014 which had been granted by the Kirulapane Branch. The total outstanding balance of Rs. 10,541,900 was remained outstanding as at 16 July 2014 without being recovered due to Branch had not properly evaluated the history of the customer before granting the loans.

- (b) Corporate Banking Division had granted the loan facilities amounting to Rs. 1,268,038,652 to 17 customers and subsequently it had been categorized as non performing. The total outstanding balance as at 28 May 2014 was Rs. 1,622,584,694 (capital of Rs. 1,205,036,387 and interest and other charges of Rs. 417,548,307). Further, the Division had not taken satisfactory actions to recover the outstanding balances.

Customer	Number of Facilities	Amount Granted	<u>Total outstanding balance as at 28 May 2014</u>		
			Capital	Interest and other Charges	Total
		Rs.	Rs.	Rs.	Rs.
A	02	12,643,812	8,231,098	496,597	8,727,695
B	20	12,501,000	12,181,035	5,970,256	18,151,291
C	03	66,151,769	44,162,471	7,179,086	51,341,557
D	05	14,297,800	13,398,038	3,767,731	17,165,769
E	02	35,445,691	31,485,686	29,033,974	60,519,660
F	02	66,609,843	35,027,351	92,979,727	128,007,078
G	02	1,000,000	3,435,141	6,657,792	10,092,933
H	06	20,600,000	19,865,216	5,305,701	25,170,917
I	07	7,873,700	6,691,097	1,989,109	8,680,206
J	02	1,600,000	1,325,616	319,507	1,645,123
K	14	35,355,000	33,772,931	18,559,695	52,332,626
L	03	70,022,000	70,702,000	32,558,000	103,260,000
M	02	26,100,000	28,754,000	14,493,000	43,247,000
N	02	854,338,000	854,338,000	113,226,000	967,564,000
O	02	31,600,000	31,600,000	67,020,000	98,620,000
P	01	3,000,000	1,500,000	2,885,000	4,385,000
Q	04	8,900,037	8,566,707	15,107,132	23,673,839
Total		1,268,038,652	1,205,036,387	417,548,307	1,622,584,694

4.2.2 Inadequate Securities Obtained in Granting Loans

It was observed that concurrent securities for the following loans given by the Foreign Currency Banking Unit (FCBU) were not adequate.

Name of Customer	Amount Granted	<u>Amount Outstanding as at 31 August 2014</u>			Inadequacy of Security
		Capital	Interest and Other Charges	Total	
	Rs. million	Rs. million	Rs. million	Rs. million	Rs. million
A	32.50	32.50	4.30	36.80	16.80
B	195.00	27.45	-	27.45	27.45
C	400.19	279.34	41.98	321.32	146.32

4.2.3 Granting the Temporary Overdraft Facilities (TOD)

According to the Section 19 (3.1) of the Credit Procedure Manual of the Bank, it is required to maintain a current account with satisfactory average balance and satisfactory deposits for a minimum period of 06 months period to eligible for an overdraft facility. However the following Branches had granted temporarily overdraft (TOD) facilities in contrary to the requirement and the following balances remained outstanding as at 10 September 2014 without being recovered.

Branch Name	Date of Account Opened	Date of TOD Granted	Amount Granted	<u>Amount Outstanding as at 10 September 2014</u>		
				Capital	Interest and other Charges	Total
			Rs.	Rs.	Rs.	Rs.
Moratumulla	01/07/2006	29/09/2006	100,000	153,343	408,361	561,704
Udawalawa	26/01/2011	14/06/2011	105,099	105,099	88,523	193,622
Homagama	05/03/2007	30/07/2007	15,307	15,307	62,468	77,775
Corporate Banking Division	09/02/2012	01/04/2012	5,000,000	5,350,448	1,982,468	7,332,916
Corporate Banking Division	28/03/2012	30/03/2012	1,500,000	1,484,064	718,176	2,202,240

5 Information Technology (IT)

5.1 Governance of IT

The following observations are made:

- (i) The IT security function is not in existence in the Bank as a part of an independent operation. The absence of an independent IT security function

could adversely affect to the awareness and training of IT governance and security, security assessments, contingency planning, media protection, physical and environmental protection, personnel security, risk assessment, system and services acquisition, system and communications protection and system and information integrity.

- (ii) It was reviewed that the Bank had not (in recent years) developed any long- term information technology strategic plan. The current planning horizon is short-term and in some ad-hoc aspects, and on a need - basis only. In the absence of a formal and approved IT strategy, there is a risk that in the future IT investments in hardware and software may not be those that best meet the Bank’s medium-to long-term business objectives.
- (iii) It was further observed that there are 32 vacancies prevailed in the IT Department including an Assistant General Manager and Chief Managers.

5.2 **IT General Controls**

The following observations are made in this connection.

- (i) The Bank had documented and implemented a detailed IT governance policy covering many areas of IT security and governance in 2012. However, the following areas of governance were not addressed in the IT policy.
 - Program Development or Acquisition Policy
 - Remote Access Policy
 - Data Center Policy
 - Antivirus Policy

Further, the change of management policy does not cover anything other than the core banking and pawning system although there are systems which make part of the Bank’s critical operations.

- (ii) The backup taken for the core banking system and pawning system data are not tested at periodic intervals for integrity of data and in certain instances where a particular user requests restoration of data, backup tapes are used for restoration.

- (iii) In the system there were duplicate CIF numbers in the customer database. This is due to the absence of a data migration review and of the inadequacy of the normalization process. Existence of duplicate CIF numbers in the customer database would increase the risk of bogus customers and this would restrict the identification of a particular customer portfolio/ exposure as at given date.

6 Systems and Controls

Deficiencies observed in the systems and controls during the course of audit were brought to the notice of the Chairman of the Bank from time to time. Special attention is needed in respect of the following areas of control.

- a) Nostro Reconciliations
- b) Complied with Accounting Standards
- c) Unreconciled Differences
- d) Suspense Accounts
- e) Loan Administration
- f) Branch Performance and Profitability
- g) Fixed Assets
- h) Information Technology