

## **Pradeshiya Sanwardhana Bank - 2014**

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The audit of financial statements of the Pradeshiya Sanwardhana Bank for the year ended 31 December 2014 comprising the statement of financial position as at 31 December 2014 and the statement of income, statement of other comprehensive income, statement of changes in equity and cash flow statement 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 13 (1) of the Finance Act, No. 38 of 1971 and Section 33 of the Pradeshiya Sanwardhana Bank Act, No 41 of 2008.

### **1.2 Management Responsibility for the Financial Statements**

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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 the 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**

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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 consistent with International Standards of Supreme Audit Institutions (ISSAI 1000-1810). 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 risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessment, 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.

Sub-sections (3) and (4) of the Section 13 of the Finance Act, No. 38 of 1971 give discretionary powers to the Auditor General to determine the scope and extent of the Audit.

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

## **2. Financial Statements**

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### **2.1 Opinion**

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In my opinion, the financial statements give a true and fair view of the financial position of the Pradeshiya Sanwardhana Bank as at 31 December 2014 and its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

### **2.2 Comments on Financial Statements**

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#### **2.2.1 Non – Compliance with Sri Lanka Accounting Standards (LKAS)**

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The following non-compliance with **LKAS 39 – Financial Instrument Recognition and Measurement** were observed in audit

- (a) Staff Loan amounting to Rs. 1,160,083,733 had been identified as a financial instrument and shown under loans and receivables in the financial statements. However, it had not been measured at amortized cost as required.
- (b) Individual impairment for individually significant loans and receivables had not been done in terms of paragraph 64 of the standard.

## 2.2.2 Unreconciled Differences

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The differences aggregating Rs.34,448,230 was observed between the refinance balances payable under the Central Bank of Sri Lanka (CBSL) refinance shown in the ledger accounts and the balances confirmed by the CBSL as at 31 December 2014.

## 2.3 Non – compliance with Laws, Rules, Regulations and Management Decisions

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Instances of non-compliances observed in audit are given below.

### Reference to Laws, Rules, Regulations, etc.

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### Non – Compliance

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(a) Section 31 of the Pawn Broker's Ordinance No.13 of 1942

A pawnbroker may bid for and purchase at a sale by auction made or purporting to be made under this Ordinance, a pledged pawned with him, and on such purchase the pawned broker shall be deemed to be the absolute owner of the pledged purchase. In contrary to this provision 23.95 kilograms of unsold pawned articles had been smelted without obtaining the absolute ownership of such articles.

(b) Public Administration Circulars No. 03/2012 of 23 February 2012

A Vehicle had been handedover to the retired General Manager without being obtained the appropriate approval from the General Treasury.

(c) Guideline 8.13.4 of the Government Procurement Guidelines 2006 – Variations to Contracts

If the aggregate amount of the variation is exceeding 10 per cent of the contract price, the Chairman should be obtained the approval from the Secretary to the line Ministry before issuing such variation orders. However, the relevant approvals had had not been obtained for the variation orders made to the following contract works.

Name of the Contract	Initial Contract Price	Value of Variation Orders	Value of Variation Orders as a percentage of Contract Price
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	(Rs.)	(Rs.)	%
Repair to existing branch office building at Mihintale	1,226,216	2,656,182	217
Construction of Thirappane branch building	20,668,821	9,507,451	46

### **3 Financial Review**

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#### **3.1 Financial Results**

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According to the financial statements presented, the operations of the Bank for the year ended 31 December 2014 had resulted in a pre-tax profit of Rs. 928,668,064 as compared with the corresponding pre-tax profit of Rs. 397,011,990 in the preceding year, thus indicating an improvement of Rs. 531,656,074 in the financial results for the year under review.

The decrease of impairment charges for loans and other losses, and interest expenses by Rs.999,561,030 and Rs. 627,908,328 respectively and increase of fee and commission income by Rs. 48,644,978 as compared with the preceding year were the main reasons attributed for this improvement in the financial result.

### 3.2 Analytical Financial Review

The following observations are made.

#### 3.2.1 Cost of Fund and Financial Yield

According to the information and financial statements furnished to audit, the following table gives the cost of funds and financial yield for the year ended under review and the previous year.

Description	Avg. Balance	2014		Avg. Balance	2013	
		Cost / Revenue	Cost / Revenue as a percentage of Average Balance		Cost / Revenue	Cost / Revenue as a percentage of Average Balance
	Rs. 000	Rs. 000	%	Rs. 000	Rs. 000	%
<b>(I) Cost of Fund</b>						
<b>(a) Deposits</b>						
Saving Deposits	27,135,633	1,117,842	4.12	22,492,183	900,907	4.01
Fixed Deposits/ Certificate of Deposits	40,430,295	3,744,264	9.26	36,145,997	4,607,587	12.75
<b>Total Deposits</b>	<b>67,565,928</b>	<b>4,862,106</b>	<b>7.2</b>	<b>58,638,181</b>	<b>5,508,494</b>	<b>9.39</b>
<b>(b) Borrowings</b>						
Refinanced Loans	7,448,855	370,001	4.97	5,903,403	262,271	4.44
Other Borrowings	1,703,025	78,761	4.62	1,391,406	168,011	12.07
<b>Total Borrowings</b>	<b>9,151,880</b>	<b>448,762</b>	<b>4.90</b>	<b>7,294,809</b>	<b>430,282</b>	<b>5.90</b>
<b>(c) Cost of Fund on Mobilization (a+b) (Weighted Average Cost of Capital)</b>	<b>76,717,808</b>	<b>5,310,868</b>	<b>6.92</b>	<b>65,932,989</b>	<b>5,938,776</b>	<b>9.01</b>
<b>(d) Other Liabilities</b>	<b>4,233,544</b>	-	-	<b>3,836,925</b>	-	-
<b>(e) Capital</b>	<b>1,235,169</b>	-	-	<b>1,099,400</b>	-	-
<b>(f) Reserves</b>	<b>3,399,256</b>	-	-	<b>2,957,782</b>	-	-

<b>(g) Total Other Liabilities with Shareholder's Equity (c+d+e+f)</b>	<b>85,585,777</b>	<b>-</b>	<b>-</b>	<b>73,827,096</b>	<b>-</b>	<b>-</b>
<b>Less :</b>						
<b>(h) Other Assets</b>	<b>3,068,274</b>	<b>-</b>	<b>-</b>	<b>2,599,514</b>	<b>-</b>	<b>-</b>
<b>(I) Financial Cost (g-h)</b>	<b>82,517,503</b>	<b>3,003,545</b>	<b>3.64</b>	<b>71,227,583</b>	<b>2,699,190</b>	<b>3.79</b>
Overhead Costs	82,517,503	1,610,614	1.95	71,227,583	1,016,078	1.43
<b>Total Cost of Funds</b>	<b>82,517,503</b>	<b>9,925,027</b>	<b>12.03</b>	<b>71,227,583</b>	<b>9,654,044</b>	<b>13.55</b>
<b>(II) Financial Yield</b>						
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Loan Portfolio	61,034,934	8,450,783	13.85	57,612,758	8,577,987	14.89
Investments	21,482,568	2,142,304	9.97	13,614,825	1,862,946	13.68
<b>Financial Yield</b>	<b>82,517,503</b>	<b>10,593,087</b>	<b>12.84</b>	<b>71,227,583</b>	<b>10,440,933</b>	<b>14.66</b>
Margin	82,517,503	668,060	0.81	71,227,583	786,889	1.10
Fee Based and Other						
Income	82,517,503	957,488	1.16	71,227,583	472,915	0.66
<b>Margin</b>	<b>82,517,503</b>	<b>1,625,548</b>	<b>1.97</b>	<b>71,227,583</b>	<b>1,259,804</b>	<b>1.77</b>
Tax	82,517,503	1,058,054	1.28	71,227,583	495,086	0.70
<b>Net Margin</b>	<b>82,517,503</b>	<b>567,494</b>	<b>0.69</b>	<b>71,227,583</b>	<b>764,718</b>	<b>1.07</b>

The following observations are made in this regard.

- (a) Cost of Deposit Ratio had decreased by 23 per cent in the year 2014 as compared with the preceding year mainly due to decrease of interest expenses by 12 per cent.
- (b) Even though the borrowings had increased by 25 per cent in the year under review, the Cost of Borrowing Ratio had decreased by 17 per cent, as a result of lower interest rates for the year 2014.
- (c) In view of the above, the Weighted Average Cost of Capital had decreased by 23 per cent in the year 2014 as compared with the preceding year.

### 3.2.2 Significant Accounting Ratios

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According to the information made available, some of the important ratios of the Bank for the year under review and the preceding year are as follows.

Category	Sector Ratio (Licensed Specialized Bank)	Actual	
		2014	2013
<b>(a) Profitability Ratio</b>			
Net Profit Ratio	16.41%	8.3%	3.61%
Net Interest Margin	3.63%	6.40%	6.32%
Net Interest Income on Interest Income	30.12%	49.86%	43.12%
Non Interest Income to Total Income	10.51%	5.30%	5.04%
Interest Cost on Interest Income	69.88%	50.14%	56.88%
Overhead Expenditure on Net Interest Income		30.49%	22.57%
Staff Cost to Operating Expenses	50.73%	62.26%	72.65%
Return on Average Assets	2.19%	1.09%	0.53%
Return on Equity	14.34%	7.39%	4.73%
Earnings per Share (Rs.)		3.04	1.74
<b>(b) Gearing Ratio</b>			
(i) Total Assets to Equity		17.02 : 1	20.51 : 1
(ii) Borrowings to Equity		1.81 : 1	2.21 : 1
<b>(c) Capital Adequacy Ratio</b>			
(i) Tier i	23.25%	8.87%	8.82%
(ii) Tier ii	20.62%	9.26%	9.21%
<b>(d) Liquid Assets Ratio ( Minimum 20 per cent)</b>	67.76%	35.51%	25.51%

The following observations are made in this regard.

- (a) The capital adequacy ratio had far below than the minimum requirement of 10 per cent. However, after issuing the debentures valued at Rs. 2.5 billion in January 2015, the capital adequacy ratio had increased to 11 per cent in the first quarter of 2015.
- (b) High interest margin of 6.40 per cent had reported as at 31 December 2014 as compared with the average Licensed Specialized Bank ratio of 3.63 per cent.
- (c) The contribution of non-interest income to the total income of the Bank was only 5.30 per cent which was significantly lower than average Licensed Specialized Bank ratio of 10.51 per cent. Therefore, the Bank was highly concentrated on interest income and would be vulnerable to change in interest rates.
- (d) According to the Banking Industry Analysis of 2014, the Bank had recorded a higher ratio of the personal cost out of total expenses (excluding the interest expenses and fee and commission expenses) which was 62.26 per cent as compared with the average Licensed Specialized Bank ratio of 50.73 per cent.
- (e) Return on average assets and return on equity ratios of the Bank were only 1.09 per cent and 7.39 per cent respectively which were significantly lower than average Licensed Specialized Bank ratio of 2.19 per cent and 14.34 per cent.

### **3.2.3 Maturity Profile of the Bank**

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Analysis of the profile of the financial assets and financial liabilities of the Bank as at 31 December 2014 revealed that the total long term financial liabilities were far in excess over total financial assets and the long term liquidity gap up to 3 to 5 years and over 5 years in 2014 had been Rs.387,289,824 and Rs.4,671,490,827 respectively. Details are given below.



	<u>0-3 Months</u>	<u>3 -12</u>	<u>1 -3</u>	<u>3- 5</u>	<u>Over 5</u>	<u>Total</u>
	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>
<b><u>Assets</u></b>						
Cash and Balance with Central Bank Sri Lanka Government	236,997,574	-	-	-	-	236,997,574
Securities	-	1,789,084,271	-	-	-	1,789,084,271
Balance with Banks	18,191,222,200	7,974,193,222	-	-	-	26,165,415,422
<b>Financial Assets</b>						
Held for Trading	-	-	-	-	206,300	206,300
<b>Loans and Receivables from</b>						
Other Customers	10,641,256,097	19,030,853,503	17,951,645,172	11,028,353,538	9,685,055,527	68,337,163,837
Other Assets	177,692,089	49,337,768	390,795,864	-	-	617,825,721
<b>Total Assets</b>	<b>29,247,167,961</b>	<b>28,843,468,763</b>	<b>18,342,441,036</b>	<b>11,028,353,538</b>	<b>9,685,261,826</b>	<b>97,146,693,125</b>
<b><u>Liabilities</u></b>						
Due to Banks	599,573,675	1,793,611,679	4,782,964,477	3,054,887,233	-	10,231,037,063
Due to Other Customers	25,603,386,928	20,806,089,165	5,935,939,862	8,088,148,842	13,922,523,985	74,356,088,781
Other Liabilities	1,680,781,534	451,943,705	495,034,379	272,607,287	434,228,669	3,334,595,573
<b>Total Liabilities</b>	<b>27,883,742,136</b>	<b>23,051,644,549</b>	<b>11,213,938,718</b>	<b>11,415,643,362</b>	<b>14,356,752,653</b>	<b>87,921,721,418</b>
<b>Maturity Gap</b>	<b>1,363,425,825</b>	<b>5,791,824,214</b>	<b>7,128,502,319</b>	<b>(387,289,824)</b>	<b>(4,671,490,827)</b>	<b>9,224,971,708</b>

## **4 Operating Review**

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### **4.1 Performance**

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The following observations are made in this connection.

#### **(a) Deposits**

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Bank's deposit structure was highly concentrated on high cost fixed deposits which represented 58 per cent of the total deposits as at 31 December 2014. Interest expenses on fixed deposits represented 77 per cent of total interest expense as at 31 December 2014. High dependence on high cost fixed deposits may be adversely affected to the cost of fund.

#### **(b) Loan Portfolio**

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The non performing loan ratio to the total loans and advances was 7.69 per cent in the year 2014, which shows an increase of 9 per cent as compared with the preceding year.

### **4.2 Operating Inefficiencies**

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The following observations are made.

- (a) According to the special investigation carried out by the Internal Audit Division of the Bank, it was revealed that two loans valued at Rs. 12.5 million had been offered by the Kolonnawa Branch by violating the existing loan granting procedures. However, disciplinary action had not been taken against the officers responsible for granting of these loans.
  
- (b) Hikkaduwa Branch had granted a loan amounting to Rs. 10 million to a customer on 13 December 2013. However, no single installment had been

recovered even up to the date of audit on 31 March 2015. The total outstanding balance with interest as at 31 December 2014 was Rs. 13,567,123.

## 5 Accountability and Good Governance

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### 5.1 Corporate Plan

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Even though a Corporate Plan for the period 2011-2015 had been prepared by the Bank, the targets set out for the year under review had not been achieved as planned. Details are shown below.

<b>Item</b>	<b>Target</b>	<b>Actual</b>	<b>Variance</b>
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	<b>Rs.</b>	<b>Rs.</b>	<b>Rs.</b>
Profit	1,702,240,000	303,539,698	1,398,700,302
Investments	33,219,153,000	27,505,171,827	5,713,981,173
Loans and Advances	80,752,893,000	61,371,585,932	19,381,307,068
Deposits from Customers	105,566,914,000	72,525,364,971	33,041,549,029
Other Liabilities	2,476,507,000	3,765,103,216	(1,288,596,216)

The following observations are also made in this connection

- (a) According to the Corporate Plan, the Bank had expected to maintain the non performing loan ratio of the Bank below 4 per cent. Nevertheless, it was 7.69 per cent as at 31 December 2014.
- (b) The Bank had targeted to increase the branch network up to 400 branches and commencement of ATM network in the year 2014. However, only 265 branches

were in operation as at end of the year under review and ATM network had not been commenced even by the end of the year under review.

- (c) Although, the Bank had targeted to mobilize, amounting to Rs. 105,566 million of deposits from customers, it was mobilized only Rs. 72,525 million or 69 per cent as at 31 December.
- (d) Although the expected split between saving deposits and fixed deposits was 55:45 in 2014, the actual split shows 42:58 as at 31 December 2014.

## **5.2 Action Plan**

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The Bank had not prepared an action plan for the year 2014 as requested by the Public Enterprise Circular No. PED 47 dated 18 December 2007.

## **5.3 Procurement Plan**

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The Bank had not prepared a master procurement plan and a procurement time schedule for the year 2014 to ensure the timely completion of the procurement and to obtain the best market value for it.

## **5.4 Budgetary Control**

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Significant variances were observed between the budgeted and actual figures, thus indicating that the Budget had not been made use of as an effective instrument of management control.

## **6 Systems and Controls**

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

- (a) Accounting
- (b) Loan Administration
- (c) Human Resources Management
- (d) Corporate Governance
- (e) Pawning
- (f) Compliance with Instructions of the Central Bank of Sri Lanka
- (g) Internal Control
- (h) Budgetary Control