

Central Bank of Sri Lanka (CBSL) – 2015

The audit of financial statements of the Central Bank of Sri Lanka (CBSL) for the year ended 31 December 2015 comprising the statement of financial position as at 31 December 2015 and the income statement, statement of 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 42 (2) of the Monetary Law Act, (Chapter 422). In carrying out this audit, I was assisted by a firm of Chartered Accountants in public practice to examine the compliance with International Financial Reporting Standards.

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 International Financial Reporting Standards (IFRS) , 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

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 Auditing 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 judgement, including the assessment of the risk of material misstatements of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the CBSL’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 CBSL’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 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

2.1 Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Central Bank of Sri Lanka (CBSL) as at 31 December 2015, and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

2.2 Comments on Financial Statements

2.2.1 Accounting Deficiencies

Accrued expenditure for the previous year had been overstated by Rs. 244,253,125 and instead of adjusting this error against the respective expenditure accounts; it had been credited to the sundry income for the year under review.

2.2.2 Receivable from General Treasury and Other Ministries

In terms of Section 39 of Monetary Law Act, each outstanding balance should be recovered prior to transferring the profit to the Consolidated Fund. However, a sum of Rs. 1,378,694,800 had remained outstanding as at the end of the year under review without being recovered at the time of transferred the profit to the Consolidated Fund. The summary of outstanding balance for each year is as follows.

year	Outstanding Balance Rs.
Before 2010	3,131,503
2010	1,311,774,231
2011	16,851,378
2012	21,374,392
2013	2,165,825
2014	3,441,143
2015	19,956,328
Total	<u><u>1,378,694,800</u></u>

2.3 Non-Compliance with Laws, Rules, Regulations and Management Decisions etc.

The CBSL had paid Pay As You Earn (PAYE) tax and tax on tax aggregating Rs. 322.6 million and Rs.179.2 million for the year under review and for the preceding year respectively from its own funds instead of being recovered from its employees contrary to Public Enterprises Circular No. 03/2016 of 29 April 2016.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the CBSL for the year under review had resulted in a pre-tax net loss of Rs. 17,814 million as compared with the corresponding pre-tax net loss of Rs. 31,532 million in the preceding year, thus indicating an improvement of Rs. 13,718 million in the financial results for the year under review. The increase of net foreign exchange revaluation gain, and net income from local currency financial assets by Rs.42,856 million and Rs.13,535 million respectively as against the increase of net expenses from foreign currency financial assets by Rs. 42,001 million in the year under review as compared with the preceding year were the main the reasons attributed for this improvement in the financial results.

3.2 Analytical Financial Review

The total net operating loss of the CBSL for the year under review was Rs. 6.1 billion including net foreign exchange revaluation gain of Rs. 10.6 billion as compared with the total net operating loss of Rs. 20.2 billion, (including net foreign exchange revaluation loss of Rs. 32.2 billion) in the preceding year, thus indicating an improvement of Rs. 14.1 billion or 70 per cent in the total net operating loss. Whereas the operating expenses including depreciation and amortization expenses during the year under review was Rs. 11.6 billion as compared with that of Rs. 11.3 billion in the previous year, thus indicating an increase of 2.65 per cent in the operating expenses. The variances relating to revenue and expenditure in the year under review as compared with the preceding year are shown below.

	2015	2014	Variance {favourable/(adverse)}	
	Rs. Bn.	Rs. Bn.	Rs. Bn.	percentage
Income/(Expenditure) from foreign currency financial assets	(15.1)	26.9	(41.9)	(155.7)
Expenditure on foreign currency financial liabilities	3.6	3.1	(0.5)	(16.1)
Foreign exchange revaluation gain/ (loss)	10.6	(32.3)	42.9	132.8
Income/(Expenditure) from local currency financial assets	0.4	(13.1)	13.5	103.0
Operating expenses	11.6	11.3	(0.3)	(2.7)
Net loss for the year	(17.8)	(31.5)	13.7	43.5

Although the income from foreign currency financial assets had decreased by 156 per cent as compared with the preceding year, the income from local currency financial assets had increased by 103 per cent as compared with the preceding year, thus resulted a decrease in net loss for the year under review.

3.3 Transactions of Contentious Nature

The following observations are made.

(a) Renting out of Buildings.

According to Section 117 of Monetary Law Act, “ the CBSL 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 the following buildings owned to the CBSL had been rented out for outside parties without being utilized for the intended purposes. Details are sown below.

Name of Building	Renting out Period	Name of Outside Party	Monthly Rental
Property in Brazil	01 February 2015 to 31 January 2017	Ministry of Foreign Affairs	US\$ 9,000
Building in New York	01 June 2012 to 31 May 2017	Ministry of Foreign Affairs	US\$ 68,000
White Aways Building	01 November 2015 to 31 October 2018	Credit Information Bureau	Rs.4,140,000
- Ground floor and 1 st floor			
- Second floor	01 November 2015 to 31 October 2018	Ministry of Southern Development	Rs.2,070,000
4 th and 5 th floors of the National Mutual Assurance Building (Central Point)	From 01 December 2015 to 30 November 2016	CHEC Port City Colombo (Pvt) Ltd	Rs.5,154,087 (from 01 December 2016- Rs.5,540,658)

The following observations are also made in this connection.

- (i) The Cabinet approval before purchase of property in Brazil had not been obtained by the CBSL up to now and the future plan for utilization of the property had not been decided yet.
- (ii) Even though the Monetary Board of the CBSL had decided on 10 May 2016 to transfer the ownership of the properties in Brazil and New York to the General Treasury, no further action had been taken in this regard up to the month of September 2016.

(b) Payment for Consultancy Services and Advisory Council

The then President of the Democratic Socialist Republic of Sri Lanka has appointed three international experts on 28 June 2014 to serve as an Advisory Council in order to advise the Presidential Commission appointed to investigate the complaints received regarding missing persons resident in Northern and Eastern Provinces and this was notified by the Extraordinary Gazette No. 1871/18 dated 15 July 2014. The expenditure such as consultancy fees, accommodation and other charges of the above Advisory Council and their staff amounted to Rs.145 million and Rs.111.5 million for the year under review and for the preceding year respectively had been incurred by the CBSL. Even though the above expenditure had been incurred by the CBSL without any reimbursement basis, the duties of above Consultants were not directly related to the objectives of the CBSL.

In this connection the Assistant Governor of the CBSL had informed me that “a Cabinet approval was granted on 01 November 2016 to recover any payments made by the CBSL since 16 August 2016 to the Consultants from the profits which to be transferred to the Consolidated Fund”

(c) Payments to the Foreign Lawyers and International Centre for Settlement of Investment Disputes (ICSID)

The Ceylon Petroleum Corporation (CPC) restrained from making payments on the oil hedging agreements entered into with Deutsche Bank AG (DB) under directions issued by the Monetary Board on 16 December 2008 as the oil hedging transactions had been found materially affected and substantially tainted. In the meantime, the DB initiated arbitration proceedings in the ICSID against the Government of Sri Lanka. In this matter, the Arbitration award was delivered on 02 November 2012 in favour of the DB for sum of USD 78,469,623.

However, annulment proceedings have been initiated by the CBSL at the ICSID against the award of Arbitration according to the direction of the Attorney General and legal team of the CBSL.

Accordingly, sums of Rs.378,676,095 and Rs.25,617,480 had been paid to the foreign lawyers who appeared in the arbitration proceedings since the year 2010 to the year 2014 and ICSID as administrative costs of annulment proceedings respectively during the year under review by the CBSL. In addition to that a provision of Rs.13,079,334 had been made in the accounts in this connection.

The above payments aggregating Rs.417,372,909 had been paid without reimbursement basis and it was observed that these payments were not directly related to the functions of the CBSL.

“The Assistant Governor of the CBSL had informed me that “although the aforesaid payments do not appear to have directly arisen from the function of the CBSL, it is observed that the arbitration proceedings were initiated against the GOSL pursuant to the non –payment of money by the CPC to DB, consequent to the direction was issued by the Monetary Board on 16 December 2008 aforesaid and therefore, the involvement of the CBSL in the ICSID arbitration proceedings was indispensable at that point.”

(d) Unsound Practices and Financial Irregularities of a Primary Dealer

The Supervision Division of the Public Debt Department of the CBSL had carried out an on-site examination of a Primary Dealer on 31 March 2015, 20 May 2015 and 21 May 2015. The examination report had been submitted to the Monetary Board on 14 September 2015.

At the onsite examinations it was revealed that the following Rules had been violated by this Primary Dealer.

- (i) **Lanka Settle System Rules Version 2.1 (2013) on usage of the Intra-day Liquidity Facility (ILF)** – The Primary Dealer had used its customer's securities as collaterals to obtain ILF.
- (ii) **The Direction on Repurchase and Reverse Repurchase Agreements dated 02 May 2002** – The Dealer had failed to allocate adequate securities against the borrowings from the customers under the Repurchase Agreements and to obtain securities with sufficient market value for lending by it under the Reverse Repurchase Agreements.
- (iii) **Section 2.2 of Lanka Settle System Rules Version 2.1 (2013) (custodial Responsibilities)** – The Primary Dealer had failed to record some customer outright transactions in the Central Depository System of the Lanka Settle System.

It was further observed, that the CBSL had issued several warning letters and the a direction on 06 June 2013 to the said Primary Dealer about its violations (non-allocation of adequate securities to certain customers and using customer securities for obtaining ILF facilities) revealed at previous examinations carried out on 10 December 2012 and 14 December 2012. Even though there were so many indications regarding the irregularities done by the Primary Dealer, the same unsound practices had been continued by this Dealer even in the year 2015 due to not taking remedial action by the CBSL.

Further, the CBSL had invested its funds in tradable reverse Repo investments with this Primary Dealer. For the tradable instruments, the custodian has the right to change the underlying security at any time. According to the Reverse Repurchase Agreement, when the underlying security is changed, the custodian is bound to provide a security with similar or more than the maturity value of the security. The said primary dealer had failed to re-assign securities with respect to the withdrawn securities and violated the reverse repurchase agreements. However, if the CBSL had invested its funds in non- tradable instruments, the custodian had not been able to change the securities contradictory to the conditions of investment agreements. The value of uncollateralized Repo investments made through CBSL with this Primary Dealer as at 31 December 2015 was Rs.1.9 billion. The Monetary Board of the CBSL had decided to rollover the above investments without collaterals as per the Board decision taken on 04 December 2015. The Lanka Secure System had shown a nil balance regarding these investments since the Primary Dealer had withdrawn the underlying securities without reassigning any security with respect to the withdrawn securities.

It was further observed that a government institution had informed the CBSL on 07 October 2015 regarding non-allocation of securities of its investments made with this Primary Dealer amounted to Rs. 2.5 billion.

(e) Settlement of Credit Card expenses

According to the provisions in the Circular dated 19 April 2011 issued by the Finance Department of the CBSL relating to advance payments, the original invoices should be presented to settle advances obtained. In contrary to the above Circular provisions, original invoices amounted to Rs.1,537,355 which were paid through the credit card during the period from 28 February 2015 to 31 December 2015 by then Governor of the CBSL had not been presented in order to settle the advances obtained by him. However, the above expenses were charged to the CBSL.

Further, CBSL had paid the personnel expenses amounted to Rs.6,564,359 which were incurred through the official credit card of then Governor during the period from 28 February 2015 to 31 December 2015. It was further observed that the above expenses had been refunded after considerable delays. Details are as follows.

Credit Card Statement Period	Date of Advance Obtained/Settled the Credit Card Bills	Amount Refunded	Refunded Date	Number of Days Delayed
		Rs.		
31.03.15 - 30.04.15	21.05.15	31,166	08.06.15	18
30.04.15 - 31.05.15	23.06.15	42,450	10.07.15	17
		25,511	22.09.15	91
31.05.15 - 30.06.15	27.07.15	38,048	18.08.15	22
		194,660	22.09.15	57
30.06.15 - 31.07.15	25.08.15	775,124	22.09.15	28
31.07.15 - 31.08.15	22.09.15	517,007	24.11.15	63
31.08.15 - 30.09.15	15.10.15	450,000	07.12.15	53
		185,766	08.12.15	54
		1,801,616	26.04.16	194
30.09.15 - 31.10.15	24.11.15	553,934	18.01.16	55
		24,193	27.01.16	64
		14,191	29.02.16	97
31.10.15 - 30.11.15	15.12.15	1,053,993	04.03.16	80
30.11.15 - 31.12.15	19.01.16	856,700	04.03.16	45

3.4 Management of Public Debt of Sri Lanka

The Central Bank of Sri Lanka (CBSL) has been established to ensure economic and price stability and financial system stability of the country. The CBSL is responsible for the agency function of Management of Public Debt of Sri Lanka. It also holds the exclusive responsibility for the issuance of Treasury securities to fulfill the cash requirements of the Government at a minimum cost to the Government.

A special audit report on the issue of Treasury Bonds by the Department of Public Debt of the Central Bank of Sri Lanka during the period from February 2015 to May 2016 had been presented to the Hon. Speaker of the Democratic Socialist Republic of Sri Lanka on 29 June 2016. Observations included in this special audit report to be treated as the observations of this report.

4. Systems and Controls

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

Area	Observations
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(a) Supervision of Non-banking Financial Institutions	- Violation of rules by a Primary Dealer
(b) Payments	- Payments to foreign lawyers and consultants without provisions for reimbursement
(c) Settlement of Advances	- Advances settled without original invoices