

## **Housing Development Finance Corporation Bank of Sri Lanka - 2016**

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The audit of financial statements of the Housing Development Finance Corporation Bank of Sri Lanka (“the Bank”) for the year ended 31 December 2016, comprising the statement of financial position as at 31 December 2016 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 26(2) of the Housing Development Finance Corporation Bank of Sri Lanka Act, No. 07 of 1997 as amended by Act, No.15 of 2003 and Act, No. 45 of 2011.

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

### **1.2 Board’s Responsibility for the Financial Statements**

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The Board of Directors (“Board”) 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 Board 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. 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 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 Board, as well as evaluating the overall presentation of the financial statements. Sub-sections (3) and (4) of the Section 13 of 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 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 of the financial position of the Housing Development Finance Corporation Bank of Sri Lanka as at 31 December 2016 and its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

#### 2.1.1 Report on other Legal and Regulatory Requirements

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These financial statements present the information required by the Banking Act, No.30 of 1988 and subsequent amendments.

### 2.2 Comments on Financial Statements

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#### 2.2.1 Lack of Evidence for audit

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The following documentary evidence as indicated against the each items shown below was not made available for audit.

<b>Item</b>	<b>Amount</b>	<b>Evidence not made available</b>
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	Rs.	
Cash at Bank		
– Deutch Bank Sinking	454,106	Bank confirmation, Bank
– BOC Collection Account (Mit)	(210,679)	Reconciliations and Bank
		Statements
Balances Due to Other Institutions	2,406,465,176	Balance Confirmations
Borrowings from Other Institutions	35,170,740	Agreements with the National
		Insurance Corporation and
		Sudu Nelum Movement

### 2.3 Accounts Receivable and Payable

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The following observations are made.

- (a) The excess loan recoveries amounting to Rs.12,181,978 appeared in the “Equal Monthly Installments (EMI) Excess Account” for more than one year without being settled those to respective customers.
- (b) As a general practice of the Bank, the cash advances and cheque advances should be settled within 14 days and 22 days respectively. However, cash advances and cheque advances given by the Bank for various purposes aggregating Rs.455,125 and Rs.4,459,266 respectively had not been settled accordingly as at 31 December 2016.

- (c) Out of Rs.17,953,267 shown in other liabilities as at end of the year under review, an amount of Rs.6,178,828 had remained in the accounts for more than three years without being settled.
- (d) A sum of Rs.1,294,,144 recovered as stamp fees from the customers had remained in the accounts for more than three years without being cleared.
- (e) Sums of Rs.613,325 or 68 per cent and Rs. 219,100 or 24 per cent out of Rs.896,175 shown in deposits account as receivable had remained outstanding for the period between 5-10 years and more than 10 years respectively. However, no confirmations with regards to those deposits had been received up to the end of the year under review.
- (f) The outstanding balance in special debtor account as at 31 December 2016 was amounting to Rs. 736,405 and out of that an amount of Rs. 144,958 had been remained outstanding since 2006.

## 2.4 Non – Compliance with Laws, Rules, Regulations and Management Decisions

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The following instances of non-compliance with Laws, Rules, Regulations and Management Decisions are observed in audit.

### Reference to Laws, Rules, Regulations and Management Decisions etc.

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### Non-compliance

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| (a) | Section 16(2) of Part IV of the Housing Development Finance Corporation Act, No. 07 of 1997                        | Issued capital of the Bank should be Rs. 1,000 million. However, stated capital of the Bank as at 31 December 2016 was Rs.962,092,936.   |
| (b) | Section 4(1) (iv) in Direction 6.1 of the Banking Act, Direction 02 of 2012 and Outsource Policy of the Bank -2014 | Bank had not complied with this provisions for selecting a outsource company in order to expedite recovery process of the Bank.  |
| (c) | Section 133 (4) (a) of Inland Revenue Act No.10 of 2006 and amendments there to.                                   | Withholding tax rates applied by the Bank during the year 2016 were not in line with the requirements of the Act.  |
| (d) | Paragraph 10 (b) of the Government Gazette (Extraordinary) No. 1465/19 dated 05 October 2006                       | Stamp duty collected from the employees on remuneration for the period from 01 July 2015 to 31 December 2016 amounting to Rs.233,450 had not been remitted to the Department of Inland Revenue even up to 24 March 2017. |

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| <p>(e) Paragraph No. 10 of the Government Gazette (Extraordinary) No. 1530/13 dated 01 January 2008.</p>   | <p>The Bank had not remitted the collected stamp duty of Rs.1,062,575 from the customers during the period from 01 July 2015 to 30 September 2016 at the time of disbursement of loan facilities to the Department of Inland Revenue.</p>  |
| <p>(f) Central Bank of Sri Lanka (CBSL) Direction No. 02/17/402/0073/002 of 17 January 2014 issued in conjunction with the Master Plan on Consolidation of the Financial Sector.</p> | <p>Though the Bank should maintain Rs.5,000 million as its core capital balance as at 01 January 2018, no action had been taken to adhere with this requirement.</p>   |
| <p>(g) Financial Regulations (FR) of the Government of the Democratic Socialist Republic of Sri Lanka. FR.757 ( 2 )</p>  | <p>No Board of Survey had been carried out by the Bank in order to verify the fixed assets during the year under review.</p>   |
| <p>(h) Public Enterprises Circular No. PED 12 of 02 June 2003</p> <p>-----</p> <p>(i) Section 5.2.4 of Chapter 5</p>   | <p>Though the draft budget should be submitted for the approval of Board of Directors prior to three months of the commencement of the financial year, the Bank had not complied with this. The Annual Budget for the year 2016 had been approved by Board only on 18 December 2015.</p>   |
| <p>(ii) Section 9.2. (b) and (d) of Chapter 9</p>  | <p>An organization should have an approved Organization Chart with an approved Cadre and it should be registered with the Department of Public Enterprises, General Treasury. However, the Bank had not complied with this provision.</p>  |
| <p>(iii) Chapter 9.3.1 of Chapter 9</p>  | <p>Every enterprise should have a Scheme of Recruitments and Promotions for each post, and it should be approved by the Board and the appropriate Ministry with the concurrence of the Department of Public Enterprises, General Treasury. However, no such Scheme available in the Bank.</p>  |
| <p>(i) Government Procurement Guidelines - 2006 and Public Finance Circular No.PF/429 (i) dated 4 June 2009</p>  | <p>The Bank is using a special Purchasing Manual for its procurement purposes without being obtained approval from the Director General of Public Finance. In the meantime, the Bank had purchased 1,669 items to the total value of Rs.82 million during the year 2016 based on this unauthorized Manual instead of follow the Government Procurement Guidelines.</p> |

(j) Loan Recovery Manual of the Bank

- Section 4.1.1

The total value of Vested Properties as at 31 December 2016 was Rs.23,291,154 and out of that 52 per cent equaled to Rs.12,138,322 had remained over ten years.

- Section 4.1.5

The revaluation on Vested Properties should be done at least once in every 2 years by an Internal Valuer or in every 4 years by an External Valuer. However, Vested Properties amounting to Rs.6,311,250 remained for the period between 2-6 years without being revalued as requested.

- Section 3.4.7

The excess money collected by auctioning the vested properties should be paid to the respective customers. However, excess money so collected amounting to Rs. 472,448 had not been paid to the respective customers by the Bank during the year under review.

### 3. Financial Review

#### 3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2016, had resulted in a pre-tax net profit of Rs. 848 million as compared with the corresponding pre-tax net profit of Rs. 1,009 million for the preceding year, thus, indicating a deterioration of Rs.161 million or 16 per cent in the financial results of the year under review. Significant increase in interest expenses and impairment charges for loans and other losses as compared with the increase in interest income and other income were the main reasons attributed for this deterioration.

According to the information made available the following table gives a summary of financial results at various stages for the year under review and in the preceding year.

	2016 ----- Rs. Million	2015 (Restated) ----- Rs. Million	Variance Favourable (Adverse) ----- percentage
Interest Income	5,472	4,660	17
Interest Expenses	(3,509)	(2,539)	(38)
<b>Net Interest Income</b>	<b>1963</b>	<b>2,121</b>	<b>(7)</b>
Net Fee and Commission Income	347	253	37
Other Operating Income (Net)	108	12	800
<b>Total Operating Income</b>	<b>2,418</b>	<b>2,386</b>	<b>1</b>

Impairment Charges for Loans and Other Losses	161	89	(81)
<b>Net Operating Income</b>	<b>2,257</b>	<b>2,297</b>	<b>(2)</b>
Staff Cost	895	829	(8)
Other Expenses	514	459	(12)
<b>Operating Profit Before Value Added Tax</b>	<b>848</b>	<b>1,009</b>	<b>(16)</b>
VAT on Financial Services	188	206	9
Tax Expenses	270	294	8
<b>Profit for the year</b>	<b>390</b>	<b>509</b>	<b>(23)</b>

### 3.2 Analytical Financial Review

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#### Significant Accounting Ratios

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The following observations are made.

- (a) Net Profit Ratio of the Bank reported as 6.58 per cent for the year 2016 which is below the sector ratio of 9.31 per cent.
- (b) Return on Average Assets represents only 0.89 per cent as compared with the sector average of 1 per cent and it been decreased by 33 per cent as compared with the previous year.
- (c) Return on Average Share Holders Funds had been decreased by 32 per cent as compared with the previous year.
- (d) Earnings per Share and Market Value per Share had been decreased by 23 per cent and 30 per cent respectively as at the end of the year 2016 as compared with the previous year.

## 4. Operating Review

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### 4.1 Performance

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The following observations are made;

#### (a) Non-performing Loans and advances (NPL)

The balance of total loans and advances as at 31 December 2016 was Rs. 31,052 million and non-performing loans advances as at that date was Rs.5,300 million or 17.58 per cent. However, it was 20.77 per cent and 22.57 per cent as at the end of the year 2015 and 2014 respectively.

#### (b) Borrowings of the Bank

According to the information made available, debt to equity ratio of the Bank for the year under review and previous 04 years is as follows.

	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
	<b>Rs.</b>	<b>Rs.</b>	<b>Rs.</b>	<b>Rs.</b>	<b>Rs.</b>
	<b>Million</b>	<b>Million</b>	<b>Million</b>	<b>Million</b>	<b>Million</b>
Total Borrowings	8,863	9,037	6,213	5,257	3,214
Shareholders' Funds	3,728	3,364	2,886	2,575	2,391
Debt to Equity Ratio	2.38	2.69	2.15	2.04	1.34

Total borrowings of the Bank as at the end of the year 2016 had slightly decreased by 1.9 per cent over the preceding year as a result of increasing the shareholders' fund by 10.82 per cent. Debt to Equity Ratio of the Bank had decreased by 11.52 per cent as compared with the gradually increment in last preceding four years. Hence, the higher debt-to-equity ratio typically shows that the Bank has been aggressive in financing its growth with debt.

- (c) EPF loans amounting to Rs.7,372,852 was in arrears for more than 18 months. Although there was a possibility to recover those loans from EPF which maintained by the Central Bank of Sri Lanka, the Bank had not taken any satisfactory actions to recover those loan balances even up to end of 31 December 2016 .
- (d) Although a Corporate Plan had been prepared in order to achieve the objectives of the Bank, the variances ranging from 29 per cent to 71 per cent were observed between the targeted and actuals figures relating to customer deposits, loans and advances, net interest income and profit before tax for the year under review.

Details are given below.

<b>Item</b>	<b>Target as per the Corporate Plan</b>	<b>Actual</b>	<b>Variance</b>
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	<b>Rs. Million</b>	<b>Rs. Million</b>	<b>percentage</b>
Customer Deposits	45,450	32,123	29
Loans and Advances	50,500	30,260	40
Net Interest Income	3,334	1,960	41
Profit Before Tax	2,252	660	71

## 4.2 Management Activities

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The following observations are made.

- (a) A sum of Rs. 8,372,529 had been written off as a loss on loan administrative charges for the year under review without recovering this from customers. However, it had been recognized as an unrealized income in previous years.

- (b) The Bank had sold 31 vested properties for the purpose of recovering the outstanding loan balances of Rs.14,418,413 incurring a loss of Rs.9,358,213 to the Bank.
- (c) Pay As You Earn (PAYE) tax of Rs.18,249,288 had been paid by the Bank during the year under review from its own fund on behalf of its employees without deducting it from the personal emoluments of the employees contrary to the Public Enterprises Circular No. PED 03/2016 of 29 April 2016. Although the Pay As You Earn (PAYE) tax on bonus payments for the month of December 2016 was Rs. 3,205,619, the Bank had paid Rs. 3,256,008 to the Department of Inland Revenue. Hence, a sum of Rs.50,389 had been over paid to the Department of Inland Revenue.
- (d) The Bank had provided a refinance loan facility without obtaining a security deposit from Lanka Electricity Company Ltd. Further, it was failed to recover the interest of Rs.731,385 receivable as at 31 December 2016.
- (e) No return had been received since the year 2015 from the investment of Rs 25,000,000 made in Cey Bank Unit.

### **4.3 Human Resources Management**

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The following observations are made

- (a) According to the information provided by the Human Resources Department of the Bank. It was revealed that 09 posts under the categories of Senior Manager, Junior Executive and Driver/Peon were in excess and 54 posts were in vacant as at 31 December 2016.
- (b) Four officers in the post of Banking Assistants Grade IV and one Banking Assistant in Grade VI 2 had been promoted as Assistant Executives and Assistant Managers Grade IV during the year 2016. However, these posts had not been included in the present Approved Cadre of the Bank.
- (c) The job advertisement for the post of Court Clerk was advertised in a weekend newspaper on 20 December 2015. However, the selected four candidates were submitted their applications prior to the date of paper advertisement. As per the advertisement, the candidates should have possessed three passes at GCE (A/L) and five credit passes at GCE (O/L) including credit pass for Mathematics, Sinhala & English Languages. Nevertheless, the candidates who selected for the above posts had not possessed the required qualifications for this post.
- (d) The Bank had recruited two Office Assistants during the year 2016 based on a request made by two Branch Managers without following formal recruitment procedures.



## 5. Accountability and Good Governance

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### 5.1 Budgetary Control

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Significant Variances ranging from 7 per cent to 52 per cent had been observed between the budgeted and actual figures, thus indicating that the budget had not made use of as an effective internal control instrument of the Bank.

## 6. Systems and Controls

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Deficiencies observed in 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.

<u>Areas of Control</u>	<u>Observations</u>
Asset Management	<ul style="list-style-type: none"><li>- Movement of fixed assets from/to Branches has not been properly maintained.</li><li>- Certain Assets were not physically available in the Branch, though it was included in the fixed assets.</li><li>- Certain Assets marked as disposed were physically available in the Branches.</li><li>- Certain assets had been identified as new addition as at 31 December 2016 by the Property Division of the Bank. However, at the physical verification they were identified as old items and removed from the assets management system.</li><li>- Depreciation for assets was made without considering the purchase date.</li><li>- No proper Accounting treatment with regards to the disposal items of the Bank</li><li>- No documentary evidence made available regarding the approvals for disposals of motor vehicle, sales proceeds on disposals and date of disposal.</li></ul>
Branch Operations	<ul style="list-style-type: none"><li>- Security cameras had not been affixed in pawning safe room of some Branches.</li><li>- Evidences were not made available with regarding the handing over of pass book to the relevant customer when opening accounts through palm top assistants.</li><li>- Certain instances were observed exceeding the insurance limit of Rs.300,000 for promotional assistants on behalf of palmtop cash collection in Branches.</li></ul>
Customer Deposits	<ul style="list-style-type: none"><li>- Interest had been calculated for certain "Dhananidana" accounts after the maturity date of the certificates.</li></ul>
Accounting	<ul style="list-style-type: none"><li>- Prevailing differences between age analysis of stamp fees payable account and returns submitted to Department of Inland Revenue.</li><li>- There was a difference between the schedule and audit calculation as per the Section 21 of Manual of Credit Operations with regard to processing fee for 408 mortgaged loans.</li></ul>

