**People's Bank and its Subsidiaries - 2016**

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The audit of the financial statements of the People's Bank ("the Bank") and the consolidated financial statements of the Bank and its Subsidiaries ("the Group") for the year ended 31 December 2016 comprising the statement of financial position as at 31 December 2016, the income statement, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows 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 . To carry out this audit I was assisted by a firm of Chartered Accountants in public practice.

This report is issued in terms of provisions in Article 154(6) of the Constitution of the 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 of these financial statements that give a true and fair view in accordance with Sri Lanka Accounting Standards and for such internal control as 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.

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, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2016, and of its financial performance and 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 Group as at 31 December 2016, and of its financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

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

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

### 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's 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., 50.16 per cent of the People's Merchant Bank PLC and 37.3 per cent of the Smart Net Lanka (Pvt) Ltd as at the reporting date.

The ownership of the Bank as at 31 December 2016 as compared with the preceding year in respect of each Company is as follows.

| | Direct Investments | | | |
|---|---|---|---|---|
| | **2016** | **Percentage** | **2015** | **Percentag** |
| | **Rs.000** | | **Rs.000** | |
| **Subsidiaries** | | | | |
| People's Travels (Pvt) Ltd | 4,950 | 99 | 4,950 | 99 |
| People's Leasing and Finance PLC | 690,958 | 75 | 840,958 | 75 |
| People's Merchant Bank PLC | 629,858 | 50.16 | 629,858 | 50.16 |
| **Total investment in Subsidiaries** | **1,325,766** | | **1,475,766** | |
| **Associates** | | | | |
| Smart Net Lanka (Pvt) Ltd | 25,000 | 37.3 | 25,000 | 37.3 |
| **Less** – Provision for impairment | (25,000) | | (25,000) | |
| **Net investment in Associates** | - | | - | |

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

The following instances of non- compliance were observed in audit.

| | Reference to Laws, Rules, Regulations and Management Decisions etc. | Non-compliance |
|---|---|---|
| (a) | People's Bank Act, No. 29 of 1961 | |
| | i) Section 12(1) | 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 exceeded 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. |
| | ii) Section 20 | No debenture shall be issued by the Bank without the approval of the Minister in charge for the subject of Finance. However, the Bank had issued Rs. 10,000 million worth debentures to the Pension Fund without such approval. |
| (b) | Section 19(b) of the People's Bank Widows and Orphans Pension Fund | The Bank's Widows and Orphans Pension Fund should hold Annual General Meeting prior to 30th June in every year after completion of the audit. However, it was observed that Annual General Meetings had not been held after 2003. |
| (c) | Section 3.9 of General instructions Circular of the Bank No. 808/2009 | Even though the branch managers should maintain a register including details of persons to whom passwords have been given and should be kept under dual control, the Bank had not complied with this provision. |
| (d) | Credit Procedure Manual of the Bank | |
| | (i) Section 2.1.8 (Title 4) and Section 3.1 (Title 5) | The purpose of facility applying should be verified by an inspection and also should be supported by necessary documents. However, no evidence was made available to prove whether the Bank had carried out an inspection and obtained relevant documents before processing facility. |

| | | |
|---|---|---|
| | (ii) Section 2.5.1 (Title 4) | In contrary to the instructions given, in certain instances the Bank had granted loans without taking any security. |
| | (iii) Section 09 | At the sample audit test it was observed that, in eleven instances some Branches had granted Temporary Overdraft Facilities to the customers exceeding the prescribed limits determined for Branch Manager without obtaining approvals. It was further observed that such facilities given aggregating Rs. 128,188,494 were in non-performing position as at the end of the year under review. |
| | (iv) Section 9.7.3 | Even though the Branches should maintain a separate transfer book including the details of approvals for Temporary Overdraft Facilities, certain instances the Branches had not properly maintained that book. |
| | (v) Section 25.3.3 | The risk assessment of customer had not been done by the Bank in certain instances. Further the Bank had provided the Permanent Overdraft Facility without considering the risk of repayment reports submitted by the risk controller of the Bank. |
| | (vi) Section 2.3.2 and Section 2.3.3 of Management Circular of the Bank No.550/2000 (84) dated 20 January 2016 | Interest rates of term loans should be the range of 13 per cent to 14 per cent (on securities). However, the Bank had granted above loans at a lower rate of 8.75 per cent even without obtaining any security. |
| (e) | Board Papers No. 634/2015 and 44/2016 | According to the decisions taken by the Bank, the loans should be released in two stages. However, the Bank had released the entire loan of Rs.10 billion in one stage. |

## 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 2016 had resulted in a pre-tax net profit of Rs.20,814 million and Rs. 25,433 million respectively as compared with the corresponding pre-tax net profit of Rs. 19,520 million and Rs. 24,121 million of the Bank and the Group respectively for the preceding year, thus indicating improvements of Rs. 1,294 million and Rs. 1,312 million of the Bank and the Group respectively. This was mainly due to increase in Other Income and decrease in Impairment for Loans and Other Losses.

Although the profit for the year of the Bank and the Group was Rs.14,995 million and Rs.17,956 million respectively, the value addition of the Bank and the Group after taking in the account the personnel emoluments ,depreciation and taxes paid to the Government were Rs.45,393 million and Rs. 53,638 million respectively. The value additions in the previous year were Rs.43,977 million and Rs. 50,263 million respectively.

**3.2 Analytical Financial Review**

**3.2.1 Profitability**

Branch network of the Bank had reported a profit of Rs. 20,569 million in 2016 as compared with Rs. 14,860 million in 2015. Profit of Rs. 20,586 million was generated by 342 Branches while loss of Rs. 17 million reported by 05 Branches during the year under review.

**3.2.2 Significant Accounting Ratios**

An analysis of certain important ratios of the Bank for the year under review and the preceding year as compared with sector ratios for Licensed Commercial Banks are as follows.

(a) Net Profit Ratio of the Bank had reported as 12.28 per cent in the year 2016 and is far below as compared with the sector ratio of 17.87 per cent.

(b) Capital Adequacy Ratio (Tier 1) of the Bank has decreased from 9.9 per cent in the year 2015 to 9.8 per cent in the year 2016. Capital Adequacy Ratio (Tier 1+ Tier 2) was also decreased from 12.5 per cent in the year 2015 to 12.1 per cent in the year 2016. However, the Bank should maintain these ratios at a level of 5 per cent and 10 per cent respectively as per the Nome issued by the Central Bank of Sri Lanka.

(c) Liquidity Ratio of the Domestic Banking Unit of the Bank was 21.73 per cent in 2016 as compared with 26.7 per cent in 2015.

(d) Gross Loans and Receivables had been increased by 14.7 per cent, while total Deposits had been increased by 19.9 per cent as compared with the previous year.

**4 Operating Review**

**4.1 Performance**

The Bank had earned a gross income of Rs.122,114 million for the year 2016 with an increase of 4.6 per cent as compared with the budgeted income. However, the Loans and receivables, and customer deposits had recorded a decrease of Rs.3,945 million and increase of Rs.52,372 million respectively as compared with the targets set out for the year under review. Though the Bank had targeted to earn total assets of Rs. 1,307,128 million, it was able to earned only Rs.1,302,048 million assets as at the year end.

## 4.2 Loan Administration

### 4.2.1 Non-Performing Loans and Advances

**(a) Loan to Anilana Hotels & Properties Ltd.**

The following observations are made.

i) The Bank had granted a Term Loan facility of Rs.108 million on 24 August 2012 for a period of 4 years inclusive of grace period of 1½ years for the purpose of constructing 5 villas in Panichchakerni (Batticaloa District) against the primary mortgage of two properties. Subsequently this loan was categorized as non-performing on 23 February 2015 and the outstanding amount as at 21 July 2016 was Rs. 129,908,076 which comprising the capital portion of Rs.106,500,125 and interest and others of Rs.23,407,951.

ii) It was observed that according to the valuation reports submitted on secured property when granting the loan, the value of the property were varied from Rs.58 million to Rs.250 million. However, the Forced Sale Value of the property was only Rs. 120 million as at 03 July 2015. Accordingly the total outstanding balance of Rs. 129.9 million had been exceeded the Forced Sale Value by Rs. 9.9 million.

iii) It was further observed that, the Bank had failed to take satisfactory recovery actions with regard to this loan.

**(b) Loan to Ruhunu Development Construction & Engineering (pvt) Ltd.**

The following observations are made.

i) A Temporary Overdraft (TOD) facility of Rs. 500 million for a period of six months had been approved by the Bank on 10 December 2014 against a letter issued by Road Development Authority (RDA) by confirming that Rs. 533 million is due to said company from RDA. Due to the delay in receiving payments, the Bank had decided to extend the loan resettlement period by 12 months with an interest rate of 11 per cent and an approval was granted to convert the outstanding balance into a short term loan facility.

ii) Subsequently the facility had been categorized as non-performing on 07 January 2016 and Rs.303,262,140 had remained outstanding without being recovered even up to 27 July 2016 which comprised capital portion of Rs. 301,356,434 and interest and others of Rs.1,905,706. With the rescheduling of the above loan facility by the Bank, capital outstanding was reduced to Rs. 299 million as at 31 December 2016.

iii) Even though as at 27 July 2016 capital outstanding of the above loan was Rs.301,356,434, the outstanding amount to the above company from RDA was only Rs.35,626,901 as at 07 October 2015 as per letter issued by the RDA. Accordingly it was noted that the total amount of the securities were not adequate to cover the outstanding amount of the loan.

*In this connection, the Bank had informed me that "the outstanding balance of Rs.299 million rescheduled and additionally secured by a property mortgage bond of Rs.30* *million and personal guarantee of the Directors. As per the approved Re-structure paper the company makes monthly payment of Rs. 5 million as agreed and 5 per cent from each bill discounting. Accordingly Rs.12.75 million has been recovered towards interest and capital outstanding reduced to Rs. 295.8 million."*

iv) According to the general conditions of the letter of offer dated 20 October 2015, if any delays occurred in receiving proceeds from the RDA, the borrower should undertake to settle short term loan out of its own funds. However, the Bank had not taken any action to recover the loan from the company even up to the date of audit on 27 July 2016.

**(c) Loan to Property Finance & Investment Kandy (private) Limited**

The Bank had granted a term loan of Rs.150 million to the above company on 27 January 2009 and categorized as non-performing on 30 April 2009. The total outstanding balance of the loan as at 21 July 2016 was Rs.323,999,155 comprising with capital of Rs. 116,288,500, interest of Rs. 183,062,124 and penal charges of Rs. 24,648,531. The capital outstanding balance of the above loan had remained same even as at 31 December 2016.

**(d) Loan to City Constructions Contractors (Pvt) Ltd**

The Liberty Plaza Branch of the Bank had granted 05 loan facilities aggregating Rs. 782.7 million to the above company during the year 2012, 2015 and 2016 and subsequently, the facilities had been categorized as non-performing loans. The total outstanding balance of those facilities as at 31 December 2016 was Rs. 1,120.19 million including capital portion of Rs.745.40 million and interest and penal charges of Rs. 374.79 million.

**4.2.2. Loans granted with inadequate securities**
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It was observed that 03 loan facilities were granted without obtaining adequate securities and the capital outstanding of those loan facilities as at 31 December 2016 was Rs.441,242,071.

**4.3 Identified Losses**
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A total loss of Rs.180.45 million had been incurred by the Bank in several instances in the year under review and the previous year. Details are shown below.

| | **2015** | | **2016** | |
|---|---|---|---|---|
| **Description** | **Number of Instances** | **Total Loss** | **Number of Instances** | **Total Loss** |
| **---------------** | | **Rs.** | | **Rs.** |
| Internal frauds | 05 | 7,057,900 | 12 | 10,283,659 |
| External frauds | 312 | 63,143,451 | 236 | 52,296,464 |
| Client, products and business practices | - | - | 06 | 367,584 |
| Damage to physical assets | 02 | 111,805 | 09 | 1,068,512 |

| | | | | |
|---|---|---|---|---|
| Business disruption and system failures | - | - | 04 | 638,160 |
| Execution, delivery and process management | 43 | 32,375,071 | 78 | 13,105,652 |
| **Total** | | **102,688,227** | | **77,760,031** |

## 4.4 Transactions of Continues Nature

The following observations are made.

### a) Abandoned Projects

It was observed that the Bank had abandoned 03 construction projects after incurring miscellaneous expenses of Rs.3,601,897 as result of failure to evaluate the viability of those projects before commencement. Hence, the expenditure incurred by the Bank had become fruitless. Details are shown below.

| Name of the Project | Period | Description of works done | Amount of expenditure incurred<br>Rs. |
|---|---|---|---|
| Puttalam Regional Head Office | 2011-2012 | Soil investigation,<br>Reviewing of bidding documents &<br>Consultancy Fee | 957,319 |
| Udupussallawa Branch | 2008-2012 | Consultancy Fee | 1,435,238 |
| Ewariwatta Service Centre | 2011 | Soil Investigation,<br>Reviewing of bidding documents &<br>Consultancy Fee | 1,209,340 |
| **Total** | | | **3,601,897** |

### b) Temporally Hold Projects

The Bank had already decided and budgeted to construct 03 Branch premises and subsequently it had been decided to temporally hold after incurring a sum of Rs. 1,575,147 as miscellaneous expenses due to high cost.

## 5 Accountability and Good Governance

### 5.1 Procurement Plan

The Bank has only prepared a Capital Budget without preparing a Procurement Plan.

### 5.2 Human Resources Management

The following observations are made.

(a) In the absence of approved Scheme of Recruitments and Promotions (SOR), the Bank had failed to recruit the persons replete with most appropriate knowledge, skills and attitudes to the respective positions.

(b) The Bank had appointed 06 employees on contract basis for key positions of the Bank i.e. the post of Chief Executive Officer/General Manager, Senior Deputy General Manager – Risk Management, Head of Treasury, Head of Marketing, Head of Finance and Head of Information Technology. However, it was observed that following policies and procedures had not been introduced and applied for those positions.

(i) Formal recruitment procedure
(ii) Pre-determined remuneration policy (salaries, bonus, allowances and other payments)
(iii) Job descriptions
(iv) Promotion procedure
(v) Pre-determined qualifications, experiences, age limit and mode of recruitment
(vi) Succession plan
(vii) Performance appraisal system
(viii) Extension policy

## 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.

| | Areas of control | Observation |
|---|---|---|
| (a) | Accounting of Financial Instruments | i. Value of financial assets held to maturity and carrying amount of trading portfolio (FVTPL) of treasury bills and treasury bonds had been calculated based on compound interest method and simple interest method instead of using Effective Interest Rate (EIR). |

| | | |
|---|---|---|
| | | ii. The group financial risk management disclosure was not included in the note in respect of financial risk management in the Group's Financial Statements. |
| (b) | Suspense Accounts | Long-outstanding unreconciled suspense accounts, which were categorized as other loans under Loans and Receivables without being cleared |
| (c) | Loan Administration and Impairment Calculation | • Long outstanding non - performing loans<br>• Loans granted without securities and inadequate securities<br>• Lack of particular details of impairment calculation included in written policy manual<br>• Lack of latest Valuation Reports and latest Audited Financial Statements of the customers. |
| (d) | Fixed Assets Management | • When transfer of fixed assets from one branch to another, transfer entries have not been properly updated in the respective records.<br>• Calculate depreciation of assets after issuing to the location only.<br>• Non availability of formal policy of identifying slow moving and obsolete assets in store<br>• Construction works already completed had remained in the Capital Work In Progress. |
| (e) | Information System | • Failure to update the Security details in the system.<br>• Not linked some pawning centers to the data center. |