

People's Bank and its Subsidiaries - 2017

The audit of the financial statements of the People's Bank ("the Bank") and the consolidated financial statements of the Bank and its Subsidiaries ("Group") for the year ended 31 December 2017 comprising the statements of financial position as at 31 December 2017 and the income statements, statements of comprehensive income, statements of changes in equity and statements 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

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

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 misstatements 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 of the financial statements that give a true and fair view 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

In my opinion, the financial statements give a true and fair view of the financial position of the Bank and the Group as at 31 December 2017 and of their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

2.1.1 Exemption

The Bank has been exempted from the provisions of Part II of the Finance Act, No. 38 of 1971 by an order of then Minister of Finance published in the Government Gazette No. 715 of 14 May 1992 by virtue of powers vested in him by Sections 5 (1) of the said Finance Act.

2.2 Comments on Financial Statements

The financial statements of the Bank comprised the consolidation of the financial statements of the Domestic Banking Units, 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 (Private) 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 (Private) Ltd. at the reporting date.

The ownership of the Bank as at 31 December 2017 as compared with the preceding year in respect of each Company is as follows.

	Direct Investments			
	2017		2016	
	Rs.000	Percentage	Rs.000	Percentage
Subsidiaries				
People's Travels (Private) Ltd	4,950	99	4,950	99
People's Leasing and Finance PLC	690,958	75	690,958	75
People's Merchant Bank PLC	629,858	50.16	629,858	50.16
Total investment in Subsidiaries	1,325,766		1,325,766	
Associates				
Smart Net Lanka (Private) Ltd	25,000	37.3	25,000	37.3
<u>Less</u> – Provision for Impairment	(25,000)		(25,000)	
Net investment in Associates	-		-	

2.3 Non compliances with Laws, Rules, Regulations and Management Decisions

The following non compliances were observed in audit.

Reference to Laws, Rules, Regulations and Management Decision -----	Non-compliance -----
(a) Section 12(1) of the People's Bank Act, No. 29 of 1961	Authorized Share Capital of the Bank was limited to 20,000,000 ordinary shares. However, the capital pending allotment amounting to Rs. 12,152 million representing 243,040,000 shares and it exceeded the authorized share capital mentioned in the Act. Nevertheless, no actions had been taken by the Bank to increase the authorized share capital by amending the Act of the Bank.
(b) Directions No. 03 of 01 September 2009 issued by the Central Bank of Sri Lanka	All Licensed Commercial Banks are required to maintain a real time monitoring system for the purpose of monitoring the all deals done by the dealers at the front office and to ensure that the dealers do not engage in excess of their delegated dealer limits. However, due to not having robust online monitoring system in the Bank, the monitoring process is done during the day at frequent intervals or on the following day.
(c) Value Added Tax (VAT) Act, No.14 of 2002 and amendments made thereto and, Gazette Notification No.1868/10 dated 23 June 2017	(i) Bank has not collected VAT on some revenue. However, the Bank has to bear an output tax on that revenue. Therefore, mapping revenue accounts with VAT payable is needed. (ii) The Bank has not considered the contributions to the Employee Provident Fund (EPF) and Employee Trust Fund (ETF) and payments made for gratuity as emoluments when making monthly Financial VAT payments. However, the provision for Financial VAT payments had been made in the financial statements after considering these expenditures. As a result, an accumulated provision of Rs 1,580 million was recorded as additional liability as at the end of the year under review.
(d) Nation Building Tax Act, No.09 of 2009 and amendments there to	As a result of not considering EPF, ETF and gratuity payments as emoluments when making monthly VAT payments on Financial Services, the Nation Building Tax on Financial Services had also shown a difference of Rs.213.9 million as compared with the actual balance of payable as at 31 December 2017.

(e) Internal Circulars

(i) DGM (Operations)
Circular No.6970/2010 of
03 December 2010

The Bank should send letters at least three times for the pawning customers with respect to the cash balances remained after auctioning of pawned articles and retain copies thereon in a separate file. However, in certain instances the respective Branches had not retained any copy of above letters and cannot verify whether the Branches had sent three reminding letters.

(ii) Section 18.1 of Pawning
Manual of the Bank

Entries should be made in the pawning articles stock book with the signature of two key handling officers when articles are lodged in or taken out. However, in certain instances, only one officer has signed and particular details were not entered in the pawning articles stock book when articles lodged out.

(iii) Office Circular
No.518/2004 (71) of 09
February 2018

Branch Manager should be obtained prior approval to provide Temporary Overdraft facilities to customers. However, in some instances the particular Branches had not obtained any prior approval in this regard.

(iv) Section 9.3.1 of the Credit
Procedure Manual of the
Bank

It is required to maintain the current account with satisfactory deposits for minimum period of six months to eligible for obtain overdraft facility. However, in certain instances the overdraft facilities were granted contrary to the said instructions.

(v) General Instruction
Circulars Nos.688/2003,
808/2009, 736/2005 and
612/96(1) of the Bank

(i) Managers and Officers in charge for Service Centers should physically check and confirm the accuracy of gold content of the articles by selecting randomly at least 10 per cent among the articles for which advances granted daily and maintain a transfer book with given format in above Circular. However, in some instances the Branches of the Bank had not complied with this.

(ii) Although the Nitric Acid and Saltwater used to test gold should be changed once a week with the initial of the respective Branch Manager or Manager (Operations), some Branches had not complied with this.

(iii) The Branches should follow the accounting and stock controlling procedures with regard to Isuru Udana and People's Gift Vouchers. However, the following lapses were observed in this connection.

- Stock records of the gift vouchers had not been properly maintained.
- Serial number order was not followed by the Branches when issuing Gift Vouchers.

- The stocks in hand have not been kept under dual control.
 - The transfer book had not been maintained in the Branches to enter the sale of gift vouchers with details.
- (iv) It was observed that officers' Job Rotation Cards had not been properly updated.
- (f) Section 3.2.2 of the DGM Circular No.571/2002(8) At the end of each month stock in hand should be balanced with the stock book and relevant entry should be verified by placing signature of authorized officer. However, certain instances were noted where the Branches had not adhered to said instructions.

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 2017 had resulted in a pre-tax net profit of Rs.25,913 million and Rs. 29,868 million respectively as compared with the corresponding pre-tax net profit of Rs. 20,814 million and Rs. 25,433 million of the Bank and the Group respectively for the preceding year, thus indicating the improvements of Rs. 5,099 million and Rs. 4,435 million in the financial results of the Bank and the Group respectively. This was mainly due to increase in interest income.

Although the profit for the year of the Bank and the Group was Rs.18,250 million and Rs.20,511 million respectively, the value addition of the Bank and the Group after taking into account the personnel emoluments, depreciation and taxes paid to the Government were Rs.50,721 million and Rs.58,825 million respectively. The value addition in the previous year was Rs.45,886 million and Rs.54,012 million respectively.

3.2 Analytical Financial Review

3.2.1 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 ratio for Licensed Commercial Banks is given below.

- (a) Net Profit Ratio of the Bank had declined from 12.28 per cent reported in the year 2016 to 11.25 per cent in the year 2017. Further, this was below the Sector Ratio of 13.41 per cent.
- (b) Capital Adequacy Ratios i.e. Tier 1 and Tier 1 + Tier 2 of the Bank were increased up to 10.8 per cent and 13.5 per cent respectively during the year 2017 from 9.8 per cent and 12.1 per cent respectively in the year 2016. Sector ratios for Capital Adequacy Ratio (Tier 1) and Capital Adequacy Ratio (Tier 1 + Tier 2) reported as 12.3 per cent and 15.2 per cent respectively for the year 2017 and as such bank maintained these ratios below the sector ratio. However, the Bank should maintain these ratios at a level of 6.25 per cent and 11.75 per cent respectively as per the directions issued by the Central Bank of Sri Lanka.

3.2.2 Profitability

The Bank had earned a gross income of Rs.160,923 million for the year 2017 with an increase of 6.7 per cent as compared with the budgeted income. The entire Branch network of the Bank had reported a profit of Rs.9,477 million in 2017 even though a loss of Rs.55,012 million was reported by 152 Branches during the year under review.

4 Operating Review

4.1 Performance

4.1.1 Planning

Loans and receivables, and customer deposits had been increased by 1.2 per cent and 0.9 per cent respectively as compared with the targets set out for the year under review. However, investments of the Bank were below the target by 21.8 per cent. Though the Bank had targeted to maintain a total assets of Rs.1,514,806 million, it was able to maintain only Rs.1,467,099 million worth of assets as at the end of the year.

4.1.2 Market Share

The following observations are made.

- (a) Interest income of Licensed Commercial Banks as at 31 December 2017 was reported as Rs.825,752 million. However, the contribution of the Bank thereon was only Rs.149,184 million or 18 per cent. Further, the profit of all Licensed Commercial Banks for the year 2017 was Rs.125,957 million and the Bank's contribution for the above was Rs. 18,250 million or 14.5 per cent.
- (b) The Bank had contributed to the total assets, loans and deposits of the Licensed Commercial Banks only by 16 per cent, 19 per cent and 19 per cent respectively in the year 2017.

4.1.3 Loan Administration

The following observations are made.

- (a) The Bank had granted Rs.528,290 million loans during the year 2017 and out of that Rs.3,607 million had been transferred to non performing category as at 31 May 2018. Further, even a single installment had not been recovered from the loan of Rs.140 million and no capital installment had been recovered from loans amounting to Rs.910 million. In the meantime, interest amounting to Rs.75 million had been serviced out with regard to the loan of Rs.133.8 million outstanding as at 31 May 2018.
- (b) Non-performing loans and advances over Rs. 5 million of the Bank as at 31 December 2017 totalled Rs.42,210.8 million which comprising the capital of Rs.12,072 million and interest of Rs.30,138.8 million. Out of that, Rs.2,576.8 million or 6 per cent do not have any security. Further, Rs.29,365 million or 69 per cent of the above loans do not have adequate securities.

(c) Loans and advances totaling Rs.621.83 million inclusive the capital portion of Rs.108.93 million and interest and other charges of Rs.512.9 million had been written off during the year 2017 treated as non-performing.

(d) **Loan to Somervilla and Company**

(i) The Bank had granted a Permanent Overdraft (POD) facility of Rs. 15 million to the above customer under loan number 204100100084991 on 14 February 2005 and the facility had secured with a tea stock amounting Rs.19 million. However, due to unavailability of the aforesaid stock, this facility has converted as Temporary Overdraft (TOD) facility on 26 January 2006 and subsequently transferred to non-performing category on 26 April 2006. The total outstanding balance of above facility was Rs. 247.9 million including capital of Rs.38.9 million and interest and other charges of Rs.209 million as at 27 November 2017.

(ii) As per the special condition of POD, a bank officer should verify whether the stock is maintained equivalent to or higher the current market value of Rs. 19 million. However, the Bank had failed to retain the above stock as security, due to absence of their regular verification as mentioned in the special condition of POD.

(e) **Loan to Miramar Beach Hotel**

Two Susahana loans amounting to Rs.40,000,000 and Rs.10,000,000 had been granted to particular customer under the Management Circular No. 589/2005 and both loans were transferred to non-performing category during the year 2017. The total outstanding as at 22 November 2017 was Rs. 68,152,436 and Rs. 13,203,597.

The following observations are also made in this regard.

- i. Though the customer should open Investment Savings Accounts (ISA) with monthly installment of Rs. 25,000 and Rs. 10,000 on behalf of these two loans, no such account had been opened by the particular customer.
- ii. Even though an insurance policy had been taken for the collateral and assigned in favour of the Bank, the policy had not been renewed after 30 August 2012.
- iii. Even the Bank had filed a case in a court to recover these loans under the case No SL/SPL/LA/312/2013, the court had delivered an unfavourable decision to the Bank. Thereafter, the Bank had appealed against the court decision under the case No CA (Writ) 974/08.

(f) **Loan to Tech Information Solution (Private) Ltd. (TISL)**

Credit facilities such as Block Loan, Trust Receipts, Letter of Credit, Acceptance Facility and Overdraft aggregating to Rs.165 million had been approved to the above company by the Bank during the year 2015. These loans facilities had been restructured by Board Executive Credit Committee due to not servicing credit facilities as agreed.

The following observations are made in this connection.

- i. During the restructuring, block loan amounting to Rs.70 million had been transferred to Non- performing category on 24 March 2017 and Board of Directors had decided to auction the mortgaged properties at the meeting held on 27 April 2017. The total outstanding balance as at 12 July 2017 was Rs.74.7 million (Capital of Rs.70 million, Interest and Penal charges of Rs. 4.7 million). However, valuation report as at 30 November 2016 indicates that the force sale value of the mortgage property was Rs.65 million. Hence, this may cause a possible loss of Rs.9.7 million to the Bank.
- ii. An internal inspection related to the mortgage of the aforesaid loan situated at No.14, Station Road, Wellawatte had not been carried out.
- iii. The Bank had released final stage of loan amounting to Rs.9.26 million to the customer on 27 March 2017 even after transferring the above facility to Non-performing category.

(g) Loan to Ogel Shoe Company (Private) Ltd

Credit facilities aggregating Rs.110 granted to the above company in 2013 had been transferred to non-performing category during the month of March 2014 and then the Bank had rescheduled the above loan facilities on 01 April 2015.

The following observations are made in this connection.

- i. Though the entire loan facilities were secured by stock in trade, no any finished goods were available at present in the company and the business is not in progress.
- ii. The property in which the factory premises located at Ulapone had offered as a security for the POD facility. This property was already mortgaged for the credit facilities obtained from Sampath Bank, Kandy Metro Branch. In spite of that, the Bank has granted the above loan facilities.
- iii. As per the recommendation of Regional Office dated 09 September 2011, because of the high security risk involved in this credit proposal, the building and the machineries located in the property at Ulapone should be insured for Rs.130 million and Rs. 170 million respectively. However no insurance policy had been presented to the audit.
- iv. Though the Bank had filed a case on Pettah Magistrate Court, still failed to recover the total outstanding amount of Rs. 43,047.87 million (Capital- Rs.37,732.88 million & Interest - Rs. 5.3 million) as at 13 July 2017.

(h) **Loan to Hiat Steel (Private) Ltd**

The Bank has granted a credit package aggregating Rs. 153,054,406 to the above company during the period from 1993 to 1996 and subsequently those facilities were transferred to non-performing category. Total outstanding facilities as at 25 June 2018 was Rs.333,161,760.

The following matters were revealed in this regard.

- (i) Even the Bank had approved a loan of Rs.15 million and Rs.51.50 million on 12 January 1995 and 01 March 1995 respectively, the actual granted amount had exceeded the approved credit limit by Rs. 86.55 million.
- (ii) No documentary evidence was made available to ensure whether the Bank had considered the repayment capacity of the company before granting the above facilities.
- (iii) The Bank had written off an amount of Rs.81,074,616 out of capital outstanding in 2006.
- (iv) The said company has ceased its operation on 20 October 2005. Hence, the mortgaged assets of the company was parate executed and vested by the Bank in 29 December 2005 due to un-available of bidders. It was observed that the Bank had incurred expenses approximately Rs.400,000 per month (Rs.4,800,000 per annum) as security charges and cost of litigation of the above mortgaged assets.
- (v) The Bank expects to dispose the acquired mortgaged land and machinery excluding the items seized by the District Court of Pugoda. However, the position report of the DGM (Recoveries) dated 01 September 2016, noted that there is no going concern value as it has already been diminished due to degradation and depreciation of the machinery. Hence, it was observed that the Bank could not recover the outstanding loan balances by disposing mortgaged assets as expected.

(i) **Loan to Lakdiva Clothing Gampola (Private) Ltd.**

The Bank has granted credit facilities totaling to Rs.52,481,338 to above company during the period of 1992 - 1995 in order to establish a garment factory at Mariyawatte, Jayamalapura, Gampola under 200 garment factory scheme upon the mortgage over the leasehold rights of the property. The total outstanding as at 25 June 2018 was Rs.421.3 million.

The following observations are also made in this regard.

- i. Even though the Managing Director of the company had agreed to pay Rs.26 million, it had not settled as agreed by the end of the year 2017.

- ii. The Bank left with no alternative, adopted a Board Resolution to sale of the mortgaged assets but it was not possible without the consent of the lessor (BOI). The terms and conditions of the original lease do not provide even the lessee to sub- lease or alienate the demise premises.

4.2 Identified Losses

The following observations are made.

- (a) As a result of increasing the number of external frauds from 236 to 244 with compared to the previous year, the total loss incurred to the Bank was Rs.36.4 million as at 31 December 2017.
- (b) A loss of Rs.6.3 million had been sustained by the Bank due to damages coursed to the physical assets during the year under review.
- (c) A total loss of Rs.17.3 million was incurred as a result of business disruption and system failure and it was significantly increased by Rs 16.7 million as compared with the previous year.

4.3 Legal Cases Instituted against the Bank and by the Bank

One hundred and sixty nine legal cases had been filed against the Bank by claiming Rs.9,571 million as compensations and out of that Rs.7,209 million had been claimed as damages as at 31 December 2017. It was further observed that 18 cases which the final judgments yet not delivered were likely against the Bank as per the opinion of the Legal Officer of the Bank and the amount claimed in respect of those cases was amounting to Rs.441 million. In the meantime, 3944 legal cases were filed by the Bank against the outsiders by claiming Rs.7,729 million as compensation up to 31 December 2017.

4.4 Operating Inefficiencies

- (a) Some Branches had exceeded their insurance limits with related to Cash, ATM Cash & Gold Articles. For example the insurance coverage for Cash, ATM Cash & Gold Articles of Ganemulla Branch for the accounting period 2017/2018 was Rs.72 million, Rs.13.2 million and Rs.650 million respectively. However, it had been exceeded by that Branch without increase the insurance limit.
- (a) Though the current accounts are not entitled for payment of interest, an interest of 3 per cent per annum had been given for a particular current account maintained at Corporate Banking Division.

4.5 Transactions of Contentious Nature

As per the General Instruction Circular No.381/76, repayment of deposits of Co-operative Societies, Companies, Firms, Clubs, Associations and Similar Institutions or Bodies including deposits held in trust or by Trustee should be made through only an Account Payee cheque favouring the depositor as mentioned in the deposit receipt. However, it was observed that 14

certificates of fixed deposit belongs to the Postgraduate Institute of Science of the University of Peradeniya valued at Rs.93.3 million were uplifted and paid by cash violating the instructions in the above Circular.

4.6 Human Resources Management

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 managerial and other positions.

5. Achievement of Sustainable Development Goals

Bank is aware of the Agenda – 2030 on Sustainable Development Goals of the United Nations Organization. Loan schemes are implemented in the Bank regarding the achievement of Sustainable Development Goals. However, targets relating to the activities to the achievement of the above goals, along with the milestones in respect of achieving those targets and the indicators for evaluating the achievement of such targets are not properly identified by the Bank.

6. Accountability and Good Governance

Internal Audit Division

Although there were 70 officers employed in the Internal Audit Division, the Corporate Banking Division and Human Resources Division of the Bank had not been subject to audit during the year 2017 and the internal audit had not been conducted with regard to the activities of IT Division since the year 2015.

7. 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) Control over Loans and Advances	<ul style="list-style-type: none"> • Prevailing differences in the receivable portfolio balances with the general ledger. • Un-reconciled general ledger balances. • Incorrect loan details available in the system. • Prevailing differences in loan interest rates in the system with the Assets and Liability Committee decisions. • Incomplete addresses of customers.
(b) Control over Credit Cards	<ul style="list-style-type: none"> • Prevailing differences between the general ledger and system due to issue aroused with the system up-grating. • Un-reconciled general ledger accounts relating to card Centre.

(c) Treasury Operations and Investments	<ul style="list-style-type: none"> • Overstatement of accrued interest of Sri Lanka Development Bonds. • Non adjustment of fair value of available for sale investment in equity securities.
(d) Related Party Transactions	<p>Currently the Bank operates a manual process to capture related party transactions and as such, risk of miss capturing may occur. Therefore, data capturing procedure and tracking and extract of related party transactions is needed.</p>
(e) Customer Deposits	<p>Several general ledger accounts relating to fixed deposits, saving deposits and for related interest without proper breakup have been maintained in the system.</p>
(f) Other Assets	<ul style="list-style-type: none"> • Long outstanding receivable balances. • Differences between inter unit assets and liabilities. • Differences between stock reports provided by supplies department and respective general ledger accounts.
(g) Property, Plant and Equipment	<ul style="list-style-type: none"> • Figures with no adequate descriptions and dates in the fixed assets register. • Assets purchased before 2009 are not available in the fixed assets register. • Differences between general ledger and breakups available in supplies departments. • No review of residual value and the useful life of fully depreciated assets. • No review and monitoring for timely capitalization of completed properties.
(h) Information Technology	<ul style="list-style-type: none"> • Absence of privilege user accounts monitoring function. • Inadequate user access monitoring function in IHRM, Prime 4, Digital Banking, Tandem NS, Mobile Banking, CCD and Corona systems. • Absence of a domain controller. • Inadequacies exist in change management documentation- Tandem NS system. • Availability of active user account of resigned employee-Core Banking System-IBM AS/400 Production Server.

- Significant delays exist in user account termination procedure-Core Banking System-IBM AS/400 Production Server.
- Non utilized user accounts exist in systems-ICPS and CBRPS.
- Inadequate information captured in the user account creation forms and termination documents-Prime 4.
- Inadequate information captured in the system generated user lists.
- Deficiencies exist in the password standard defined in the Information Security Policy Document
- Inadequate application level password parameters
- Inadequate password parameters in operating systems- E-Remittance and Treasury System
- Inadequate password setting in Oracle 11g database server-Prime 4
- Outdated operating systems-windows server 2003