Housing Development Finance Corporation Bank – 2017

The audit of financial statements of the Housing Development Finance Corporation Bank of Sri Lanka ("the Bank") for the year ended 31 December 2017 comprising the statement of financial position as at 31 December 2017 and the income statement, statement of 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 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.7 of 1997 as amended by Act, No.15 of 2003 and Act, No.45 of 2011.

This report is issued in terms provisions in Article 154 (6) of the Constitution of 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 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

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 risk of material misstatements 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 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 Housing Development Finance Corporation Bank of Sri Lanka as at 31 December 2017 and 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.

2.2 Lack of Evidence for audit

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

Item	Amount Rs.	Evidence not made available
Cash at Bank		
– Deutch Bank Sinking	454,106	Direct confirmations from respective banks, bank statements and bank reconciliation statements
– BOC, Collection Account (Mit)	258,526	
– BOC, Kandy Branch	38,628	
– BOC, Matale Branch	(28,380)	
Balances due to other Institutions	93,872,309	Balance confirmations
Borrowings from other Institutions	500,000	Agreement with Sudu Nelum Movement

2.3 Accounts Receivable and Payable

The following observations are made.

(a) The excess loan recoveries amounting to Rs. 29,785,012 appeared in the "Equal Monthly Installments (EMI) Excess Account" for more than one year without being settled them to the respective customers.

(b) Although the cash and cheque advances should be settled within 14 and 22 days respectively, such advances given by the Bank for various purposes aggregating Rs. 470,600 and Rs. 6,008,747 respectively had not been settled accordingly as at 31 December 2017 and these advances were outstanding between the period ranging from 23-278 days and 17-181 days respectively.

(c) The Bank had not taken necessary actions to settle the long outstanding balances of Rs.4,567,738 and Rs. 2,238,028 appeared in Dividend Account and Advance Received on Auction Property Account respectively in the General Ledger as at 31 December 2017.

(d) Although the balance of Government Loan Interest Control Nominal Account (G/L Account 1420100004) should be zero as at the end of the year, there was a balance of Rs 9,238,545 in that account as at 31 December 2017 without being cleared.

2.4 Non –compliance with Laws, Rules, Regulations and Management Decisions

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	Non-compliance
(a)	Section 16(2) of Part IV of the Housing Development Finance Corporation Act, No. 7 of 1997.	Issued capital of the Bank should be Rs.1,000 million. However, stated capital of the Bank as at 31 December 2017 was Rs.962,092,936.
(b)	Direction No. 02/17/402/0073/002 of 17 January 2014 issued by the Central Bank of Sri Lanka (CBSL) in conjunction with the Master Plan on Consolidation of the Financial Sector.	Though the Bank should maintain Rs. 5,000 million as its core capital as at 1 January 2018, no action had been taken to adhere with this requirement.
(c)	Financial Regulations (FR) of the Government of the Democratic Socialist Republic of Sri Lanka. - FR 396 (d)	If a cheque remain un-cashed for more than 6 months from the date of issue, confirmation should be obtained from the bank that the cheque will not be paid, treat the cheque as cancelled and report it in appropriate ledgers. However, the Bank was not complied with this and those cheques were appeared in the bank reconciliation statements prepared for the month of December 2017 as un-cashed cheques.
(d)	Provisions in Public Enterprises Circular No. PED 12 of 02 June 2003.	
	(i) Section 5.2.4	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 Annual Budget for the year 2017 had been approved by Board only on 20 December 2016.

	(ii) Section 9.2. (b) and (d)	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.
	(iii) Section 9.3.1	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.
(e)	Public Enterprises Circulars No.1/2015(i) of 27 October 2016 and No. 01/2015 of 25 May 2015	(i) An officer who is entitled to an official vehicle has the option either to use the official vehicle or to avail monthly transport allowance of Rs. 50,000 and monthly fuel allowance applicable to the post. However, in contrary to that, the Bank had excessively paid Rs.300,000 to those entitled officers based on the internal approval granted by the Human Resources & Remunerations Committee.
		(ii) The Bank has paid driver allowance of Rs.540,000 annually in addition to vehicle allowance for three officers who entitled for official vehicles contrary to the provisions in the Circular.
		(iii) Although no approval should be given for payment of maintenance cost to the officers who entitled for vehicle allowance, the Bank had paid amounting to Rs. 450,000 for nine officers as maintenance cost during the year under review. Further, a sum of Rs. 1,548,791 had been paid in addition to the fuel allowance for fourteen officials in contrary to the provisions in the Circular.
(f)	Government Procurement Guidelines and Public Finance Circular PF/429 (i) dated 4 June 2009	The Bank is being used a special Purchasing Manual for the purpose its procurements without obtaining the approvals from the Director General of Public Finance and the Bank had procured 1,311 items worth Rs.74 million during the year 2017 based on this unauthorized Manual instated of following the Government Procurement Guidelines.

(g)	Section 133 of Inland Revenue Act No.10 of 2006 and amendments made thereto.	(i) Instead of applying 2.5 per cent and 10 per cent as rates of withholding tax for individuals and companies respectively, the Bank had applied 8 per cent for individuals and 2.5 per cent and 8 per cent for the companies in contraventions to the provisions. (ii) The Bank has deducted income tax from interest of all accounts where the interest paid less than five thousand rupees per month.
(h)	Paragraph 10 (b) of the Government Gazette (Extraordinary) No.1465/19 of 05 October 2006	Though the stamp duty valued at Rs. 397,425 had been collected from the remuneration of employees during the period from 01 July 2015 to 31 December 2017, it was not remitted to the Department of Inland Revenue
(i)	Section 19 of the Government Gazette No. 1465/20 dated 05 October 2006 and Section 10 of the Government Gazette No. 1530/13 dated 01 January 2008	(i) The Bank should pay stamp duty to any receipt or discharge given for any money or property. However, the Bank had failed to pay Rs.2,137,332 collected as stamp duty to the Department of Inland Revenue. (ii) The Bank had not remitted the stamp duty of Rs.1,739,907 collected from the customers at the time of disbursement of loan facilities during the period from 01 July 2015 to 31 December 2017 to the Department of Inland Revenue.
(j)	Loan Recovery Manual of the Bank	
	(i) Section 4.1.1	The capital outstanding value of Vested Properties as at 31 December 2017 was Rs. 22,246,905. Out of that 50 per cent of Vested Properties equal to Rs. 10,927,479 had remained over ten years.
	(ii) Section 4.1.5	A revaluation on Vested Properties should be done at least in every 2 years by an Internal Valuer or 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.
	(iii) Section 3.4.7	The excess money collected by auctioning the vested properties should be paid to the respective customers. However, such excess money amounting to Rs.1,294,630 had not been paid to the respective 10 customers by the Bank during the year under review.

(k)	Guideline 4.3 of Consultancy Guidelines 2007	Consultancy Services which exceed the period of one year should be advertised in national newspapers. However, the Bank had not complied with this direction.
(l)	Internal Circular No. GCL/2017/225 dated 01 March 2017	Impersonal and General Ledger Accounts should be zero as at end of the day. However, General Ledger of Inter System GL CBS LMS (General Ledger number 1600100001) and Collection Loans and Advances Account (General Ledger number 1330100003) had not been zero as at the end of year 2017.

3. Financial Review

3.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year ended 31 December 2017, had resulted in a pre-tax net profit of Rs. 557 million as compared with the corresponding pre-tax net profit of Rs. 660 million for the preceding year, thus indicating a deterioration of Rs.103 million or 16 per cent in the financial results of the year under review. Significant increase in interest expenses and decrease in other operating income as against with the increase in interest income in the year under review 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.

	2017	2016 (Restated)	Variance {Favourable /(Adverse)}
	Rs. Million	Rs. Million	Percentage
Interest Income	6,613	5,472	21
Interest Expenses	(4,742)	(3,509)	(35)
Net Interest Income	**1,871**	**1,963**	**(4)**
Net Fee and Commission Income	353	347	2
Other Operating Income (Net)	12	108	(89)
Total Operating Income	**2,236**	**2,418**	**(7)**
Impairment Charges for Loans and Other Losses	25	(160)	115
Net Operating Income	**2,261**	**2,258**	**0.13**
Staff Cost	941	896	(5)
Other Expenses	531	514	(3)
Operating Profit Before Value Added Tax and Nation Building Tax	**789**	**848**	**(7)**
VAT on Financial Services	232	188	(23)
Profit /(Loss) before tax	**557**	**660**	**(16)**
Tax Expenses	149	177	16
Profit for the year	**408**	**483**	**(15)**

3.2 Value Addition of the Bank

Even though the operations of the Bank during the under review had resulted in a profit of Rs. 408 million, the contribution of the Bank to the country during the year under review after taking into account the depreciations, staff cost and taxes to the Government was Rs. 1,423 million and it was Rs.1,345 million in the previous year. Hence, the value addition of the Bank had been increased by Rs.78 million in the year under review.

3.3 Analytical Financial Review

Significant Accounting Ratios

According to the information made available, some important observations with regard to accounting ratios of the Bank for the year under review and the preceding year are given below.

(a) Net Profit Ratio of the Bank reported as 5.85 per cent for the year 2017 which is below the sector ratio of 8.24 per cent.

(b) Return on Average Assets represents only 0.86 per cent as compared with the sector average of 1 per cent and it had been decreased by 21.82 per cent as compared with the previous year.

(c) Return on average for Share Holders Funds had been decreased by 24 per cent as compared with the previous year.

(d) Earnings per Share and Market Value per Share had been decreased by 15 per cent and 31 per cent respectively as at the end of the year 2017 as compared with the previous year.

(e) Debt to equity ratio of the Bank for the year under review and previous 04 years is as follows.

	2017	**2016**	**2015**	**2014**	**2013**
Total Borrowings (Rs. Million)	7,917	8,863	9,037	6,213	5,257
Shareholders'Funds (Rs. Million)	4,200	3,821	3,364	2,886	2,575
Debt to Equity Ratio	1.88	2.32	2.69	2.15	2.04

Total borrowings of the Bank as at the end of the year 2017 had slightly decreased by 11 per cent over the preceding year as a result of increasing the shareholders' fund by 9.92 per cent.

4. Operating Review

4.1 Performance

4.1.1 Planning

The following observations are made.

(a) Although the Corporate Plan for the period of 2017-2020 was prepared in order to achieve the objectives of the Bank, variances ranging from 2 per cent to 51 per cent were observed between the targets set out and actual achievements with regard to customer deposits, loans and advances, net interest income and profit before tax mentioned in the Corporate Plan for the year under review. Details are shown below.

Item	Target as per Corporate Plan	Actual	Variance {Favourable/ (Adverse)}
	Rs.Million	Rs.Million	Percentage
Customer Deposits	36,000	36,655	1.82
Loans and Advances	34,200	34,970	2.25
Net Interest Income	2,466	1,872	(24)
Profit Before Tax	1,144	557	(51)

(b) Although according to the Action Plan for the year under review it was planned to increase the Branch Network up to 45 Branches, no Branch had been opened during the year under review and it was remained stood at 39 Branches as at the end of the year under review.

4.1.2 Non-performing Loans and Advances (NPL)

The following observations are made.

(a) The total outstanding balance of loans and advances as at 31 December 2017 was Rs. 35,737 million and non-performing loans and advances as at that date was Rs. 6,384 million or 18.47 per cent of total outstanding balance of loans and advances. However, it was 17.58 per cent and 22.57 per cent as at the end of the year 2016 and 2015 respectively.

(b) Gross non-performing loans and advances ratio of 18.47 per cent is significantly higher than the sector ratio of 4.5 per cent.

(c) Two thousand twelve loans valued at Rs. 742,174,640 granted during the year 2017 had been transferred to non performing category and total capital outstanding as at the end of the year 2017 was Rs. 727,472,766.

4.1.3 Loans granted against the Employees' Provident Fund (EPF)

The following observations are made.

(a) Total outstanding loans which granted against the Employee Provident Fund as at 31 December 2017 was Rs. 9,512,770,575 and out of that, a sum of Rs. 4,154,617,827 had been treated as non- performing loans and it is represented 43.67 per cent of the total outstanding.

(b) EPF loans amounting to Rs. 45,544,434 was in arrears for more than 18 months as at 31 December 2017. Although there was a possibility to recover those loans from EPF contributions, the Bank had not taken any satisfactory action to recover those loan balances even up to the end of the year under review.

4.2 Management Activities

The following observations are made.

(a) The Bank had incurred a loss of Rs. 705,356 by selling of vested properties pledged against the recoverable balance of Rs. 2,123,624.

(b) The Bank had advertised condominium loans by incurring advertising expenditure of Rs. 1,069,505 for the year under review. However, no cost benefit analysis had been carried out in this regard and no progress achieved.

(c) Additional interest expense of Rs. 110,231,835 was incurred during the period under review due to granting higher interest rate as compared with the normal interest rate for 15,404 fixed deposits.

(d) The Bank is highly depended on high cost fixed deposits and deposits with the maturity period of less than 1 year. Out of the total deposits of the Bank, 84 per cent was consisted with fixed deposits.

(e) External rating of the Bank was significantly deteriorated as compared with the previous years. According to the Fitch Rating Report, the Affirmed National Long Term Rating of the Bank had been deteriorated from BBB (lka) Stable in the year 2016 to BBB (lka) Negative in the year 2017.

(f) The cumulative growth of the prathilaba saving accounts and the corporate fixed deposits (Head Office) had been decreased by 6.2 per cent and 60.81 per cent respectively in the year under review as compared with the previous year.

4.3 Transactions of Contentious Nature

The Bank had borne the Pay As You Earn (PAYE) tax of its employees amounting to Rs.21,192,035 without deducting it from the personal emoluments of the respective employees contrary to the Public Enterprises Circular No. PED 03/2016 of 29 April 2016.

4.4 Uneconomic Transactions

The following observations are made.

(a) A person to the post of Consultant – Human Resources Development and Administration had been recruited for upgrading the human resources process of the Bank on September 2016. However, he was unable to perform the duties described in the appointment letter and the Bank had paid Rs. 3,830,000 as consultant fee to him from September 2016 to March 2018.

(b) The Bank had provided a refinance loan facility without obtaining a security deposit from Lanka Electricity Company Ltd. Further, the Bank was failed to recover the interest receivable of Rs. 731,385 as at 01 January 2017 with regard to above loan facility.

4.5 Market Share

The Market Share of the Bank based on the loans and advances and total deposits are shown below.

(a) Market Share based on Loans and Advances.

	Year 2017	2016	2015	2014	2013
Total Loans and Advances of the Bank (Rs. Million)	35,737	31,052	27,316	23,899	20,112
Total Loans and Advances of the Market (Rs. Million)	639,706	533,230	456,961	440,670	347,117
Market share of the Bank (percentage)	5.59	5.82	5.98	5.42	5.79

(b) Market Share based on Deposits

	Year 2017	2016	2015	2014	2013
Total Deposits of the Bank (Rs. Million)	36,655	32,123	28,593	24,479	18,902
Total Deposits of the Market (Rs. Million)	974,574	846,146	764,155	709,671	617,081
Market share of the Bank (percentage)	3.76	3.78	3.74	3.45	3.06

5. Sustainable Development

5.1 Sustainable Development Goals

The Bank has failed to identify and develop the measurement criteria to achieve sustainable development goals which related to the scope of the Bank in complying with the United Nations Sustainable Development Agenda for the year 2030.

6. Accountability and Good Governance

6.1 Budgetary Control

Significant Variances ranging from 10 per cent to 121 per cent were observed between the budgeted and actual figures, thus indicating that the budget had not been made use of as an effective internal control instrument of the Bank.

7. Systems and Controls

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.

Areas of Control	Observation
Asset Management	- A land in Ampara was identified as operating lease without considering the substance of the transaction. - Fixed Assets System was not facilitated to include lease hold assets. - Computer Equipment amounting Rs. 1,379,229 or 46 per cent from the total assets of IT Stores had remained idle for over one year. - Office equipments amounting to Rs. 275,545 or 40 per cent from the total assets had remained idle for over one year. - Movement register of fixed assets from/to Branches have not been properly maintained. - Certain assets were not physically available in the Branch, though it was included in the fixed assets list. - Depreciation of assets was done without considering the purchase date.
Control over Customer Deposits	- Client code creation and authorization were not segregated. - Some Prathilaba Savings accounts were not opened with an initial deposit.
Automated Teller Machines Withdrawals	- Minimum balance for other banks cash withdrawals through ATM machines had not been limited. -

Accounting	-	A difference of Rs. 3,289,295 was observed between the value of Investment Property Revaluation gain as per the financial Statements and as per the Income Tax Computation for the year 2016/2017.
	-	Under provision of Rs. 1,371,599 and over provision of Rs.1,143,360 was observed in Value Added Tax and Nations Building Tax respectively on Financial Services Account as at 31 December 2017.