NOTES TO THE FINANCIAL STATEMENTS

1. Reporting Entity

1.1.Corporate information

Commercial Bank of Ceylon PLC (the "Bank") is a public limited liability company listed on the Colombo Stock Exchange (CSE), incorporated on June 25, 1969 under the Companies Ordinance No. 51 of 1938, and domiciled in Sri Lanka. It is a licensed commercial bank regulated under the Banking Act No. 30 of 1988 and amendments thereto. The Bank was re-registered under the Companies Act No. 07 of 2007 on January 23, 2008, under the Company Registration No. PQ 116. The registered office of the Bank is situated at "Commercial House", No. 21, Sir Razik Fareed Mawatha, Colombo 01, Sri Lanka.

The ordinary shares of the Bank have a primary listing on the CSE.

The staff strength of the Bank as at December 31, 2017 was 4,982 (4,987 as at December 31, 2016).

Corporate information is presented in the inner back cover of this Annual Report.

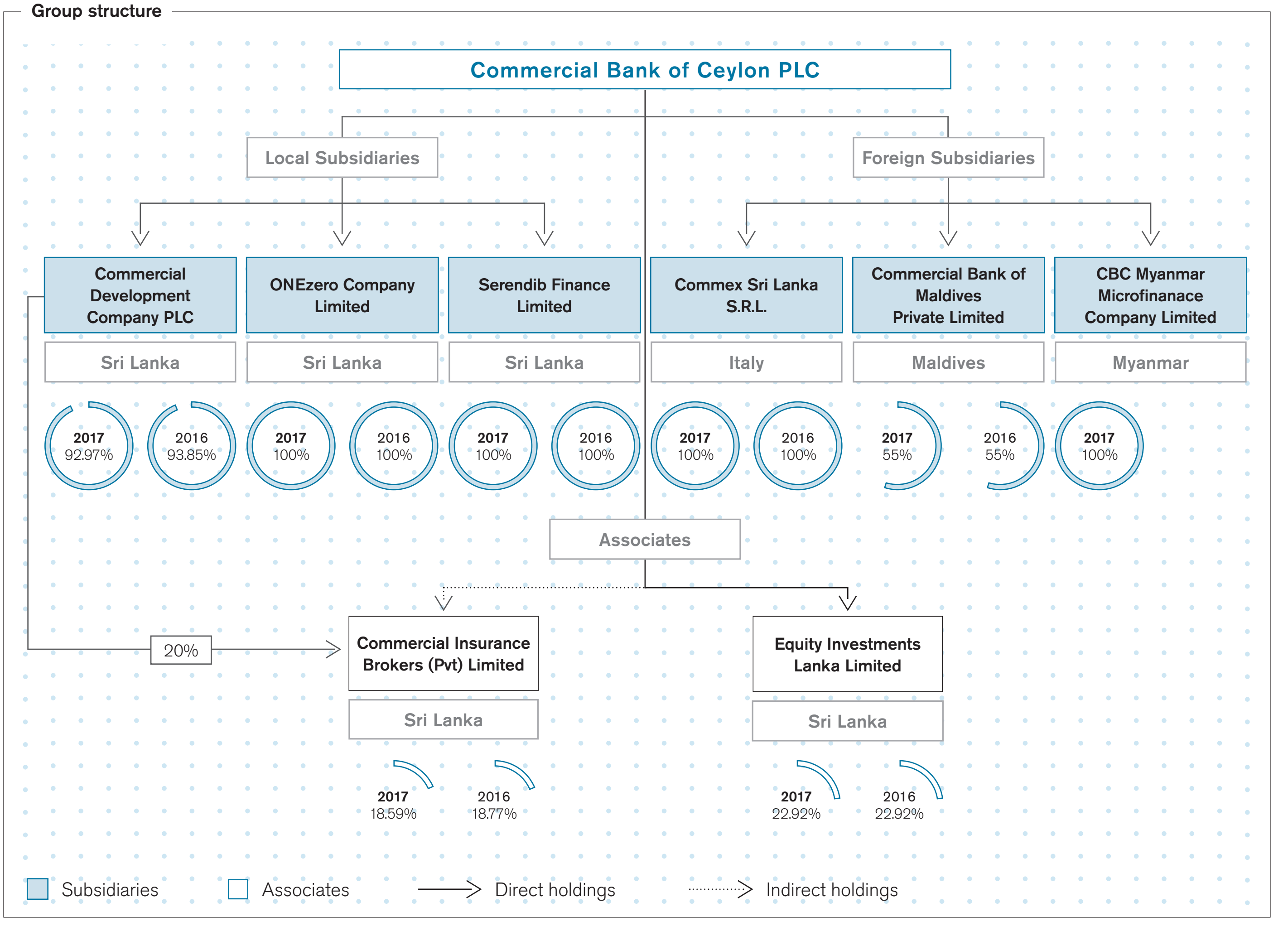
1.2 Consolidated Financial Statements

The Consolidated Financial Statements as at and for the year ended December 31, 2017, comprise the Bank (Parent Company) and its Subsidiaries (together referred to as the "Group" and individually as "Group entities") and the Group's interest in its Associates.

The Bank does not have an identifiable parent of its own. The Bank is the Ultimate Parent of the Group.

1.3 principal business activities, nature of operations of the Group and ownership by the Bank in its subsidiaries and associates

Group structure



Commercial Bank of Ceylon PLC

The principal business activities of the Bank are providing a comprehensive range of financial services encompassing accepting deposits, personal banking, trade financing, offshore banking, resident and non-resident foreign currency operations, travel-related services, corporate and retail credit, syndicated financing, project financing, development banking, lease financing, hire purchase financing, rural credit, issuing of local and international debit and credit cards, tele-banking, internet banking, mobile banking, money remittance facilities, dealing in Government Securities and treasury-related products, salary remittance package, bullion trading, export and domestic factoring, pawning, margin trading, e-Banking services, bancassurance and Islamic banking products and services, etc.

Commercial Development Company PLC (CDC)

Principal business activities of CDC are property development, related ancillary services and outsourcing of staff for non-critical functions of the Bank.

During 2015, the Board of Directors of the Bank resolved to reduce the shareholding of CDC, (in which the Bank had a stake of 94.55%) to comply with the requirements of the Listing Rule No. 7.13 of the CSE on Minimum Public Holding. Accordingly, the Bank disposed a part of shares through the CSE and reduced the shareholding in CDC to 92.97% by December 31, 2017 (93.85% by December 31, 2016) and is in the process of taking steps to dispose the required number of shares to adhere to the requirements of the Listing Rules.

CDC, holds a 20% stake of Commercial Insurance Brokers (Pvt) Limited (CIB). The Bank has a significant influence over financial and operating activities of CIB though it effectively holds only 18.59% as at December 31, 2017 (18.77% as at December 31, 2016).

ONEzero Company Limited

The principal business activities being providing IT – related services.

Serendib Finance Limited

Principal business activities being providing financial services including leasing, hire purchase, loans, etc.

Commex Sri Lanka S.R.L.

Commex Sri Lanka S.R.L. inaugurated its money transfer operation during 2016 following the grant of a Money Transfer License from the Bank of Italy.

It operates as an agent to the Bank for opening of accounts, providing money transfer services, issuance and encashment of foreign currencies and travellers cheques, collecting applications for credit facilities and handling of ATM cards, etc.

Commercial Bank of Maldives Private Limited

Commercial Bank of Maldives Private Limited, a fully-fledged Tier 1 Bank, inaugurated its banking operations in the Maldives on September 26, 2016. This is a Subsidiary of the Bank partnering with Treetop Investments Maldives.

The principal activities include offering of an extensive range of banking and related financial services.

CBC Myanmar Microfinanace Company Limited

CBC Myanmar Microfinanace Company Limited was incorporated in Myanmar on April 4, 2017 as a fully owned subsidiary of the Bank.

The principle business activities include engaging in microfinance business.

A licence was issued by the Myanmar Microfinance Supervisory Enterprise for the Company to operate as a non-saving deposit organisation. The Company is yet to commence its commercial operations.

Equity Investments Lanka Limited

The principal activities include investment services, risk capital and venture capital management.

Commercial Insurance Brokers (Pvt) Limited (CIB)

CIB, a private limited liability company is an insurance broker registered with the Ministry of Finance in terms of legislation.

There were no significant changes in the nature of the principal business activities of the Bank and the Group during the financial year under review.

2. Basis of Accounting

2.1 Statement of compliance

The Consolidated Financial Statements of the Group and the separate Financial Statements of the Bank, have been prepared and presented in accordance with the Sri Lanka Accounting Standards (SLFRSs and LKASs), laid down by The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and in compliance with the requirements of the Companies Act and the Banking Act and provide appropriate disclosures as required by the Listing Rules of the CSE. These Financial Statements, except for information on cash flows have been prepared following the accrual basis of accounting.

These SLFRSs and LKASs are available at www.casrilanka.com

The Group did not adopt any inappropriate accounting treatments, which are not in compliance with the requirements of the SLFRSs and LKASs, regulations governing the preparation and presentation of the Financial Statements.

Details of the Group's Significant Accounting Policies followed during the year are given in Notes 6 to 10 on pages 182 to 192.

The formats used in the preparation of the Financial Statements and the disclosures made therein also comply with the specified formats prescribed by the CBSL for the preparation, presentation and publication of Annual Audited Financial Statements of Licensed Commercial Banks.

2.2 Responsibility for Financial Statements

The Board of Directors of the Bank is responsible for the preparation and presentation of the Financial Statements of the Group and the Bank as per the provisions of the Companies Act No. 07 of 2007 and Sri Lanka Accounting Standards.

The Board of Directors acknowledges their responsibility for Financial Statements as set out in the "Annual Report of the Board of Directors", "Statement of Directors' Responsibility" and the certification on the Statement of Financial Position on pages 136, 146 and 167, respectively.

These Financial Statements include the following components:

- an Income Statement and a Statement of Profit or Loss and Other Comprehensive Income providing the information on the financial performance of the Group and the Bank for the year under review. Refer pages 165 and 166;
- a Statement of Financial Position providing the information on the financial position of the Group and the Bank as at the year end. Refer page 167;
- a Statement of Changes in Equity depicting all changes in shareholders' funds during the year under review of the Group and the Bank. Refer pages 168 to 171;
- a Statement of Cash Flows providing the information to the users, on the ability of the Group and the Bank to generate cash and cash equivalents and utilisation of those cash flows. Refer page 172;
- Notes to the Financial Statements comprising Significant Accounting Policies and other explanatory information. Refer pages 173 to 332.

2.3 Approval of Financial Statements by the Board of Directors

The Financial Statements of the Group and the Bank for the year ended December 31, 2017 (including comparatives for 2016), were approved and authorised for issue by the Board of Directors in accordance with Resolution of the Directors on February 23, 2018.

2.4 Basis of measurement

The Financial Statements of the Group have been prepared on the historical cost basis except for the following material items stated in the Statement of Financial Position.

Items	Basis of measurement	Note No./s	Page/s
Held-for-trading financial instruments including financial derivatives	Fair value	30 & 31	221 & 222
Financial investments – Available for sale	Fair value	34	232
Land and buildings	Measured at cost at the time of acquisition and subsequently at revalued amounts which are the fair values at the date of revaluation	39	245
Defined benefit obligation	Net liability for defined benefit obligations are recognised as the present value of the defined benefit obligation, less net total of the plan assets, plus unrecognised actuarial gains, less unrecognised past service cost, and unrecognised actuarial losses	50	268
Equity settled share-based payment arrangements	Fair Value on grant date	54	280

2.5 Going concern basis of accounting

The Management has made an assessment of its ability to continue as a going concern and is satisfied that it has the resources to continue in business for the foreseeable future.

Furthermore, the Management is not aware of any material uncertainties that may cast significant doubt upon the Group's ability to continue as a going concern. Therefore, the Financial Statements of the Group continue to be prepared on a going concern basis.

2.6 Functional and presentation currency

Items included in these Financial Statements are measured using the currency of the primary economic environment in which the Bank operates (the Functional Currency).

Each entity in the Group determines its own functional currency and items included in the Financial Statements of these entities are measured using that Functional Currency. There was no change in the Group's Presentation and Functional Currency during the year under review.

These Financial Statements are presented in Sri Lankan Rupees, the Group's Functional and Presentation Currency.

The information presented in US Dollars in the Section on "Supplementary Information" on pages 434 and 435 does not form part of the Financial Statements and is made available solely for the information of stakeholders.

2.7 Presentation of Financial Statements

The assets and liabilities of the Group presented in the Statement of Financial Position are grouped by nature and listed in an order that reflects their relative liquidity and maturity pattern.

No adjustments have been made for inflationary factors affecting the Financial Statements.

An analysis on recovery or settlement within 12 months and after more than 12 months from the Reporting date is presented in Note 62 on "Maturity Analysis"on pages 289 and 290.

2.8 Rounding

The amounts in the Financial Statements have been rounded-off to the nearest rupees thousands, except where otherwise indicated as permitted by the Sri Lanka Accounting Standard – LKAS 1 on "Presentation of Financial Statements".

2.9 Offsetting

Financial assets and financial liabilities are offset and the net amount reported in the Statement of Financial Position, only when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis or to realise the assets and settle the liabilities simultaneously. Income and expenses are not offset in the Income Statement, unless required or permitted by an Accounting Standard or Interpretation (issued by the International Financial Reporting Interpretations Committee and Standard Interpretations Committee) and as specifically disclosed in the Significant Accounting Policies of the Bank.

2.10 Materiality and aggregation

Each material class of similar items is presented separately in the Financial Statements. Items of dissimilar nature or function are presented separately, unless they are immaterial as permitted by the Sri Lanka Accounting Standard – LKAS 1 on "Presentation of Financial Statements" and amendments to the LKAS 1 on "Disclosure Initiative" which was effective from January 1, 2016.

Notes to the Financial Statements are presented in a systematic manner which ensures the understandability and comparability of Financial Statements of the Group and the Bank. Understandability of the Financial Statements is not compromised by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.

2.11 Comparative information

Comparative information including quantitative, narrative and descriptive information is disclosed in respect of the previous period in the Financial Statements in order to enhance the understanding of the current period's Financial Statements and to enhance the inter period comparability. The presentation and classification of the Financial Statements of the previous year are amended, where relevant for better presentation and to be comparable with those of the current year.

2.12 Use of judgements and estimates

In preparing the Financial Statements of the Group in conformity with SLFRSs and LKASs, the Management has made judgements, estimates and assumptions which affect the application of Accounting Policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised prospectively.

Significant areas of critical judgements, assumptions and estimation uncertainty, in applying Accounting Policies that have most significant effects on the amounts recognised in the Financial Statements of the Group are as follows:

A. Judgement

Information about judgements made in applying Accounting Policies that have the most significant effects on the amounts recognised in these Financial Statements is included in the following notes.

2.12.1 Determination of control over investees

Management applies its judgement to determine whether the control indicators set out in Note 37 on page 241 indicates that the Group controls the investees.

2.12.2 Classification of financial assets and liabilities

The Significant Accounting Policies of the Group provide scope for assets to be classified at inception into different accounting categories under certain circumstances.

- In classifying financial assets or liabilities at "Fair value through profit or loss" (FVTPL), the Group has determined that it has met the criteria for this designation set out in Notes 30 and 31 on pages 221 to 222.
- In classifying financial assets as "Held to maturity" (HTM), the Group has determined that it has both the positive intention and ability to hold the assets until their maturity date as required by Note 35 on page 238.
- In classifying financial assets as "Available for sale" (AFS), the Group has determined that all non-derivative financial assets that are designated as AFS or those financial assets not classified as loans and receivables, FVTPL or HTM be classified as AFS as set out in Note 34 on page 232.

B. Assumptions and estimation uncertainties

Information about assumptions and estimation uncertainties that have a significant risk of resulting in material adjustments for the year ended December 31, 2017 are included in the following Notes.

2.12.3 Fair Value of financial instruments

The fair values of financial assets and financial liabilities recognised on the Statement of Financial Position, for which there is no observable market price are determined using a variety of valuation techniques that include the use of mathematical models. The Group measures fair value using the fair value hierarchy that reflects the significance of input used in making measurements. Methodologies used for valuation of financial instruments and fair value hierarchy are stated in Note 26 on pages 214 to 219.

2.12.4 Impairment losses on loans and receivables

The Group reviews its individually significant loans and advances at each Reporting date to assess whether an impairment loss should be provided in the Income Statement. In particular, the Management's judgement is required in the estimation of the amount and timing of future cash flows when determining the impairment loss.

These estimates are based on assumptions about a number of factors and hence actual results may differ, resulting in future changes to the provisions made.

The individual impairment provision applies to financial assets evaluated individually for impairment and is based on Management's best estimate of the present value of the future cash flows that are expected to be received. In estimating these cash flows, Management makes judgements about a borrower's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, and the workout strategy and estimate of cash flows considered recoverable.

A collective impairment provision is established for:

- groups of homogeneous loans and advances that are not considered individually significant; and
- groups of assets that are individually significant but that were not found to be individually impaired.

The collective provision for groups of homogeneous loans is established using statistical methods (such as, net flow rate methodology, risk migration analysis) or, a formula approach based on historical loss rate experience, using the statistical analysis of historical data on delinquency to estimate the amount of loss. Management applies judgement to ensure that the estimate of loss arrived at, on the basis of historical information is appropriately adjusted to reflect the economic conditions and portfolio factors as at the Reporting date. The loss rates are regularly reviewed against actual loss experience.

In assessing the need for collective impairment, Management considers factors such as credit quality (for example, loan to collateral ratio, level of restructured performing loans), portfolio size, concentrations and economic factors. To estimate the required allowance, assumptions are made to define how inherent losses are modelled and to determine the required input parameters, based on historical experience and current economic conditions (including policy rates, inflation, growth in Gross Domestic Product, sovereign rating, etc.).

The accuracy of the provision depends on the model assumptions and parameters used in determining the collective provision.

Refer Note 18 on page 201 for details.

2.12.5 Impairment of financial investments – available for sale

The Group reviews the debt securities classified as AFS investments at each Reporting date to assess whether they are impaired. This requires similar judgements as applied on the individual assessment of loans and advances.

The Group also records impairment charges on AFS equity investments when there has been a significant or prolonged decline in the fair value below their cost along with the historical share price movements, duration and extent up to which the fair value of an investment is less than its cost.

Refer Note 7.1.11.2 on page 187 for details.

2.12.6 Impairment of non-financial assets

The Group assesses whether there are any indicators of impairment for an asset or a Cash Generating Unit (CGU) at each Reporting date or more frequently, if events or changes in circumstances necessitate to do so. This requires the estimation of the "Value in use" of such individual assets or the CGUs. Estimating "Value in use" requires the Management to make an estimate of the expected future cash flows from the asset or the CGU and also to select a suitable discount rate in order to calculate the present value of the relevant cash flows. This valuation requires the Group to make estimates about expected future cash flows and discount rates and hence, they are subject to uncertainty.

Refer Note 7.5 on page 188 for details.

2.12.7 Revaluation of property, plant and equipment

The Group measures land and buildings at revalued amounts with changes in fair value being recognised in Equity through Other Comprehensive Income (OCI). The Group engages independent professional valuers to assess fair value of land and buildings. The key assumptions used to determine the fair value of the land and building and sensitivity analyses are provided in Note 39.5 (b) and 39.5 (c) on pages 252 to 256.

2.12.8 Useful life-time of the property, plant and equipment

The Group reviews the residual values, useful lives and methods of depreciation of Property, Plant and Equipment at each Reporting date. Judgement of the Management is exercised in the estimation of these values, rates, methods and hence they are subject to uncertainty.

Refer Note 20 on page 203.

2.12.9 Deferred tax assets

Deferred tax assets are recognised in respect of tax losses to the extent that it is probable that future taxable profit will be available and can be utilised against such tax losses. Judgement is required to determine the amount of deferred tax assets that can be recognised, based upon the likely timing and level of future taxable profits, together with future tax-planning strategies.

Refer Note 48 on page 265 for details.

2.12.10 Defined benefit obligation

The cost of the defined benefit plans determined using an actuarial valuation. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future salary increases, mortality rates, future pension increases, etc. Due to the long-term nature of these plans, such estimates are subject to significant uncertainty.

Refer Note 50 on pages 268 to 275 for the assumptions used.

2.12.11 Provisions for liabilities, commitments and contingencies

The Group receives legal claims in the normal course of business. Management has made judgements as to the likelihood of any claim succeeding in making provisions. The time of concluding legal claims is uncertain, as is the amount of possible outflow of economic benefits. Timing and cost ultimately depends on the due processes in respective legal jurisdictions.

Information about significant areas of estimation uncertainty and critical judgements in applying Accounting Policies other than those stated above that have significant effects on the amounts recognised in the Consolidated Financial Statements are described in Notes 7.9 to 7.15 on pages 190 and 191.

2.13 Events after the reporting period

Events after the reporting period are those events, favourable and unfavourable, that occur between the Reporting date and the date when the Financial Statements are authorised for issue.

In this regard, all material and important events that occurred after the reporting period have been considered and appropriate disclosures are made in Note 70 on page 332, where necessary.

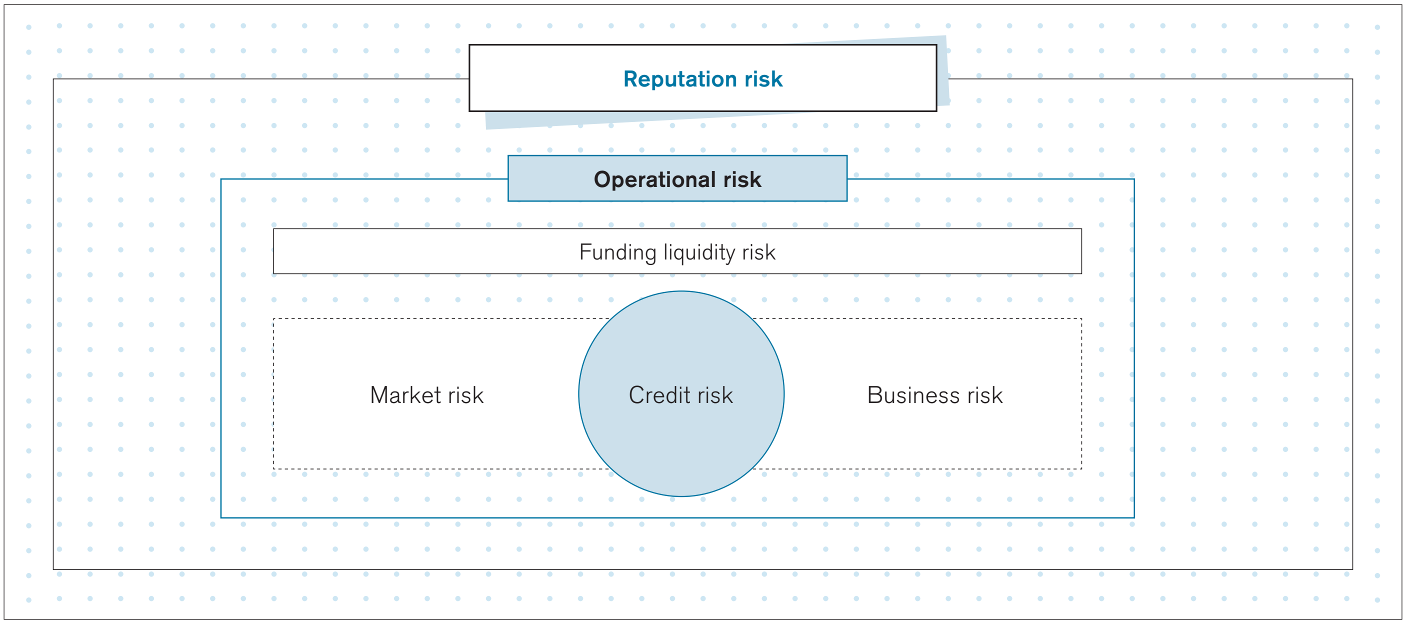
3. Financial Risk Management

3.1 Introduction and overview

Risk is inherent in the Bank's activities, but is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. This process of risk management is critical to the Bank's continuing profitability and each individual within the Bank is accountable for the risk exposures relating to his or her responsibilities.

The Group has exposure mainly to the following risks from financial instruments:

- Credit risk;
- Market risk;
- Liquidity risk; and
- Operational risk.



3.2 Bank's risk management framework

The Board of Directors of the Bank has the overall responsibility for the establishment and oversight of the Bank's Risk Management Framework.

The Risk Management Policy of the Bank translates overall risk appetite on business activities in a holistic approach to provide the guidance required for convergence of strategic and risk perspectives of the Bank.

The Group's risk management policies are established to identify and analyse the risks faced by the Group, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. The Risk Management Policy Framework constitutes the Credit Policy, Lending Guidelines, ALM Policy including Liquidity Risk Policy, Foreign Exchange Policy, Operational Risk Policy, IT Risk Management Policy, Market Risk Management Policy, Stress Testing Policy, etc., which have been firmly established to provide control and guidance for decision-making throughout the Bank in a uniform manner.

The Committee structure embedded to the system acts as a fact finding and decision-making authority through meaningful discussions of multiple points of view. The Risk Management Committees effectively deliberate on matters at hand to provide guidance to the business lines with a view to managing risk in accordance with the strategic goals and risk appetite of the Bank.

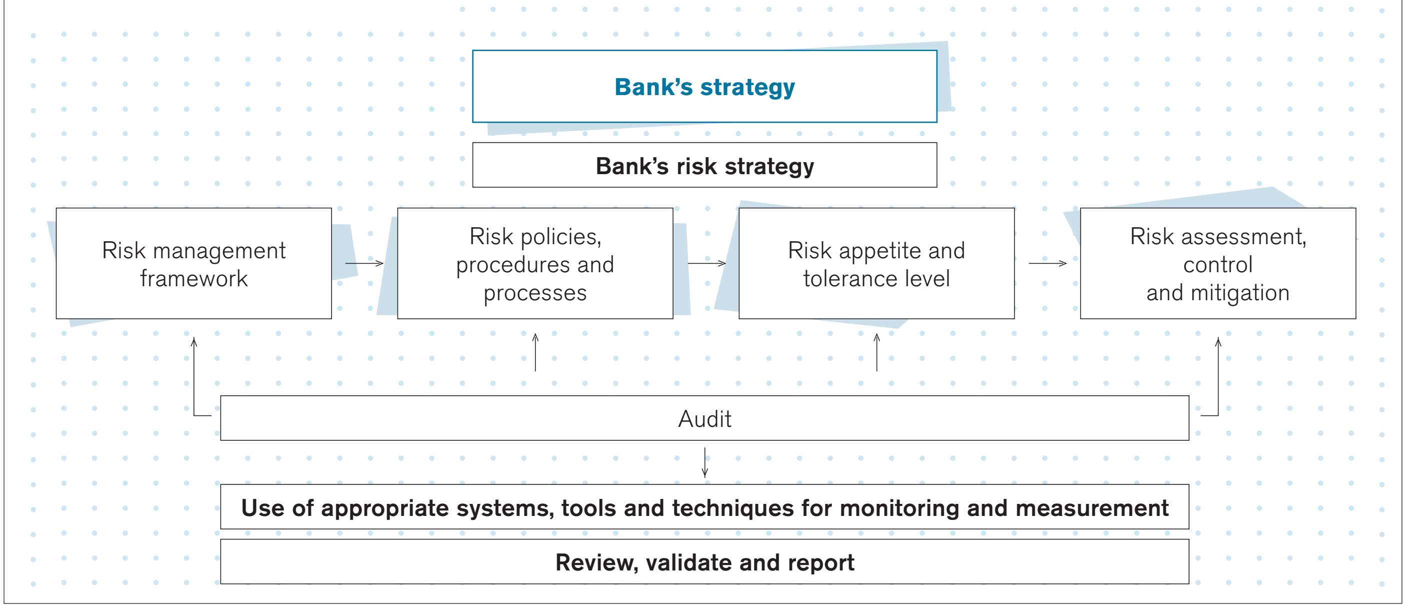
The Board of Directors of the Bank has formed a mandatory Subcommittee namely, the Board Integrated Risk Management Committee (BIRMC) as per Banking Act Direction No. 11 of 2007 on Corporate Governance. The performance of the Committee and the duties and roles of members are reviewed by the Board annually.

The meetings of the Executive Integrated Risk Management Committee (EIRMC) are conducted on a monthly basis to discuss Credit and Operational risk matters of the Bank while priority is given for liquidity and market risks at the Assets and Liabilities Committee (ALCO) meetings that convene at least once a fortnight.

In addition, the Integrated Risk Management Department carries out semi-annual Bank-wide risk assessment function focusing on adherence to laws, regulations, and regulatory guidelines as well as internal controls and approved policies. A dedicated Compliance Department is entrusted with the responsibility of monitoring these requirements on an ongoing basis.

Further, the Internal Audit function of the Bank independently monitors and evaluates the risk management function of the Bank and provides their views on adequacy of the Risk Management Framework to the Board Audit Committee.

Bank's financial risk management framework



Credit risk

The risk that the Bank will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and for geographical and industry concentrations and by monitoring exposures in relation to such limits.

Management of credit risk

Lending Guidelines of the Bank formulated in consultation with lending units provide expected granularity of credit assessment, risk grading, their acceptability of collateral, etc., as well as limits on exposures and concentration levels to various sectors, counterparties, geographies, and segments.

A robust risk grading system incorporating Basel requirements of facility rating and counterparty rating are adopted by the Bank for evaluation of credit proposals. This risk grading framework consists 10 grades of varying degrees of risk as indicators for the Lending Officers to evaluate and arrive at suitable risk-reward trade-offs in their propositions. These risk grades are reviewed by the Integrated Risk Management Department regularly.

Portfolio level credit risk analyses are taken up at monthly EIRMC as well as quarterly BIRMC meetings. Individual credit proposals evaluated by the Lending Officers are approved by the Authorising Officers within the hierarchy in Delegated Authority Levels whilst ensuring a minimum of four eyes principle when approving any lending proposals. Escalation of approving levels occurs based on exposure levels as well as final risk ratings of borrowers.

The Executive Credit Committee (ECC) and the Board Credit Committee (BCC) are entrusted with approval of high value facilities while the Board will be the ultimate authority for approving facilities beyond predetermined threshold levels. Deliberations take place at BCC level on facilities taken up for approval within the specified threshold and recommendation for approval of the Board based on quantum of exposures proposed is exercised.

The Integrated Risk Management Department provides risk approval for individual proposals above predetermined threshold levels, consequent to a rigorous independent risk evaluation guided by Credit Policy, Lending Guidelines, and circular instructions within a limit framework stemming from risk appetite of the Bank.

Market risk

The risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates, foreign exchange rates, and equity prices. The Bank classifies exposures to market risk into either trading or non-trading portfolios and manages each of those portfolios separately.

The market risk for the trading portfolio is monitored and managed closely.

Management of market risk

Market Risk Policy, ALCO Policy, and Foreign Exchange Risk Policy are the three main policies that constitute the framework governing the Market Risk Management function of the Bank.

Due to the business model adopted by the Bank, exposure to equity and commodity risk was kept at bay throughout the year.

However, Interest Rate Risk arising from the Banking Book as well as Trading Book and Foreign Exchange Risk arising from dealing in currencies other than local currency, continued to expose the Bank to associated risk elements.

Volatile interest scenarios experienced by the country during the period impacted the financial market in Sri Lanka and resulted in shrinking Net Interest Margin. Interest Rates of the Banking Book was subjected to varying degrees of rate shocks to identify impact on earnings perspective in such rate scenarios. The results reflected predictions which assisted the Bank in formulating strategies to manage the financial position in an effective manner with the limited choices available.

Trading Book too was subjected to Value at Risk (VaR) framework as described in the, Section on "Managing Risk: An Overview" on pages 154 to 158. The Bank also carried out sensitivity analysis on a regular basis to ascertain the impact on portfolios maintained, mainly in Government Securities and marking to market such portfolios to reflect fair value for decision-making process.

Foreign exchange positions were maintained within the regulatory framework in a market where much volatility was observed in the major currency that the Bank deals in, i.e., US Dollars. The positions were subjected to sensitivity analysis to provide insight to possible losses/gains arising from currency appreciation/depreciation, as the reporting currency of the Bank being Sri Lankan Rupees.

Liquidity risk

The risk that the Bank will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. liquidity risk arises because of the possibility that the Bank might be unable to meet its payment obligations when they fall due under both normal and stress circumstances.

To limit this risk, Management has arranged for diversified funding sources in addition to its core deposit base and adopted a policy of managing assets with liquidity in mind and monitoring future cash flows and liquidity on a daily basis. The Bank has developed internal control processes and contingency plans for managing liquidity risk. This incorporates an assessment of expected cash flows and the availability of high grade collateral which could be used to secure additional funding, if required.

Management of liquidity risk

Market Risk Management Policy and the ALCO Policy of the Bank approved by the Board of Directors set the tone for managing liquidity risk of the Bank. Liquidity risk of the Bank is given utmost priority when managing a wide range of other risks due to the fact that it is considered as the most critical risk for any financial institution.

The Bank's Treasury Department is entrusted with managing liquidity of the Bank on real time basis to ensure smooth functioning of business activities of all other business units of the Bank.

Having access to a substantial stable Current Account and Savings Account (CASA) base due to its wide branch network and the top of the mind perception created in the depositors in general, for stability provides immense strength to the Bank in managing liquidity.

Having high quality liquid assets at the disposal of the Bank is another plus factor for the Bank. The strength of such was amply reflected in the Basel III computation the Bank carries out for arriving at Liquidity Coverage Ratio as per the CBSL Guidelines that recorded very healthy results as compared to regulatory minimum threshold levels.

Contingency funding plans in force, constant monitoring of salient liquidity ratios, and scenario based stress testing being carried out regularly, provide the sense of Bank with required indicators enabling the Bank to take proactive measures that could provide time to overcome any adverse liquidity position on a future date.

Operational risk

The risk that the Bank will incur a loss due to systems failure, human error, fraud or external events. When controls fail to operate effectively, operational risks can cause damage to reputation, have legal or regulatory implications or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but it endeavours to manage these risks through a control framework and by monitoring and responding to potential risks.

Controls include effective segregation of duties, access, authorisation and reconciliation procedures, staff education, and assessment processes, such as the use of internal audit.

Management of operational risk

Sound Operational Risk Management practices are embedded into the work process through the Bank's culture, internal policy framework, and as per regulatory requirements.

Circular instructions and Operational Risk Management Policy play a major part in bringing together business practices with accepted benchmarks to ensure minimum disruption to processes, personnel, technology, and infrastructure.

Internal control framework and audit function with firmly established "three lines of defences" serve the Bank to manage operational risk at current acceptable levels.

Risk and Control Self-Assessment (RCSA) framework is adopted to identify risks involved in business activities of the Bank and to implement appropriate mitigatory measures after assessing criticality of such risks.

IT Risk of the Bank is managed through strict monitoring of Key IT Risk Indicators while Vulnerability Assessment and Penetration Tests are being carried out by both internal and external parties at regular intervals to identify the relevant risks.

Refer Note 69 on pages 303 to 332 for "Financial Risk Review".

A detailed write-up on how the risk management is carried out within the Bank's Risk Management Framework with due consideration given to factors such as governance, identification, assessment, monitoring, reporting, and mitigation are discussed in the Section on "Managing Risk: An Overview" on pages 154 to 158. The said write-up on "Managing Risk: An Overview" does not form part of the Financial Statements.

4. Fair Value Measurement

"Fair value" is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Group has access at that date. The fair value of a liability reflects its non-performance risk.

When one is available, the Group measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no quoted pricing in an active market, then the Group uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction.

The fair value of an asset or a liability is measured using the assumptions that market participants would use the fair value hierarchy when pricing the asset or liability, assuming that market participants act in their economic best interest.

The Group recognises transfers between levels of the fair value hierarchy as of the end of the reporting period during which the change has occurred.

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. External professional valuers are involved for valuation of significant assets such as land and building.

An analysis of fair value measurement of financial and non-financial assets and liabilities is provided in Note 26 on pages 214 to 219.

5. Changes in Accounting Policies

The Group and the Bank have consistently applied the Accounting Policies as set out in Notes 6 to 10 on pages 182 to 192 to all periods presented in these Financial Statements, except for application of "Hedge Accounting" principles of LKAS 39 on "Financial Instruments: Recognition and Measurement" as set out in Note 7.1.5 on pages 185 and 186.

Significant accounting policies

The Significant Accounting Policies set out below have been applied consistently to all periods presented in the Financial Statements of the Group, unless otherwise indicated.

These Accounting Policies have been applied consistently by Group entities.

Set out below is an index of Significant Accounting Policies, the details of which are available on the pages that follow:

6. Significant Accounting Policies – General

6.1 Basis of consolidation

The Group's Financial Statements comprise, Consolidated Financial Statements of the Bank and its Subsidiaries in terms of the Sri Lanka Accounting Standard – SLFRS 10 on "Consolidated Financial Statements" and the proportionate share of the profit or loss and net assets of its Associates in terms of the Sri Lanka Accounting Standard – LKAS 28 on "Investments in Associates and Joint Ventures". The Bank's Financial Statements comprise the amalgamation of the Financial Statements of the Domestic Banking Unit, the Offshore Banking Centre and the international operations of the Bank.

6.1.1 Business combinations

Business combinations are accounted for using the acquisition method when control is transferred to the Group. The consideration transferred in the acquisition and identifiable net assets acquired are measured at fair value. Any goodwill that arises is tested annually for impairment (Refer Note 7.5 on page 188). Any gain on a bargain purchase is recognised in profit or loss immediately. Transaction costs are expensed as incurred, except if they are related to the issue of debt or equity securities.

The consideration transferred does not include amounts related to the settlement of pre-existing relationships. Such amounts are generally recognised in profit or loss.

Any contingent consideration is measured at fair value at the date of acquisition. If an obligation to pay contingent consideration that meets the definition of a financial instrument is classified as equity, then it is not re-measured and settlement is accounted for within equity. Otherwise, subsequent changes in the fair value of the contingent consideration are recognised in profit or loss.

6.1.2 Non-Controlling Interests (NCI)

Details of NCI are given in Note 58 on page 285.

6.1.3 Subsidiaries

Details of the Bank's subsidiaries and their contingencies are set out in Notes 37 and 59.4 (a) on pages 141 to 143 and 287.

6.1.4 Loss of control

When the Group loses control over a subsidiary, it derecognises the assets and liabilities of the subsidiary, and any related NCI and other components of equity. Any resulting gain or loss is recognised in profit or loss. Any interest retained in the former subsidiary is measured at fair value when control is lost.

Subsequently, it is accounted for as an Associate or in accordance with the Group's Accounting Policy for financial instruments depending on the level of influence retained.

6.1.5 Associates

Details of associates together with their fair values and the Group's share of contingent liabilities of such associates are set out in Notes 38 and 59.4 (b) on pages 243 to 245 and 287.

6.1.6 Transactions eliminated on consolidation

Intra-group balances, transactions, and any unrealised income and expenses (except for foreign currency transaction gains or losses) arising from intra-group transactions are eliminated in preparing the Consolidated Financial Statements. Unrealised gains arising from transactions with equity accounted investees are eliminated against the investment to the extent of the Group's interest in the investee. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

6.1.7 Material gains or losses, provisional values or error corrections

There were no material gains or losses, provisional values or error corrections recognised during the year in respect of business combinations that took place in previous periods.

6.2 Foreign currency

6.2.1 Foreign currency transactions and balances

Foreign currency transactions are translated into the functional currency, which is Sri Lankan Rupees, using the exchange rates prevailing at the dates of the transactions. In this regard, the Bank's practice is to use the middle rate of exchange ruling at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies as at the Reporting date are translated into the functional currency at the middle exchange rate of the functional Currency ruling as at the Reporting date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency as at the beginning of the year adjusted for effective interest and payments during the year and the amortised cost in foreign currency translated at the exchange rate as at the Reporting date.

Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated into the Functional Currency at the spot exchange rate at the date that the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate as at the date of the transaction.

Foreign currency differences arising on translation are generally recognised in profit or loss. However, foreign currency differences arising from the translation of the following items are recognised in OCI:

- Available-for-sale equity instruments; or
- A financial liability designated as a hedge of the net investment in a foreign operation to the extent that the hedge is effective; and
- Qualifying cash flow hedges to the extent that the hedge is effective.

6.2.2 Foreign currency translations

The Group's Consolidated Financial Statements are presented in Sri Lankan Rupees, which is also the Bank's Functional Currency. The Financial Statements of the Offshore Banking Centre of the Bank and the Financial Statements of the foreign operations of the Bank have been translated into the Group's Presentation Currency as explained under Notes 6.2.3 and 6.2.4 below.

6.2.3 Transactions of the offshore banking centre

These are recorded in accordance with Note 6.2.1 above, except the application of the annual weighted average exchange rate for translation of the Income Statement and the Statement of Profit or Loss and Other Comprehensive Income. Net gains and losses are dealt through the profit or loss.

6.2.4 Foreign operations

The results and financial position of overseas operations that have a functional currency different from the Bank's presentation currency are translated into the Bank's presentation currency as follows:

- Assets and liabilities, including goodwill and fair value adjustments arising on acquisition, are translated at the rates of exchange ruling as at the Reporting date.
- Income and expenses are translated at the average exchange rate for the period, unless this average rate is not a reasonable approximation of the rate prevailing at the transaction date, in which case income and expenses are translated at the exchange rates ruling at the transaction date.
- All resulting exchange differences are recognised in the OCI and accumulated in the Foreign Currency Translation Reserve (Translation Reserve), which is a separate component of Equity, except to the extent that the translation difference is allocated to the NCI.

When a foreign operation is disposed of such that the control is lost, the cumulative amount in the translation reserve related to that foreign operation is reclassified to profit or loss as part of the gain or loss on disposal. If the Group disposes of only part of its interest in a subsidiary that includes a foreign operation while retaining control, then the relevant proportion of the cumulative amount of the translation reserve is reattributed to NCI.

7. Significant Accounting Policies – Recognition of Assets and Liabilities

7.1 Financial instruments – initial recognition, classification and subsequent measurement

7.1.1 Date of recognition

The Group initially recognises loans and advances, deposits and subordinated liabilities, etc., on the date on which they are originated. All other financial instruments (including regular-way purchases and sales of financial assets) are recognised on the trade date, which is the date on which the Group becomes a party to the contractual provisions of the instrument.

7.1.2 Initial measurement of financial instruments

The classification of financial instruments at initial recognition depends on their purpose and characteristics and the Management's intention in acquiring them. (Please refer Notes 7.1.3 and 7.1.4 for further details on classification of financial instruments).

All financial instruments are measured initially at their fair value plus transaction costs that are directly attributable to acquisition or issue of such financial instrument, except in the case of financial assets and financial liabilities at fair value through profit or loss as per the Sri Lanka Accounting Standard – LKAS 39 on "Financial Instruments: Recognition and Measurement".

Transaction cost in relation to financial assets and financial liabilities at fair value through profit or loss are dealt with through the Income Statement.

7.1.2.1 "Day 1" profit or loss on employee below market loans

When the transaction price differs from the fair value of other observable current market transactions in the same instrument, or based on a valuation technique whose variables include only data from observable markets, the Group recognises the difference between the transaction price and fair value (a "Day 1" profit or loss) in "Interest Income and Personnel Expenses". In cases where fair value is determined using data which is not observable, the difference between the transaction price and model value is only recognised in the profit or loss when the inputs become observable, or when the instrument is derecognised. The "Day 1 loss" arising in the case of loans granted to employees at concessionary rates under uniformly applicable schemes is deferred and amortised using Effective Interest Rates (EIR) over the remaining service period of the employees or tenure of the loan whichever is shorter.

Refer Note 8.1 on page 191.

7.1.3 Classification and subsequent measurement of financial assets

Group classifies financial assets into one of the following categories:

- Financial assets at fair value through profit or loss, and within this category as –
  - held for trading; or
  - designated at fair value through profit or loss;
- Loans and receivables;
- Held to maturity; and
- Available for sale.

The subsequent measurement of financial assets depends on their classification.

Please refer Note 25 on pages 210 to 213 for details on different types of financial assets recognised on the Statement of Financial Position.

7.1.3.1 Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss include financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss which are discussed in Notes 7.1.3.1.1 and 7.1.3.1.2 below:

7.1.3.1.1 Financial assets – Held-for-trading

Details of "Financial assets – Held for trading" are given in Note 31 on pages 223 to 225.

Derivatives recorded at fair value through profit or loss

Details of "Derivative financial assets" recorded at fair value through profit or loss are given in Note 30 on page 221.

7.1.3.1.2 Financial assets designated at fair value through profit or loss

The Group designates financial assets at fair value through profit or loss in the following circumstances:

- the assets are managed, evaluated and reported internally on a fair value basis; or
- the designation eliminates or significantly reduces an accounting mismatch, which would otherwise have arisen; or

- the asset contains an embedded derivative that significantly modifies the cash flows which would otherwise have been required under the contract.

Financial assets designated at fair value through profit or loss are recorded in the Statement of Financial Position at fair value. Changes in fair value are recorded in "Net gain or loss on financial assets and liabilities designated at fair value through profit or loss". Interest earned is accrued in "Interest Income", using the EIR, while dividend income is recorded in "other operating income" when the right to receive the payment has been established.

The Group has not designated any financial assets upon initial recognition as at fair value through profit or loss.

7.1.3.2 Loans and receivables to banks and other customers

Loans and receivable to banks and other customers include amounts due from banks, loans and advances and lease receivable of the Group.

Details of "Loans and receivables to banks and other customers" are given in Notes 32 and 33 on pages 225 to 232.

7.1.3.2.1 Securities purchased under resale agreements (reverse repos)

When the Group purchases a financial asset and simultaneously enters into an agreement to resale the asset (or a similar asset) at a fixed price on a future date (reverse repo), the arrangement is accounted for as a financial asset in the Statement of Financial Position reflecting the transaction's economic substance as a loan granted by the Group. Subsequent to initial recognition, these securities issued are measured at amortised cost using the EIR with the corresponding interest receivable being recognised as interest income in profit or loss.

Details of "Securities purchased under resale agreements" are given in the Statement of Financial Position on page 167.

7.1.3.3 Other financial investments classified as loans and receivables

Details of "Financial investments – Loans and receivables" are given in Note 36 on pages 239 to 241.

7.1.3.4 Financial investments – Available for sale

Details of "Financial investments – Available for sale" are given in Note 34 on pages 232 to 238.

7.1.3.5 Financial investments – Held-to-maturity

Details of "Financial investments – Held to maturity" are given in Note 35 on page 238.

7.1.3.6 Cash and cash equivalents

Details of "Cash and cash equivalents" are given in Note 27 on page 219.

7.1.3.7 Balances with central banks

Details of "Balances with central banks" are given in Note 28 on pages 219 and 220.

7.1.4 Classification and subsequent measurement of financial liabilities

Group classifies financial liabilities into one of the following categories:

- Financial liabilities at fair value through profit or loss, and within this category as –
  - Held for trading; or
  - Designated at fair value through profit or loss;
- Financial liabilities at amortised cost.

The subsequent measurement of financial liabilities depends on their classification.

Please refer Notes 7.1.4.1 and 7.1.4.2 as detailed below:

7.1.4.1 Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss include financial liabilities held for trading and financial liabilities designated upon initial recognition as at fair value through profit or loss. Refer Notes 7.1.4.1.1 and 7.1.4.1.2 below:

7.1.4.1.1 Financial liabilities held for trading

Details of "Derivative financial liabilities" classified under Financial Liabilities Held for Trading are given in Note 44 on page 262.

7.1.4.1.2 Financial liabilities designated at fair value through profit or loss

Financial liabilities designated at fair value through profit or loss are recorded in the Statement of Financial Position at fair value. Changes in fair value are recorded in "Net gain or loss on financial assets and liabilities designated at fair value through profit or loss". Interest paid/payable is accrued in "Interest expense", using the EIR.

The Group has not designated any financial liabilities upon initial recognition as at fair value through profit or loss.

7.1.4.2 Financial liabilities at amortised cost

Financial instruments issued by the Group that are not designated at fair value through profit or loss are classified as liabilities under "Due to banks", "Due to Other Customers/Deposits from Customers", "Securities sold under repurchase agreements", or "Subordinated liabilities" as appropriate, where the substance of the contractual arrangement results in the Group having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity shares. The Group classifies capital instruments as financial liabilities or equity instruments in accordance with the substance of the contractual terms of the instrument.

After initial recognition, such financial liabilities are subsequently measured at amortised cost using the EIR method. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR.

The EIR amortisation is included in "Interest expense" in the Income Statement. Gains and losses too are recognised in the Income Statement when the liabilities are derecognised as well as through the EIR amortisation process.

7.1.4.2.1 Due to banks

Details of "Due to banks" are given in Note 43 on page 261.

7.1.4.2.2 Due to other customers/deposits from customers

Details of "Due to other customers/deposits from customers" are given in Note 45 on pages 263 and 264.

7.1.4.2.3 Subordinated liabilities

Details of "Subordinated liabilities" are given in Note 52 on pages 276 and 277.

7.1.4.2.4 Securities sold under repurchase agreements (repos)

When the Group sells a financial asset and simultaneously enters into an agreement to repurchase the asset (or a similar asset) at a fixed price on a future date (repos), the arrangement is accounted for as a financial liability in the Statement of Financial Position reflecting the transaction's economic substance as a deposit. Subsequent to initial recognition, these securities are measured at amortised cost using the EIR with the corresponding interest payable being recognised as interest expense in profit or loss.

Details of "Securities sold under repurchase agreements (repos)" are given in the Statement of Financial Position on page 167.

7.1.5 Derivatives held for risk management purposes and hedge accounting

Derivatives held for risk management purposes include all derivative assets and liabilities that are not classified as trading assets and liabilities. Derivatives held for risk management purposes are measured at fair value in the Statement of Financial Position.

The Group designates certain derivatives held for risk management as well as certain non-derivative financial instruments as hedging instruments in qualifying hedging relationships. On initial designation of the hedge, the Group formally documents the relationship between the hedging instrument and hedged item, including risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationship. The Group makes an assessment, both at inception of the hedge relationship and on an ongoing basis, of whether the hedging instrument is expected to be highly effective in offsetting the changes in fair value or cash flow of the respective hedged item during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80% to 125%. The Group makes an assessment for a cash flow hedge of a forecast transaction, of whether the forecast transaction is highly probable to occur and presents an exposure to variations in cash flows that could ultimately affect profit or loss.

The Group currently uses cash flow hedging relationships for risk management purposes as discussed in the Notes 7.1.5.1 to 7.1.5.5 below:

7.1.5.1 Fair value hedges

When a derivative is designated as the hedging instrument in a hedge of the change in fair value of a recognised asset or liability or a firm commitment that could affect the profit or loss, changes in the fair value of the derivative are recognised immediately in profit or loss together with changes in the fair value of the hedged item that are attributable to the hedged risk.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. However, if the derivative is novated to a central counterparty by both parties as a consequence of laws or regulations without changes in its terms except for those are necessary for the novation, then the derivative is not considered as expired or terminated.

Any adjustment up to the point of discontinuation to a hedged item for which the effective interest method is used is amortised to profit or loss as part of the recalculated EIR of the item over its remaining life.

7.1.5.2 Cash flow hedges

When a derivative is designated as the hedging instrument in a hedge of the variability in cash flows attributable to a particular risk associated with a recognised asset or liability that could affect the profit or loss, the effective portion of changes in the fair value of the derivative are recognised in OCI and presented in the hedging reserve within equity. Any ineffective portion of changes in the fair value of the derivative is recognised immediately in profit or loss. The amount recognised in OCI is reclassified to profit or loss as a reclassification adjustment in the same period as the hedged cash flows affect profit or loss, and in the same line item in the Statement Profit or Loss and OCI.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for cash flow hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. However, if the derivative is novated to a central counterparty by both parties as a consequence of laws or regulations without changes in its terms except for those are necessary for the novation, then the derivative is not considered as expired or terminated.

Details of "Cash flow hedges" are given in Note 44.2 on page 262.

7.1.5.3 Net investment hedges

When a derivative instrument or a non-derivative financial liability is designated as the hedging instrument in a hedge of a net investment in a foreign operation, the effective portion of changes in the fair value of the derivative are recognised in OCI and presented in the translation reserve within equity. Any ineffective portion of changes in the fair value of the derivative is recognized immediately in profit or loss. The amount recognised in OCI is reclassified to profit or loss as a reclassification adjustment on disposal of the foreign operation.

7.1.5.4 Other non-trading derivatives

If the derivative is not held for trading, and is not designated in a qualifying hedging relationship, then all changes in its fair value are recognised immediately in profit or loss as a component of net income from other financial instruments at fair value through profit or loss.

7.1.5.5 Embedded derivatives

Derivatives may be embedded in another contractual arrangement (a host contract). The Group accounts for an embedded derivative separately from the host contract when:

- the host contract was not itself carried at fair value through profit or loss;
- the terms of the embedded derivative would have met the definition of a derivative if they were contained in a separate contract; and
- the economic characteristics and risks of the embedded derivative were not closely related to the economic characteristics and risks of the host contract.

Separated embedded derivatives are measured at fair value, with all changes in fair value recognised in profit or loss unless they formed part of a qualifying cash flow or net investment hedging relationship. Separated embedded derivatives are presented in the Statement of Financial Position together with the host contract.

7.1.6 Reclassification of financial assets and liabilities

Financial assets are not reclassified subsequent to their initial recognition, except in the period after the Group changes its business model for managing financial assets. The Group reclassifies financial assets and liabilities into and out of the different categories of financial instruments as permitted by the Sri Lanka Accounting Standard – LKAS 39 on "Financial Instruments: Recognition and Measurement".

7.1.6.1 Reclassification of financial instruments at "fair value through profit or loss"

The Group does not reclassify financial instruments out of the fair value through profit or loss category while it is held or issued. Non-derivative financial assets and liabilities designated at fair value through profit or loss upon initial recognition are not reclassified subsequently out of fair value through profit or loss category.

The Group may in rare circumstances, reclassify financial instruments out fair value through profit or loss category, if such instruments are no longer held for the purpose of selling or repurchasing in the near term notwithstanding that such financial instruments may have been acquired for the purpose of selling or repurchasing in the near term.

Financial assets classified as fair value through profit or loss at the initial recognition which would have also met the definition of "loans and receivable" as at that date is reclassified out of the fair value through profit or loss category only if the Group has the intention or ability to hold such asset for the foreseeable future or until maturity.

Fair value of financial instrument at the date of reclassification becomes the new cost or new amortised cost of the financial instrument. Any gain or loss already recognised in respect of the reclassified financial instrument until the date of reclassification is not reversed to the Income Statement.

If financial asset is reclassified and if the Group subsequently increases its estimate of future cash receipts as a result of increased recoverability of those cash receipts, the effect of such increase is recognised as an adjustments to the EIR from the date of the change in estimate rather than an adjustment to the carrying amount of the asset at the date of change in estimates.

The Group does not reclassify any financial instrument into the "Fair value through profit or loss" category after initial recognition.

7.1.6.2 Reclassification of financial investments – Available for sale

The Group may reclassify financial investments out of AFS category as a result of change in intention or ability or in rare circumstances that a reliable measure of fair value is no longer available.

For a financial asset with a fixed maturity reclassified out of the "available-for-sale" category, any previous gain or loss on that asset that has been recognised in equity is amortised to profit or loss over the remaining life of the asset using the EIR. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the EIR. In the case of a financial asset that does not have a fixed maturity, the gain or loss is recognised in the profit or loss when such financial asset is sold or disposed of. If the financial asset is subsequently determined to be impaired, then the amount recorded in equity is recycled to profit or loss. If a financial asset is reclassified and if the Group subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase is recognised as an adjustment to the EIR from the date of the change in estimate.

7.1.6.3 Reclassification of Financial Investments – Held to Maturity

As a result of a change in intention or ability, if it is no longer appropriate to classify an investment as held to maturity, Group may reclassify such financial asset as AFS and remeasured at fair value. Any difference between the carrying value of the financial asset before reclassification and fair value is recognised in equity through OCI.

However, if the Group were to sell or reclassify more than an insignificant amount of held to maturity financial investments before maturity (other than in certain specific circumstances permitted in the Sri Lanka Accounting Standard – LKAS 39 on "Financial Instruments: Recognition and Measurement"), the entire category would be tainted and would have to be reclassified as AFS. Furthermore, the Group would be prohibited from classifying any financial asset as held-to-maturity during the following two years.

The above reclassifications at the election of the Management and is determined on an instrument-by-instrument basis.

7.1.7 Derecognition of financial assets and financial liabilities

7.1.7.1 Financial assets

The Group derecognises a financial asset (or where applicable a part of thereof) when the contractual rights to the cash flows from the financial asset expire or it transfers the rights to receive the contractual cash flows in a transaction in which substantially all risks and rewards of ownership of the financial asset are transferred or in which the Group neither transfers nor retains substantially all risks and rewards of ownership and it does not retain control of the financial asset.

On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset derecognised) and the sum of the consideration received (including any new asset obtained less any new liability assumed) and any cumulative gain or loss that had been recognised in OCI is recognised in profit or loss. Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability.

The Group enters into transactions whereby it transfers assets recognised on its Statement of Financial Position, but retains either all or substantially all risks and rewards of the transferred assets or a portion of them. In such cases, the transferred assets are not derecognised. Examples of such transactions are securities lending and sale and repurchase transactions.

When assets are sold to a third party with a concurrent total rate of return swap on the transferred assets, the transaction is accounted for as a secured financing transaction similar to sale and repurchase transactions because the Group retains all or substantially all risks and rewards of ownership of such assets.

When the Group has transferred its right to receive cash flows from an asset or has entered into a pass-through arrangement and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Group's continuing involvement in the asset. In that case, the Group also recognises an associated liability. The transferred asset and the associated liability are measured on the basis that reflected the rights and obligations that the Group has retained.

In certain transactions, the Group retains the obligation to service the transferred financial asset for a fee. The transferred asset is derecognised, if it meets the derecognition criteria. An asset or liability is recognised for the servicing contract, if the servicing fee is more than adequate (asset) or is less than adequate (liability) for performing the servicing.

7.1.7.2 Financial liabilities

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled or expired.

Where an existing financial liability is replaced by another from the same lender on substantially different terms or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability. The difference between the carrying value of the original financial liability and the consideration paid is recognised in profit or loss.

7.1.8 Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount reported in the Statement of Financial Position if, and only if, there is a currently enforceable legal right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liabilities simultaneously.

Income and expenses are presented on a net basis only when permitted under SLFRSs, or for gains and losses arising from a group of similar transactions such as in the Group's trading activity.

7.1.9 Amortised cost measurement

An "amortised cost" of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the EIR method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

7.1.10 Fair value of financial instruments

Fair value measurement of financial instruments including the fair value hierarchy is explained in Notes 4 and 26 on pages 180 and 214.

7.1.11 Identification and measurement of impairment of financial assets

At each Reporting date, the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired.
A financial asset or a group of financial assets is "impaired" when objective evidence demonstrates that a loss event has occurred after the initial recognition of the asset(s) and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

Objective evidence that financial assets (including equity securities) are impaired can include:

- significant financial difficulty of the borrower or issuer;
- reschedulement of credit facilities;
- default or delinquency by a borrower;
- restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider;
- indications that a borrower or issuer will enter bankruptcy;
- the disappearance of an active market for a security; or
- other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the Group or economic conditions that correlate with defaults in the Group.

In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is considered as an objective evidence of impairment.

7.1.11.1 Impairment of financial assets carried at amortised cost

Details of the individual and collective assessment of impairments are given in Note 18 on pages 201 to 203.

7.1.11.2 Impairment of financial investments – Available for sale

For available-for-sale financial investments, the Group assesses at each Reporting date whether there is objective evidence that an investment is impaired.

In the case of debt instruments classified as AFS, the Group assesses individually whether there is objective evidence of impairment based on the same criteria as financial assets carried at amortised cost. However, the amount recorded for impairment is the cumulative loss measured as the difference between the amortised cost and the current fair value, less any impairment loss on that investment previously recognised in profit or loss. Future interest income is based on the reduced carrying amount/impaired balance and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income on such assets is also recorded within "Interest income".

In the case investments classified as AFS, objective evidence would also include a "significant" or "prolonged" decline in the fair value of the investment below its cost. In general, the Group considers a decline of 20% to be "significant" and a period of nine months to be "prolonged". However, in specific circumstances a smaller decline or a shorter period may be appropriate. Where there is evidence of impairment, the cumulative impairment loss on that investment previously recognised in Equity through the OCI is removed from Equity and charged to profit or loss.

If, in a subsequent period, the fair value of an impaired available-for-sale debt instrument increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, then such impairment loss is reversed through profit or loss; otherwise, any increase in fair value is recognised through OCI. Any subsequent recovery in the fair value of an available-for-sale equity instrument is always recognised in OCI.

The Group writes-off certain financial investments – available for sale, either partially or in full and any related provision for impairment losses, when the Group determines that there is no realistic prospect of recovery.

7.2 Non-current assets held for sale and disposal groups

The Group intends to recover the value of Non-current Assets and disposal groups classified as held for sale as at the Reporting date principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset or disposal group is available-for-sale in its present condition, Management has committed to the sale and the sale is expected to have been completed within one year from the date of classification.

As per the Sri Lanka Accounting Standard – SLFRS 5 on "Non-current Assets Held for Sale and Discontinued Operations", these assets are measured at the lower of the carrying amount and fair value, less costs to sell. Thereafter, the Group assesses at each Reporting date or more frequently if events or changes in circumstances indicate that the investment or a group of investment is impaired. The Group recognises an impairment loss for any initial or subsequent write down of the assets to fair value less costs to sell and also recognises a gain for any subsequent increase in fair value less costs to sell of an asset, only to the extent of the cumulative impairment losses that have been recognised previously. Impairment loss is first allocated to goodwill, and then to the remaining assets and liabilities on a *pro rata* basis, except that no loss is allocated to financial assets, deferred tax assets or employee benefit assets which continue to be measured in accordance with the Group's other accounting policies.

As a result, once classified, the Group neither amortises nor depreciates the assets classified as held-for-sale.

In the Income Statement of the reporting period and of the comparable period of the previous year, income and expenses from discontinued operations are reported separately from income and expenses from continuing operations, down to the level of profit after taxes, even when the Group retains a NCI in a subsidiary after the sale. The resulting profit or loss (after taxes) is reported separately in the Income Statement.

7.3 Property, plant and equipment

Details of "Property, plant and equipment" are given in Note 39 on pages 245 to 257.

7.3.1 Depreciation

Details of "Depreciation" are given in Note 20 on pages 203 and 204.

7.3.2 Borrowing costs

As per the Sri Lanka Accounting Standard – LKAS 23 on "Borrowing Costs", the Group capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the asset. A qualifying asset is an asset which takes a substantial period of time to get ready for its intended use or sale. Other borrowing costs are recognised in the profit or loss in the period in which they occur.

7.4 Intangible assets

Details of "Intangible assets" are given in Note 40 on pages 258 to 260.

Amortisation recognised during the year in respect of intangible assets is included under the item of "Amortisation of intangible assets" under "Depreciation and amortisation" in profit or loss.

Refer Note 20 on pages 203 and 204.

7.5 Impairment of non-financial assets

At each Reporting date, the Group reviews the carrying amounts of its non-financial assets (other than investment properties and deferred tax assets) to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. Goodwill is tested annually for impairment.

For impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that is largely independent of the cash inflows of other assets or CGUs. Goodwill arising from a business combination is allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the combination.

The "recoverable amount" of an asset or CGU is the greater of its value in use and its fair value less costs to sell. "Value in use" is based on the estimated future cash flows, discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or CGU.

An impairment loss is recognised if the carrying amount of an asset or CGU exceeds its recoverable amount.

The Group's corporate assets do not generate separate cash inflows and are used by more than one CGU. Corporate assets are allocated to CGUs on a reasonable and consistent basis and tested for impairment as part of the testing of the CGUs to which the corporate assets are allocated.

Impairment losses are recognised in profit or loss. They are allocated first to reduce the carrying amount of any goodwill allocated to the CGU, and then to reduce the carrying amounts of the other assets in the CGU on a *pro rata* basis.

An impairment loss in respect of goodwill is not reversed. For other assets, an impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

7.6 Dividends payable

Dividends on ordinary shares are recognised as a liability and deducted from equity when they are recommended and declared by the Board of Directors and approved by the shareholders. Interim dividends are deducted from Equity when they are declared and no longer at the discretion of the Bank.

Dividends for the year, that are approved after the Reporting date and not provided for, are disclosed as an event after the reporting period in accordance with the Sri Lanka Accounting Standard – LKAS 10 on "Events after the reporting period" in Note 70 on page 332.

7.7 Employee benefits

7.7.1 Defined Benefit Plans (DBPs)

A defined benefit plan is a post-employment benefit plan other than a Defined contribution plan as defined in the Sri Lanka Accounting Standard – LKAS 19 on "Employee Benefits".

7.7.1.1 Defined benefit pension plans

7.7.1.1.1 Description of the plans and employee groups covered

The Bank operates three types of Defined Benefit Pension Plans for its employees as described below:

(a) The Bank has an approved Pension Fund, which was established in 1992. As per the Deed of Trust, only those employees who were less than 45 years of age as at January 1, 1992 were covered by the Pension Fund in order to leave a minimum contribution for a period of 10 years before they are eligible to draw pension from the Pension Fund. Further, only the employees who joined the Bank on or before December 31, 2001, were in pensionable service of the Bank;

During 2006, the Bank offered a restructured pension scheme to convert the Defined Benefit Plan (DBP) to a Defined Contribution Plan (DCP) for the pensionable employees of the Bank and over 99% of them accepted it. As a result, the above Pension Fund now covers only those employees who did not opt for the restructured pension scheme and those employees who were covered by the Pension Fund previously but retired before the restructured pension scheme came into effect;

(b) Provision for pensions has been made for those employees who retired on or before December 31, 2001, and on whose behalf the Bank could not make contributions to the Retirement Pension Fund for more than 10 years. This liability although not funded has been provided for in full in the Financial Statements;

(c) Provision has been made in the Financial Statements for Retirement Gratuity from the first year of service for all employees who joined the Bank on or after January 1, 2002, as they are not in pensionable service of the Bank under either the DBP or DCP. However, if any of these employees resign before retirement, the Bank is liable to pay gratuity to such employees. This liability although not funded has been provided for in full in the Financial Statements.

The subsidiaries of the Bank do not operate Pension Funds.

The Bank's net obligation in respect of Defined Benefit Pension Plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in the current and prior periods, discounting that amount and deducting the fair value of any plan assets, as per the Sri Lanka Accounting Standard – LKAS 19 on "Employee Benefits" as detailed in Note 50 on pages 268 to 275.

The past service cost is recognised as an expense on a straight-line basis over the period until the benefits become vested. If the benefits are already vested following the introduction of, or changes to, a pension plan, past service cost is recognised immediately.

7.7.1.1.2 Recognition of actuarial gains or losses

Actuarial gains or losses are recognised in the OCI in the period in which they arise.

7.7.1.1.3 Recognition of retirement benefit obligation

The defined benefit asset or liability comprises the present value of the defined benefit obligation, less past service cost not yet recognised and less the fair value of plan assets out of which the obligations are to be settled directly. The value of any asset is restricted to the sum of any past service cost not yet recognised and the present value of any economic benefits available in the form of refunds from the plan or reductions in the future contributions to the plan.

The calculation of defined benefit obligations is performed annually by a qualified actuary using the Projected Unit Credit Method. When the calculation results in a potential asset for the Group, the recognised asset is limited to the present value of economic benefits available in the form of any future refunds from the plan or reductions in future contributions to the plan. To calculate the present value of economic benefits, consideration is given to any applicable minimum funding requirements.

Remeasurement of the net defined benefit liability, which comprises actuarial gains and losses, the return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in OCI. The Group determines the net interest expense/(income) on the net defined benefit liability/(asset) for the period by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then net-defined benefit liability/(asset), taking into account any changes in the net-defined benefit liability/(asset) during the period as a result of contributions and benefit payments. Net interest expense and other expenses related to defined benefit plans are recognised in profit or loss.

When the benefits of a plan are changed or when a plan is curtailed, the resulting change in benefit that relates to past service or the gain or loss on curtailment is recognised immediately in profit or loss. The Group recognises gains and losses on the settlement of a defined benefit plan when the settlement occurs.

Amounts recognised in profit or loss as expenses on DBPs and provisions made on DBPs together with the details of valuation methods are given in Notes 19 and 50 on pages 203 and 268 to 275, respectively.

7.7.2 Defined Contribution Plans (DCPs)

A defined contribution plan is a post-employment plan under which an entity pays fixed contributions into a separate entity and will have no legal or constructive obligations to pay a further amount. Obligations to DCPs are recognised in the profit or loss as the related service is provided. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in future payments is available. The Group has three such plans as explained in Notes 7.7.2.1, 7.7.2.2 and 7.7.2.3.

Amounts recognised in profit or loss as expenses on DCPs are given in Note 19 on page 203.

7.7.2.1 Defined contribution pension plan

As explained in Note 7.7.1.1.1(a), during 2006, the Bank restructured its pension scheme which was a DBP to a DCP. This restructured plan was offered on a voluntary basis to the eligible employees of the Bank. The scheme provides for lump sum payments instead of commuted/monthly pensions to the eligible employees at the point of their separation, in return for surrendering their pension rights. The lump sum offered consisted of a past service package and a future service package. The shortfall on account of the past service package in excess of the funds available in the Pension Fund was borne by the Bank in 2006.

The future service package includes monthly contributions to be made by the Bank for the employees who accepted the offer, to be made during their remaining period of service, at predetermined contribution rates to be applied on their salaries, which are estimated to increase for this purpose at 10% p.a. based on the salary levels that prevailed as at the date of implementation of this scheme. In addition, interest to be earned on the assets of the DCP is also allocated to the employees who opted for the restructured scheme.

The assets of this Fund are held separately from those of the Bank and are independently administered by the Trustees as per the provisions of the Trust Deed.

7.7.2.2 Employees' Provident Fund

The Bank and employees contribute to an approved Private Provident Fund at 12% and 8% respectively, on the salaries of each employee. Other entities of the Group and their employees contribute at the same percentages as above to the Employees' Provident Fund managed by the Central Bank of Sri Lanka.

7.7.2.3 Employees' Trust Fund

The Bank and other entities of the Group contribute at the rate of 3% of the salaries of each employee to the Employees' Trust Fund managed by the Central Bank of Sri Lanka.

7.7.3 Other long-term employee benefits

The Group's net obligation in respect of long-term employee benefits other than pension plans is the amount of future benefits that employees have earned in return for their service in the current and prior periods. That benefit is discounted to determine its present value, and the fair value of any related assets is deducted. The discount rate used as the yield as at the Reporting date is the current market rate that has been extrapolated to reflect long-term rate of discount based on market rates of interest on short-term Corporate/Government Bonds and anticipated long-term rate of inflation. The calculation is performed using the Projected Unit Credit Method. Remeasurements are recognised in profit or loss in the period in which they arise.

The Group does not have any other long-term employee benefit plans.

7.7.4 Terminal benefits

Termination benefits are expensed at the earlier of when the Group can no longer withdraw the offer of those benefits and when the Group recognises costs for a restructuring. If benefits are not expected to be wholly settled within 12 months of the Reporting date, then they are discounted.

7.7.5 Short-term employee benefits

Short-term employee benefits are expensed as the related service is provided. A liability is recognised for the amount expected to be paid if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

7.7.6 Share-based payment arrangements

Share-based payment arrangements in which the Group receives services as consideration for its own equity instruments are accounted for as equity-settled share-based payment transactions, regardless of how the equity instruments are obtained by the Group. Senior Executive Employees of the Group receive remuneration in the form of share-based payment transactions, whereby employees render services as consideration for equity instruments (equity-settled transactions). The Group does not operate any cash-settled share-based payment transactions.

The Group applies the requirements of the Sri Lanka Accounting Standard – SLFRS 2 on "Share-based Payment" in accounting for equity-settled share-based payment transactions, if any, that were granted after January 1, 2012 and had not vested at the same date. As per the Sri Lanka Accounting Standard – SLFRS 2 on "Share-based Payment", on the grant date fair value of equity-settled share-based payment awards (i.e., share options) granted to employees is recognised as personnel expense, with a corresponding increase in equity, over the period in which the employees unconditionally become entitled to the awards. The amount recognised as an expense is adjusted to reflect the number of share awards for which the related service and non-market performance vesting conditions are expected to be met, so that the amount ultimately recognised as an expense is based on the number of share awards that do meet the related service and non-market performance conditions at the vesting date. For share-based payment awards with non-vesting conditions, the grant date fair value of the share-based payment is measured to reflect such conditions and there is no true-up for differences between expected and actual outcomes.

The Employee Share Option Plan – 2015, which was granted is subjected to the above accounting treatment.

However, the Employee Share Option Plan – 2008 which was granted prior to January 1, 2012, the effective date of the SLFRS 2 was not subjected to the above accounting treatment and the proceeds received during the year by the Group in consideration for shares issued were accounted for as Stated Capital within Equity.

The details of Employee Share Option Plans are given in Notes 53.2 and 54 on pages 279 to 281.

The dilutive effect of outstanding options is reflected as additional share dilution in the computation of diluted Earnings per Share as disclosed in Notes 23.2 and 23.3 on page 208.

7.8 Other liabilities

Details of "Other liabilities" are given in Note 50 on pages 268 to 275.

7.9 Provisions

Details of "Other provisions" are given in Note 49 on page 267.

7.10 Restructuring

Provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring either has commenced or has been announced publicly. Future operating losses arising on such restructuring are not provided for.

The Group does not have any provision for restructuring as at the Reporting date.

7.11 Onerous contracts

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract. Before a provision is established, the Group recognises any impairment loss on the assets associated with that contract.

The Group does not have any onerous contracts as at the Reporting date.

7.12 Bank levies

A provision for bank levies is recognised when the condition that triggers the payment of the levy is met. If a levy obligation is subject to a minimum activity threshold so that the obligating event is reaching a minimum activity, then a provision is recognised when that minimum activity threshold is reached.

7.13 Financial guarantees and loan commitments

“Financial guarantees” are contracts that require the Group to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make payment when it is due in accordance with the terms of a debt instrument. “Loan commitments” are firm commitments to provide credit under pre-specified terms and conditions.

Liabilities arising from financial guarantees or commitments to provide a loan at a below-market interest rate are initially measured at fair value and the initial fair value is amortised over the life of the guarantee or the commitment. The liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment to settle the liability when a payment under the contract has become probable.

The Group has issued no loan commitment that are measured at FVTPL. The Group recognises a provision in accordance with the Sri Lanka Accounting Standard – LKAS 37 on “Provisions, Contingent Liabilities and Contingent Assets”, if the contract was considered to be onerous. Liabilities arising from financial guarantees and loan commitments are included within provisions.

7.14 Commitments

All discernible risks are accounted for in determining the amount of known liabilities as explained in Notes 7.8 and 7.9 above.

Details of the Commitments are given in Notes 59.2 to 59.4 on page 287 .

7.15 Contingent liabilities and commitments

A detailed list of “Contingent liabilities and commitments” and “Litigation against the Bank and the Group” are given in Notes 59 and 61 on pages 285 to 288.

7.16 Stated capital and reserves

Details of the “Stated capital and reserves” are given in Notes 53, 55, 56 and 57 to the Financial Statements on pages 278 to 280 and 282 to 285.

7.17 Earnings per Share (EPS)

Details of “Basic and Diluted EPS” are given in Note 23 on pages 207 and 208.

7.18 Operating segments

Details of “Operating segments” are given in Note 63 on pages 291 to 293.

7.19 Fiduciary assets

The Bank provides trust and other fiduciary services that result in the holding or investing of assets on behalf of its clients. Assets held in a fiduciary capacity are not reported in these Financial Statements as they do not belong to the Bank.

8. Significant accounting policies – Recognition of income and expense

Details of “Income and expense” are given in Notes 12 to 21 on pages 195 to 205.

8.1 Interest income and expense

Details of “Interest income and expense” are given in Note 13 on pages 195 to 198.

8.2 Fee and commission income and expense

Details of “Fees and commission income and expense” are given in Note 14 on pages 198 and 199.

8.3 Net gains/(losses) from trading

Details of “Net gains/(losses) from trading” are given in Note 15 on page 199.

8.4 Dividend income

Dividend income is recognised when the right to receive income is established. Usually, this is the ex-dividend date for quoted equity securities.

Dividends are presented in net gains/(losses) from trading, net gains/(losses) from financial investments or other income (net) based on the underlying classification of the equity investment.

Details of “Dividend income” are given in Notes 15, 16 and 17 on pages 199 and 200.

8.5 Leases

The determination of whether an arrangement is a lease or it contains a lease, is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset.

8.5.1 Finance leases

8.5.1.1 Finance leases – Group as a lessee

Finance leases that transfer substantially all risks and rewards incidental to ownership of the leased item to the Group are classified as finance leases and capitalised at the commencement of the lease at the lower of the fair value of the leased property and the present value of the minimum lease payments. Lease payments are apportioned between finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability.

A leased asset is depreciated over the useful life of the asset. However, if there is no reasonable certainty that the Group will obtain ownership by the end of the lease term, the asset is depreciated over the shorter of the estimated useful life of the asset and the lease term.

8.5.1.2 Finance leases – Group as a lessor

When the Group is the lessor under a lease agreement that transfers substantially all of the risks and rewards incidental to the ownership of the asset to the lessee, the net investment in lease (i.e., after deduction of unearned charges) are included in "loans and advances to banks" or "loans and advances to other customers", as appropriate. The finance income receivable is recognised in "interest income" over the periods of the leases so as to achieve a constant rate of return on the net investment in the leases.

8.5.2 Operating leases

8.5.2.1 Operating leases – group as a lessee

Assets held under leases other than finance leases are classified as operating leases and are not recognised in the Group's Statement of Financial Position. Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease. Contingent rental payable is recognised as an expense in the period in which they are incurred.

8.5.2.2 Operating leases – Group as a lessor

Assets leased under leases other than finance leases are classified as operating leases. Initial direct costs incurred in negotiating operating leases are added to the carrying amount of the leased asset and recognised over the lease term on the same basis as rental income.

Contingent rents are recognised as revenue in the period in which they are earned.

Details of "Operating leases" are given in Note 68 on page 302.

8.6 Rental income and expenses

Rental income and expense are recognised in profit or loss on an accrual basis.

9. Significant Accounting Policies – Income Tax Expense

9.1 Current tax

Details of "Income tax expense" are given in Note 22 on pages 205 to 207.

9.2 Deferred tax

Details of "Deferred tax assets and liabilities" are given in Note 48 on pages 265 to 267.

9.3 Tax exposures

In determining the amount of current and deferred tax, the Group considers the impact of tax exposures, including whether additional taxes and penalties are due. Finalisation of the tax liability with authorities may change the position already recorded in the Financial Statements and such changes to tax liabilities could impact the tax expense in the period in which such a determination is made either as an over or under provision.

9.4 Crop Insurance Levy (CIL)

As per the provisions of the Section 14 of the Finance Act No. 12 of 2013, the CIL was introduced with effect from April 1, 2013 and is payable to the National Insurance Trust Fund. Currently, the CIL is payable at 1% of the profit after tax.

9.5 Withholding tax on dividends distributed by the Bank, subsidiaries and associates

9.5.1 Withholding tax on dividends distributed by the Bank

Withholding tax that arises from the distribution of dividends by the Bank is recognised at the time the liability to pay the related dividend is recognised.

9.5.2 Withholding tax on dividends distributed by the subsidiaries and associates

Dividends received by the Bank from its subsidiaries and associates, have attracted a 10% deduction at source.

9.6 Economic Service Charge (ESC)

As per the provisions of the Finance Act No. 11 of 2004, and amendments thereto, the ESC was introduced with effect from April 1, 2004. Currently, the ESC is payable at 0.5% of the total turnover and is deductible from the income tax payments. Unclaimed ESC, if any, can be carried forward and set-off against the income tax payable in the five subsequent years.

9.7 Value Added Tax (VAT) on financial services

The value base for the computation of value added tax on financial services is calculated by adjusting the economic depreciation computed on rates prescribed by the Department of Inland Revenue to the accounting profit before income tax and emoluments payable. Emoluments payable include benefits in money and not in money including contribution or provision relating to terminal benefits.

9.8 Nation Building Tax (NBT) on financial services

With effect from January 1, 2014, NBT of 2% was introduced on supply of financial services via an amendment to the NBT Act No. 09 of 2009. NBT is chargeable on the same base used for calculation of VAT on financial services as explained in Note 9.7 above.

The amount of Value Added Tax and NBT charged in determining the profit or loss for the period is given in the Income Statement on page 165.

10. Significant Accounting Policies – Statement of Cash Flows

10.1 Statement of Cash Flows

The Statement of Cash Flows is prepared using the "Indirect Method" of preparing cash flows in accordance with the Sri Lanka Accounting Standard – LKAS 7 on "Statement of Cash Flows". Cash and cash equivalents comprise of short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value. Cash and cash equivalents as referred to in the Statement of Cash Flows are comprised of those items as explained in Note 27 on page 219.

The Statement of Cash Flows is given on page 172.

11. New Accounting Standards issued but not yet effective

A number of new standards and amendments to standards, which have been issued but not yet effective as at the Reporting date, have not been applied in preparing these Consolidated Financial Statements. Accordingly, the following Accounting Standards have not been applied in preparing these Financial Statements and the Group plans to apply these standards on the respective effective dates:

Accounting standard	Summary of the requirements	Possible impact on Consolidated Financial Statements
SLFRS 9 – "Financial Instruments"	SLFRS 9, issued in 2014 which replaces the existing guidance in LKAS 39 – "Financial Instruments: Recognition and Measurement" is effective for annual reporting periods beginning on or after January 1, 2018. The key aspects of SLFRS 9 are; 1. Classification – Financial assets SLFRS 9 contains a new classification and measurement approach for financial assets that reflects the business model in which assets are managed and their cashflow characteristics. SLFRS 9 includes three principal classification categories for financial assets – i.e. measured at amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). It eliminates the existing LKAS 39 categories of Held to maturity, Loans and receivables and Available for sale. 2. Impairment – Financial assets, loan commitments and financial guarantee contracts SLFRS 9 replaces the "Incurred Loss Model" in LKAS 39 with forward looking "Expected Loss Model" (ECL). This will require considerable judgement over how changes in economic factors affect ECL, which will be determined on a probability weighted basis. SLFRS 9 requires loan loss to be recognised at an amount equal to either 12 month ECL or life time ECL. Lifetime ECLs are the ECLs that result from possible default events over the expected life of a financial instrument, whereas 12 months ECLs are the portion of the ECLs that results from default events that are possible within 12 months after the Reporting date. 3. Inputs into measurement of ECLs The key inputs into measurement of ECLs are likely to be the term structures of the following variables which will be derived from internally developed statistical models and other historical data that leverage regulatory models. They will be adjusted to reflect forward looking information. • Probability of Default (PD) are estimates at a certain date which will be calculated based on statistical models and assessed using rating tools tailored to the various categories of counterparties and exposures. • Loss Given Default (LGD) is the magnitude to the likely loss if there is default. The Bank estimates LGD parameters based on history of recovery rates of claims against defaulted counter parties. • Exposure at Default (EAD) represents the expected exposure in the event of a default. The Bank will derive the EAD from the current exposure to the counterparty and potential chances to the current amount allowed under the contract.	The most significant impact on the Bank's financial statements from the implementation of SLFRS 9 is expected to result from the new impairment requirements. Impairment losses will increase and become more volatile for financial instruments within the scope of SLFRS 9. The Bank has employed statistical models to analyse the data collected and generate estimates of the remaining lifetime PD of exposure and how these are expected to change as a result of the passage of time. This analysis includes the identification and calibration of relationship between changes in default rates and changes in key macro-economic factors as well as analysis of the impact of certain other factors on the risk of default. The Bank has estimated LGD parameters based on the history of recovery rates of claims against defaulted counterparties. The LGD models consider the structure, collateral, seniority of the claim, counterparty industry and recovery costs of any collateral that is integral to the financial asset. EAD for lending commitments and financial guarantees, include the amount drawn, as well as potential future amounts that may be drawn or repaid under the contract, which has been estimated based on historical observations and forward looking forecasts. Under SLFRS 9, the Bank has incorporated forward looking information into both its assessment of whether the credit risk of an instrument has increased significantly since its initial recognition and its measurement of ECL. The Bank has completed the initial high level assessment of the potential impact on its Financial Statements for the year ended December 31, 2016, resulting from the application of SLFRS 9 with the assistance of an external consultant. Based on the preliminary assessments undertaken to date which is yet to be audited, the total estimated additional loan loss provision on the Financial Statements for the year ended December 31, 2016 on adoption of SLFRS 9 is expected to be in the range of 25% to 35% of the total impairment provision as per the current LKAS 39. It will also have an impact on Tier 1 Capital Adequacy Ratio of approximately 60 bps.

Accounting standard	Summary of the requirements	Possible impact on Consolidated Financial Statements
		The above assessment is preliminary (and is yet to be audited) because not all transition work has been finalised. The actual impact of adopting SLFRS 9 on January 1, 2018 may change because; • SLFRS 9 will require the Bank to revise accounting process and internal controls and these changes are not yet complete; • The Bank is refining and finalising its models for ECL calculations; and • The new accounting policies, assumptions, judgements and estimation techniques employed are subject to change until the Bank finalises its first financial statements for the year December 31, 2018 that include the date of initial application. The Bank is in the process of assessing the additional loan loss provision impact on the Financial Statements for the year ended December 31, 2017, resulting from the application of SLFRS 9. The Bank is expected to maintain solid capital position even after taking into account the first time adoption of SLFRS 9, effective from January 1, 2018. The Group does not expect significant impact on the Consolidated Financial Statements resulting from the application of SLFRS 9 on the other Group entities.
SLFRS 15 – "Revenue from Contracts with Customers"	SLFRS 15 establishes a comprehensive framework for determining whether, how much, and when revenue is recognised. New qualitative and quantitative disclosure requirements aim to enable Financial Statements users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Entities will apply five-step model to determine when to recognise revenue and at what amount. The model specified that revenue is recognised when or as an entity transfers control of goods and services to a customer at the amount to which the entity expects to be entitled. Depending on whether certain criteria are met, revenue is recognised. It replaces existing revenue recognition guidance, including LKAS 18 on "Revenue" and LKAS 11 on "Construction Contracts" and IFRIC 13 on "Customer Loyalty Programmes". SLFRS 15 is effective for annual reporting periods beginning on or after January 1, 2018.	The Group and the Bank do not expect significant impact on its Financial Statements resulting from the application of SLFRS 15.
SLFRS 16 – "Leases"	SLFRS 16 eliminates the current dual accounting model for lessees which distinguishes between On-Balance Sheet finance leases and Off-Balance Sheet operating leases. Instead there will be a single On-Balance Sheet accounting model that is similar to current finance lease accounting. SLFRS 16 is effective for annual reporting periods beginning on or after January 1, 2019.	The Group and the Bank are assessing the potential impact on its Financial Statements resulting from the application of SLFRS 16, based on operating leases set-out in Note 68 on page 302.

12. Gross Income

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured.

For the year ended December 31,	Note	Page No.	GROUP 2017 Rs. '000	GROUP 2016 Rs. '000	BANK 2017 Rs. '000	BANK 2016 Rs. '000
Interest income	13.1	196	104,049,102	81,314,607	103,034,386	80,738,176
Fees and commission income	14.1	198	10,510,800	8,230,131	10,169,211	8,143,041
Net gains/(losses) from trading	15	199	233,956	(1,466,711)	233,956	(1,466,711)
Net gains/(losses) from financial investments	16	199	129,210	110,759	129,030	110,701
Other income (net)	17	200	1,918,687	5,536,749	2,027,365	5,617,403
Total			116,841,755	93,725,535	115,593,948	93,142,610

13. Net Interest Income

Interest income and expense are recognised in profit or loss using the effective interest rate (EIR) method.

Interest income and expense presented in the Income Statement include:

- Interest on Held-for-trading financial instruments calculated using EIR method;
- Interest on Loans and receivables calculated using EIR method;
- Interest on Available-for-sale investments calculated using EIR method;
- Interest on Held-to-maturity investments calculated using EIR method;
- Interest on financial liabilities measured at amortised cost calculated using EIR method.

Effective Interest Rate (EIR)

The "effective interest rate" is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or financial liability.

The calculation of the EIR includes transaction costs and fees and points paid or received that are an integral part of the EIR. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

When calculating the effective interest rate for financial instruments other than credit impaired assets, the Group estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses. For credit impaired financial assets, a credit adjusted effective interest rate is calculated using estimated future cash flows.

For the year ended December 31,	Note	Page No.	GROUP 2017 Rs. '000	GROUP 2016 Rs. '000	BANK 2017 Rs. '000	BANK 2016 Rs. '000
Interest income	13.1	196	104,049,102	81,314,607	103,034,386	80,738,176
Less: Interest expense	13.2	196	64,481,804	48,186,331	64,010,991	47,914,573
Net interest income			39,567,298	33,128,276	39,023,395	32,823,603