

REPORT OF THE AUDIT COMMITTEE

REPORTS OF DIRECTORS

COMMITTEE REPORTS

The purpose of the Audit Committee is to assist the Board in its general oversight of financial reporting, internal controls and audit functions. The composition requirements and the terms of reference of the Audit Committee are set out in Direction No. 12 of 2007 on Corporate Governance for Licensed Specialised Banks in Sri Lanka issued by the Central Bank of Sri Lanka (hereinafter referred to as the Direction). This is complementary to the Charter formulated by the Audit Committee.

This report provides information on the compliance with regulatory requirements and where appropriate the process adopted by the Audit Committee to discharge their responsibilities.

COMPOSITION

All members of this Committee are independent Non-Executive Directors. The Chairman is a Chartered Accountant with considerable experience in the field of Finance and Audit. The profiles of the members are given elsewhere in the Annual Report.

The composition of the Committee as at the date of this report is as follows:

- Mr T K Bandaranayake (Chairman)
- Mr S N P Palihena
- Mr A S Abeywardene

Mr Abeywardene was appointed a member in place of Mr D S Weerakkody during the year. The Head of Group Internal Audit holds the management rank of Vice-President and serves as the Secretary of the Committee. He has direct access to the members of the Audit Committee.

MEETINGS

During the financial year ended 31 March 2011, nine Audit Committee meetings were held. Proceedings of the Audit Committee meetings are reported regularly to the Board.

Attendance by the Committee members at the meetings is given in the table on page 60 of the Annual Report.

The General Manager/CEO and Executive Vice-President (Finance) attend the meetings by invitation. The Committee met with the External Auditor, KPMG Ford, Rhodes, Thornton & Co. on two occasions, without any executive being present so as to provide the External Auditor an opportunity to have a frank dialogue with the Committee.

MANDATE AND ROLE

The Audit Committee assists the Board of Directors in fulfilling its oversight responsibilities for the Bank's accounting and financial reporting process and audit of the financial statements of the Bank by monitoring (1) the integrity of the Bank's financial statements, (2) the independence and qualifications of its External Auditor, (3) the Bank's system of internal controls, (4) the performance of the Bank's internal audit process and External Auditor and (5) the Bank's compliance with laws, regulations and codes of conduct with a view to safeguarding the interests of all stakeholders of the Bank.

The Committee has discharged the responsibilities assigned by Rule No. 3 (6) (ii) of the Corporate Governance Direction No. 12 of 2007 issued by the Central Bank of Sri Lanka. Where appropriate more details are provided under separate headings in this Report.

FINANCIAL REPORTING

The Committee assists the Board of Directors to discharge their responsibility for the preparation of true and fair financial statements in accordance with the books of accounts and Sri Lanka Accounting Standards by: (1) reviewing the adequacy and effectiveness of the internal control system and procedures to provide reasonable assurance that all transactions are accurately and completely recorded in the books of accounts, (2) reviewing the integrity of the process by which financial statements are derived from the books of accounts, (3) reviewing the choice of appropriate accounting policies and the judgments made in the application of such accounting policies, (4) reviewing the process by which compliance with Sri Lanka Accounting Standards and other regulatory provisions relating to financial statements are ensured with a reasonable degree of assurance.

The Committee reviewed all quarterly non-audited interim financial statements and financial statements for the year ended 31 March 2011 together with supporting information that included significant assumptions and judgments made in the preparation of financial statements. The Committee also took into consideration the internal audit reports, management letter issued by the External Auditor, compliance reports and the responsibility statements in relation to the financial statements issued by the Chief Finance Officer and Chief Executive Officer in making an overall assessment on the integrity of the Financial Reporting system.

The Annual Report of the Directors for this financial year to 31 March 2011 includes a separate report on internal controls on page 73. This report is issued pursuant to Rule 3 (8) (ii) (b) of the Direction No. 12 of 2007 on Corporate Governance for Licensed Specialised Banks and includes inter alia an affirmative assurance on the integrity of Financial Reporting System to produce reliable financial statements that are true and fair.

The Committee confirms that to the best of its knowledge and belief the financial statements issued for external purposes by the Bank complied with generally accepted principles of accounting as enunciated in Sri Lanka Accounting Standards and complies with the statutory provisions of DFCC Bank Act No. 35 of 1955, Banking Act No. 30 of 1988 and to the extent applicable, the Companies Act No. 7 of 2007. The provisions of the Companies Act do not apply where express provisions are included on the same subject in the DFCC Bank Act.

INTERNAL AUDIT AND INSPECTION

With the concurrence of the Board, the Audit Committee has continued to engage the services of two firms of Chartered Accountants to supplement the Bank's Internal Audit function in carrying out periodic audits at some of the business units. Representatives from the audit firm are invited to the Audit Committee meetings convened to discuss their reports.

The Audit Committee also provides a forum for the review of Internal Audit Reports and consideration of findings, recommendations and corrective action taken by management to overcome the deficiencies identified, with a view to managing significant business risks and improving controls. Department/ Unit heads attend meetings when their reports are discussed.

RISKS AND CONTROLS

The Committee has adopted a risk-grading matrix for identifying and assessing risks identified during audits. The Committee seeks and obtains the required assurance from the head of the business unit on the remedial action taken in order to maintain the effectiveness of internal controls.

EXTERNAL AUDIT

The Audit Committee assists the Board of Directors to implement a transparent process (1) in the engagement and remuneration of the External Auditor for audit services with the approval of the shareholders; (2) in reviewing the non-audit services to ensure that they do not lead to impairment of the independence of the Auditor; (3) in assisting the Auditor to complete the audit programme within an agreed time frame in compliance with relevant guidelines issued by Central Bank of Sri Lanka.

In order to discharge its responsibilities the Audit Committee meets with the Auditor as and when it is necessary. During this meeting with the Auditor the Audit Committee (1) reviews the non-audit services provided by the External Auditor to ensure that provision of such services are not in conflict with the guidelines issued by the Central Bank of Sri Lanka and that the remuneration for such services are not of such value so as to impair their independence; (2) request for information relating to the total remuneration of the External Auditor for audit and non-audit services provided to the Bank and its Group; (3) discusses and finalises the scope of the audit to ensure that it is in compliance with the guidelines issued by the Central Bank of Sri Lanka.

In the context of determining the independence of the Auditor, the Committee reviewed the statements issued by the External Auditor pursuant to Section 163 (3) of the Companies Act No. 7

of 2007. As per this declaratory statement the Auditor has confirmed that they do not have any relationship that would impair their independence and disclosed the total remuneration for the financial year ended 31 March 2011 for both audit and permitted non-audit services.

The Audit Committee has also recommended the adoption of a Policy on the engagement of the External Auditor to provide non-audit services. This policy document approved by the Board of Directors, in addition to complying with the regulatory requirements, has included guidelines to ensure that the independence of the External Auditor is not impaired by the scale and scope of non-audit services.

The Audit Committee also meets with the Auditor at the conclusion of the audit to review the Management Letter issued by the Auditor before it is transmitted to the Board of Directors and the Central Bank of Sri Lanka.

REGULATORY COMPLIANCE

The Bank's procedures in place to ensure compliance with mandatory Banking and other statutory requirements were monitored on an ongoing basis. The Audit Committee receives a copy of the Compliance Report that provides information on the status of compliance with statutory provisions relevant to the Bank. The purpose of the review is to assess the risks of non-compliance and currently there is an overlap of the functions between the Audit Committee and the Integrated Risk Committee in this respect. The compliance reporting is subject to Internal Audit Verification on a sample basis. The Committee is satisfied that the Bank substantially complies with these requirements.

EVALUATION

An evaluation of the effectiveness of the Committee was carried out by the other members of the Board and the Committee has been found to be effective.

REAPPOINTMENT OF AUDITOR

The Audit Committee having evaluated the quality of audit service provided by the current auditor has recommended to the Board of Directors that Messrs KPMG Ford, Rhodes, Thornton & Co. be reappointed as Auditors for the year ending 31 March 2012, subject to the approval of shareholders at the Annual General Meeting.



T K Bandaranayake
Chairman - Audit Committee

30 May 2011

REPORT OF THE HUMAN RESOURCES AND REMUNERATION COMMITTEE

REPORTS OF DIRECTORS

COMMITTEE REPORTS

COMPOSITION

The Human Resources and Remuneration Committee appointed by the Board of Directors, consists of three Non-Executive Directors, Mr J M S Brito is the Chairman of the Committee and Messrs C P R Perera and G K Dayasri are the other members. Mr Dayasri was appointed to the Committee during the year in place of Mr D S Weerakkody. The Chief Executive Officer - Mr Nihal Fonseka attended meetings by invitation and participated in its deliberations except when his own evaluation and remuneration was under discussion. He also serves as the Secretary. The Group Vice-President, Human Resources assists the Committee by providing relevant information. The Committee invites external specialists with banking industry knowledge to attend meetings as and when required.

MANDATE

The Committee has adopted as its mandate the tasks specified in Section 3 (6) (iii) and Direction No. 12 of 2007 of the Central Bank of Sri Lanka on

Corporate Governance for licensed specialised banks. The Committee in determining the remuneration policy relating to Directors, Chief Executive Officer and Key Management Personnel of the Bank in terms of Directions ensures appropriate compensation levels in order to attract, retain and motivate talented staff with the core capabilities matched to its strategy and also to ensure that the Bank consistently delivers value to all stakeholders and to make the organisation more competitive. To achieve this, the Committee uses a mixture of fixed and variable pay to reward employees.

PROCEDURE

In keeping with this policy of pay for performance, the Committee reviewed the performance of the Bank for determining and recommending to the Board the annual salary pool and the bonus pool for the Bank. The Committee also appraised the performance of the Chief Executive Officer based on the pre-agreed targets and desired skills and reviewed his remuneration

In addition, the Committee considers and recommends to the Board of Directors from time to time, the requirements of additional/new expertise/skills and also salary revisions. The Committee periodically assesses the succession plan for key management positions.

MEETINGS

The Committee held two meetings during the financial year to carry out its task. The attendance by members is given in page 60 of the Annual Report.



J M S Brito

*Chairman - Human Resources and
Remuneration Committee*

30 May 2011

REPORT OF THE NOMINATION COMMITTEE

REPORTS OF DIRECTORS

COMMITTEE REPORTS

COMPOSITION

The Nomination Sub-Committee of the Board of Directors consist of three Non-Executive Directors.

Mr R B Thambiyah, an Independent Director is the Chairman with Messrs J M S Brito and C R Jansz serving as members currently. The Committee was reconstituted and Messrs Thambiyah and Jansz were appointed in place of Messrs C P R Perera and D S Weerakkody during the year. The General Manager, Mr A N Fonseka attends the meeting by invitation, while the Secretary to the Board functions as the Secretary of the Committee.

MANDATE

The Committee carries out the tasks set out in Section 3 (6) (iv) of Direction No. 12 of 2007 issued by the Central Bank of Sri Lanka on Corporate Governance in licensed specialised Banks. In terms of this Direction the

role of the Committee is to identify and evaluate persons with the required skills, knowledge, standing, fitness and propriety to join the Board of the Bank and to evaluate the suitability of Directors who are seeking re-election. The Committee is responsible for the task of putting in place a procedure for the appointment of the CEO and Key Management Personnel. The Committee makes recommendations to the Board of Directors for consideration.

PROCEDURE

The Committee meets when required and acts within its mandate approved by the Board of Directors and makes recommendations to the Board for consideration.

MEETINGS

Two meetings were held during the financial year to identify possible candidates to fill Board vacancies and to assess the fitness and propriety of Directors. Individual Committee Members do not participate in discussions in matters relating to them. The attendance by Directors at meetings is given in page 60 of the Annual Report. All appointments made to the Board during the year were recommended by the Committee and the Committee has recommended the re-election of Directors offering themselves for re-election at the Annual General Meeting.



R B Thambiyah

Chairman - Nomination Committee

23 May 2011

REPORT OF THE BOARD INTEGRATED RISK MANAGEMENT COMMITTEE

REPORTS OF DIRECTORS COMMITTEE REPORTS

COMPOSITION

The Board Integrated Risk Management Committee (BIRMC) of DFCC consisted of the three Non-Executive Directors and five Non-Voting Members. The Head of Internal Audit, Mr A G N Bandara, attends meetings by invitation while the Chief Risk Officer, Mr S de Silva, functions as the Secretary to the Committee. The following were the Members of the Committee as at 31 March 2011:

Voting Members

Mr J M S Brito - *Chairman*

Mr S N P Palihena - *Non-Executive Director*

Mr A S Abeyewardene - *Non-Executive Director*

Non-Voting Members

Mr A N Fonseka - *Chief Executive Officer/ Ex-Officio Director*

Mr H A Ariyaratne - *Executive Vice-President/Lending*

Mr S Nagarajah - *Executive Vice-President/Finance*

Ms R A P Withana - *Executive Vice-President/Operations*

Mrs M Gunawardhena - *Senior Vice-President/Treasury & Resource Development*

There were no changes to the composition during the year.

CHARTER AND RESPONSIBILITIES

The approved Charter for the BIRMC stipulates authority, structure, responsibilities and tasks of BIRMC. As per its Charter, the primary responsibilities of BIRMC are to review and ensure:

- Integrity and adequacy of the risk management function of the Bank
- Adequacy of the Bank's capital on a solo and consolidated basis and its allocation
- Risk exposures and risk profiles of the Bank and its subsidiaries are within acceptable parameters and to make recommendations to the Board of Directors on any action required;
- The compliance of the Bank's operations with relevant laws, regulations and standards including the adherence to the Direction on Corporate Governance issued by the Central Bank.

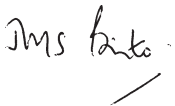
The process through which the BIRMC discharges its responsibilities is detailed in the Risk Management Section of this Annual Report.

MEETINGS

BIRMC meets on a quarterly basis. During the year, four Committee meetings were held. The attendance of members is listed on page 60 of the Annual Report. The Committee reviewed policy frameworks, risk management strategies and key risk indicators at these meetings and was satisfied that the risk exposures of the bank were being appropriately managed. During the year, certain risk limits were introduced and existing risk limits were reviewed in the areas of liquidity risk, market risk, operational risk and counter-party credit risk. The Committee reviewed the potential impact of assumed hypothetical stress conditions on the Bank and concluded that the available capital cushion was more than adequate to meet the assumed stress conditions.

REPORTING

The proceedings of the BIRMC meetings are reported to the Board through submission of the meeting minutes. Recommendations on specific matters are submitted separately for approval by the Board. The recommendations made by the BIRMC during the year under review were approved by the Board without any material variation.



J M S Brito
Chairman

30 May 2011

STATEMENT OF INTERNAL CONTROL

REPORTS OF DIRECTORS

INTRODUCTION

Internal Control is the process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the DFCC Bank's (Bank) objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Internal control consists of the following components:

- (a) The control environment;
- (b) The entity's risk assessment process;
- (c) The information system, including the related business processes, relevant to financial reporting and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

The subset of this wider internal control system is the internal controls designed and implemented to provide reasonable assurance on the integrity of the financial reporting system to prepare true and fair financial statements for external use.

RESPONSIBILITY

The Board of Directors acknowledge their responsibility for the adequacy and effectiveness of the Bank's system of internal controls which is designed to provide assurance on maintenance of proper accounting records and the reliability of financial information generated and safeguarding of the assets of the Bank. However, such systems are designed to manage the Bank's key exposures to risk within acceptable risk parameters, rather than to eliminate the risk of failure to achieve the business goals and objectives of the Bank. Therefore, the system of internal controls can only provide reasonable and not absolute assurance against errors or material misstatement of management and financial information and records or against financial losses or fraud.

FRAMEWORK FOR MANAGING MATERIAL RISKS OF THE BANK

The Board has set up an ongoing process for identifying, monitoring and managing the material risks faced by the Bank. This includes establishment of a dedicated Risk Department that provides regular reports on various risks, subject to an oversight by Internal Audit Department through Internal Audit Reports that enables the Audit Committee to review the adequacy and effectiveness of the system of internal controls continuously to match the changes in the business environment or regulatory guidelines. In making this assessment, all key processes relating to material or significant transactions capture and recording in the books of accounts are identified and covered on an on-going basis that is compatible with the guidance for Directors of Banks on the Directors' Statement of Internal Control issued by The Institute of Chartered Accountants of Sri Lanka.

KEY INTERNAL CONTROL PROCESSES

The key processes that have been established in reviewing the adequacy and integrity of the system of internal controls include the following:

- The Board has established Sub-Committees to assist the Board in exercising an oversight on the effectiveness of the Bank's daily operations and ensuring that they are in accordance with the corporate objectives, strategies and the budgetary targets as well as the policies and business directions that have been approved.
- The internal audit division of the Bank verifies compliance of operations with policies and procedures and the effectiveness of the internal control systems and highlights significant findings in respect of any non-compliance. Audits are carried out on all units and branches, the frequency of which is determined by the level of risk assessed, to provide an independent and objective report on operational and management activities of these units and branches. The annual audit plan is reviewed and approved by the Audit Committee and the findings of the audits are submitted to the Audit Committee for review at their periodic meetings.
- The Audit Committee of the Bank reviews internal control issues identified by the internal audit, the External Auditors, regulatory authorities and management and evaluates the adequacy and effectiveness of the risk management and internal control systems. They also review the internal audit function focussing on the scope of audits and the quality of reporting. The minutes of the Audit Committee meetings are tabled for the information of the Board on a periodic basis. Further

details of the activities undertaken by the Audit Committee of the Bank are set out in the Audit Committee Report on page 66.

- The Board Integrated Risk Management Committee (BIRMC) is established by the Board to assist the Board to oversee the overall management of principal areas of risk of the Bank. The BIRMC includes representation from all key business and operations areas of the Bank and assists the Board in the implementation of policies, procedures and controls identified by the BIRMC.
- Operational committees have also been established with appropriate mandates to ensure effective management and supervision of the Bank's core areas of business operations. These committees include the Management Committee, the Credit Committee, the Asset/Liability Committee, the Bad Debt Review Committee and the Information Technology Steering Committee.

ASSESSMENT OF THE ADEQUACY AND EFFECTIVENESS OF INTERNAL CONTROL

Although this process is carried out every year on a continuing basis consequent to a new requirement of the regulator to provide a separate Report on Internal Control by the Board of Directors on the effectiveness of the internal control mechanism to prepare reliable financial statements for external use supplemented with independent certification by the Auditor, in 2010 The Institute of Chartered Accountants of Sri Lanka issued a new Auditing Standard 3050.

This required documentation of all processes with audit evidence of checks performed by the Bank on an on-going basis. In order to facilitate the independent certification by the External Auditor, this financial year within a relatively short period of time identified officers of the Bank documented internal controls associated with key processes that are related to significant items in the Income Statement and the Balance Sheet that are issued for external use.

Additionally they were tested by Internal Audit specifically for this purpose which is in addition to the Internal Audit checks performed on on-going basis throughout the year.

This process may be described as a journey to be undertaken by the Bank with progressive improvements to ensure that not only a robust internal control system is designed and effectively used by the Bank but it is also formally documented in sufficient details demonstrating the internal control framework within the Bank with evidence. Such a process cannot be completed in one year. In this context, therefore there were certain sub processes of Human Resources, Deposits and Related party transactions that were not subjected to detailed testing specifically for this purpose. The Directors are of the opinion that these exceptions do not in any way detract from the conclusion that the financial reporting system is reliable to provide reasonable assurance that the financial statements for external use are true and fair and complies with Sri Lanka Accounting Standards (SLAS) and the regulatory requirements of the Central Bank of Sri Lanka (CBSL).

The Auditor, Messrs KPMG Ford, Rhodes, Thornton & Co. has also acknowledged that the financial statements for the year ended 31 March 2011 are true and fair, prepared in accordance with SLAS and regulatory requirements of CBSL.

This assessment of internal control process is confined only to the Bank and did not include its subsidiaries. However, the Board of Directors of 99% owned commercial banking subsidiary, DFCC Vardhana Bank Limited (DVB) issued an affirmative assurance in their Statement on Internal Control, on the adequacy and the effectiveness of the internal control system which was included in the DVB's Annual Report for the year ended 31 December 2010. The said Statement by the Directors was independently reviewed by KPMG Ford, Rhodes, Thornton & Co. who is also the Auditor of the Bank.

CONFIRMATION

Based on the above processes, the Board confirms that the financial reporting system of the Bank has been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes is in accordance with Sri Lanka Accounting Standards and regulatory requirements of the Central Bank of Sri Lanka.

REVIEW OF THE STATEMENT BY EXTERNAL AUDITORS

The External Auditors have reviewed the above Directors' Statement on internal control for the year ended 31 March 2011 and reported to the Board that nothing has come to their attention that causes them to believe that the statement is inconsistent with their understanding of the process adopted by the Board in the review of the design and effectiveness of the internal control system over the financial reporting of the Bank.

By Order of the Board,



T K Bandaranayake
Chairman
Audit Committee



J M S Brito
Chairman
Board of Directors



Nihal Fonseka
Chief Executive Officer/Director

30 May 2011