

**THE HONGKONG AND SHANGHAI
BANKING CORPORATION LIMITED
SRI LANKA BRANCH**

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED
31ST DECEMBER 2013**



KPMG
(Chartered Accountants)
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INDEPENDENT AUDITORS' REPORT

TO THE MANAGEMENT OF HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED - SRI LANKA BRANCH ("THE BRANCH")

Report on the Financial Statements

We have audited the accompanying financial statements of Hongkong and Shanghai Banking Corporation Limited - Sri Lanka Branch ("the Branch") which comprises the Statement of Financial Position as at 31st December 2013, and the Statement of Comprehensive Income, Statement of Changes in Equity and Cash Flow Statement for the year then ended, and notes to the financial statements set out on pages 2 to 60.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Scope of Audit and Basis of Opinion

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Sri Lanka Auditing Standards. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. We therefore believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, so far as appears from our examination, the Branch maintained proper accounting records for the year ended 31st December 2013 and the financial statements give a true and fair view of the financial position of the Branch as at 31st December 2013 and of its financial performance and its cash flow for the year ended in accordance with Sri Lanka Accounting Standards.

Report on Other Legal and Regulatory Requirements

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

Chartered Accountants

Colombo
21st March 2014

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
INCOME STATEMENT

FOR THE YEAR ENDED 31ST DECEMBER

	Note	2013 Rs.'000	2012 Rs.'000
Interest income		25,839,261	22,057,108
Interest expenses		(7,860,324)	(7,008,912)
Net interest income	5	<u>17,978,937</u>	<u>15,048,196</u>
Fee and commission income		4,444,812	4,143,535
Fee and commission expenses		(660,675)	(805,565)
Net fee and commission income	6	<u>3,784,137</u>	<u>3,337,970</u>
Net gain from trading	7	1,547,379	3,446,115
Other operating income (net)	8	117,696	93,862
Total operating income		<u>23,428,149</u>	<u>21,926,143</u>
Impairment (charge)/reversal for loans and other losses	9	(807,642)	54,633
Net operating income		<u>22,620,507</u>	<u>21,980,776</u>
Personnel expenses	10	(2,944,260)	(3,638,219)
Other expenses	11	(4,994,494)	(4,800,820)
Operating profit before value added tax (VAT)		14,681,753	13,541,737
Value added tax (VAT) on financial services		(2,043,160)	(1,493,296)
Profit before tax		<u>12,638,593</u>	<u>12,048,441</u>
Income tax expense	12	(4,406,918)	(3,848,647)
Profit for the year		<u>8,231,675</u>	<u>8,199,794</u>

Figures in brackets indicate deductions.

The Financial Statements are to be read in conjunction with the related notes, which form a part of the Financial Statement of the Branch set out on pages 2 to 60. The audit report is given on page 1.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF COMPREHENSIVE INCOME**

FOR THE YEAR ENDED 31ST DECEMBER

	Note	2013 Rs.'000	2012 Rs.'000
Profit for the year		8,231,675	8,199,794
Other comprehensive income/(expenses)			
Actuarial gain on defined benefit plans		200,599	225,327
Gain from translating the financial statements of foreign currency operation		363,401	1,491,431
Gain on re-measuring available-for-sale financial assets		2,701,955	1,249,861
Gain on revaluation of property plant and equipment		416,400	264,780
Tax expense relating to components of other comprehensive income	12.d	(946,975)	(375,299)
Other comprehensive income for the year, net of taxes		2,735,380	2,856,100
Total comprehensive income for the year		10,967,055	11,055,894

Figures in brackets indicate deductions.

The Financial Statements are to be read in conjunction with the related notes which form a part of the Financial Statement of the Branch set out on pages 2 to 60. The audit report is given on page 1.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF FINANCIAL POSITION

AS AT		31/12/2013	31/12/2012	01/01/2012
	Note	Rs.'000	Rs.'000 (Restated)	Rs.'000 (Restated)
ASSETS				
Cash and cash equivalents	14	9,471,769	10,464,125	7,803,516
Balances with Central banks	15	8,045,947	10,478,758	8,807,367
Placements with banks	16	5,636,400	23,407,000	14,867,267
Derivative financial instruments	17	2,983,392	5,935,245	3,686,729
Other Financial assets held-for-trading	18	11,995,713	7,218,481	1,041,424
Loans and receivables to banks	19	30,559,850	7,131,914	7,171,868
Loans and receivables to other customers	20	129,012,751	123,081,468	116,069,608
Financial investments – Available-for-sale	21	107,011,206	77,452,338	73,800,084
Property, plant and equipment	22	1,917,323	1,472,059	1,218,483
Deferred tax assets	23	-	89,395	333,345
Other assets	24	19,524,359	16,448,926	17,805,624
Total Assets		326,158,710	283,179,709	252,605,315
LIABILITIES				
Due to banks	25	97,620,005	73,281,289	62,409,005
Derivatives	26	4,088,096	3,850,947	2,636,024
Due to other customers	27	154,946,963	149,647,020	141,045,736
Current tax liabilities		2,687,452	2,894,196	2,559,247
Deferred tax liabilities	23	683,869	-	-
Other liabilities	28	23,085,546	19,865,457	21,337,413
Total Liabilities		283,111,931	249,538,909	229,987,425
EQUITY				
Assigned capital	29	3,152,358	3,152,358	3,152,358
Statutory reserve fund	30	1,790,585	1,625,952	1,216,792
Other reserves	31	8,694,576	5,754,899	2,563,167
Retained earnings		29,409,260	23,107,592	15,685,573
Total Equity		43,046,779	33,640,801	22,617,890
Total equity and liabilities		326,158,710	283,179,709	252,605,315
Contingent liabilities and commitments	35	741,593,231	608,406,976	530,240,873

The Financial Statements are to be read in conjunction with the related notes, which form a part of the Financial Statement of the Branch set out on pages 2 to 60. The audit report is given on page 1.

The Management is responsible for the preparation of these Financial Statements

Approved and signed for on behalf of the Management

Sriyan Cooray
(Signed) Acting Chief Executive Officer

Kanchana Hewavitharana
(Signed) Chief Financial Officer

21st March 2014
Colombo

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31ST DECEMBER 2013

	Assigned Capital Rs.'000	Exchange Equalisation of Capital Rs.'000	Exchange Equalisation of Reserves Rs.'000	IFA Reserve Rs.'000	AFS Reserve Rs.'000	SBP Reserve Rs.'000	Reserve Fund Rs.'000	Revaluation Reserve Rs.'000	Retained Earnings Rs.'000	Total Equity Rs.'000
Balance as at 1 st January 2012 as previously stated	3,152,358	202,200	540,000	903,314	(639,456)	-	1,216,792	778,391	16,325,029	22,478,628
Restatement of Share Based Payment (Note A)	-	-	-	-	-	139,262	-	-	-	139,262
Restated Balance as at 1 st January 2012	3,152,358	202,200	540,000	903,314	(639,456)	139,262	1,216,792	778,391	16,325,029	22,617,890
Total comprehensive income for the year	-	-	-	-	-	-	-	-	8,199,794	8,199,794
Profit for the year	-	203,250	1,284,232	-	905,984	-	-	264,780	197,854	2,856,100
Other comprehensive income (net of tax)	-	-	-	-	-	-	-	-	-	-
Total comprehensive income for the year	-	203,250	1,284,232	-	905,984	-	-	264,780	8,397,648	11,055,894
Transactions with equity holders, recognised directly in equity	-	-	-	-	-	-	-	-	(409,160)	-
Transfers to reserves during the year	-	-	-	-	-	409,160	-	-	-	-
Cost of share options granted during the year	-	-	-	-	-	-	-	-	-	10,738
Change in fair value of restricted share awards	-	-	-	-	-	-	-	-	318	318
Transfer to IFA reserve	-	-	-	1,472,771	-	-	-	-	(1,472,771)	-
Deferred Tax on Revaluation	-	-	-	-	-	-	-	(44,039)	-	(44,039)
Total transactions with equity holders	-	-	-	1,472,771	-	10,738	409,160	(44,039)	(1,881,613)	(32,983)
Balance as at 31 st December 2012	3,152,358	405,450	1,824,232	2,376,085	266,528	150,000	1,625,952	999,132	22,841,064	33,640,801
Balance as at 1 st January 2013	3,152,358	405,450	1,824,232	2,376,085	266,528	150,000	1,625,952	999,132	22,841,064	33,640,801
Total comprehensive income for the year	-	-	-	-	-	-	-	-	8,231,675	8,231,675
Profit for the year	-	50,100	313,301	-	1,947,607	-	-	361,196	63,176	2,735,380
Other comprehensive income (net of tax)	-	-	-	-	-	-	-	-	-	-
Total comprehensive income for the year	-	50,100	313,301	-	1,947,607	-	-	361,196	8,294,851	10,967,055
Transactions with equity holders, recognised directly in equity	-	-	-	-	-	-	164,633	-	(164,633)	-
Transfers to reserves during the year	-	-	-	-	-	-	164,633	-	-	7,666
Cost of share options granted during the year	-	-	-	-	-	7,666	-	-	-	4,257
Change in fair value of restricted share awards	-	-	-	-	-	-	-	-	4,257	4,257
Transfer to IFA reserve	-	-	-	2,207,414	-	-	-	-	(2,207,414)	-
Profit transferred to head office	-	-	-	-	-	-	-	-	(1,573,000)	(1,573,000)
Total transactions with equity holders	-	-	-	2,207,414	-	7,666	164,633	-	(3,940,790)	(1,561,077)
Balance as at 31 st December 2013	3,152,358	455,550	2,137,533	4,583,499	2,214,135	157,666	1,790,585	1,360,328	27,195,125	43,046,779

The Financial Statements are to be read in conjunction with the related notes, which form a part of the Financial Statement of the Branch set out on pages 2 to 60. The audit report is given on page 1.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF CHANGES IN EQUITY (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER 2013

Note A - Restatement of Share Based Payment Reserve

The Branch has not recognised the share options granted to employees without recharge arrangement by HSBC Holdings Plc which should be classified as "Equity settled share based payment" as per SLFRS 2 - "Share based payment" in the previous year financial statements. This error has been corrected during the year by restating the previous year financial statements as per LKAS 8 - "Accounting Policies, Changing in Accounting Estimates and Errors".

	1/1/2012
	Rs' 000
Share based payment reserve	<u>139,262</u>
	<u><u>139,262</u></u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
CASH FLOW STATEMENT

FOR THE YEAR ENDED 31ST DECEMBER

	2013 Rs.'000	2012 Rs.'000
Cash Flow From Operating activities		
Interest received	26,281,178	21,073,192
Interest paid	(7,515,127)	(6,839,869)
Recoveries on previously written off loans	825,184	788,301
Fees and commission received	3,784,138	3,334,703
Dividends received	-	446
Net receipts from trading activities	1,547,379	2,687,883
Operating expenses paid	(7,531,718)	(8,149,793)
Operating profit before changes in operating assets and liabilities	17,391,034	12,894,863
Changes In Operating Assets & Liabilities		
(Increase)/decrease in treasury bills and other eligible bills	(16,584,085)	23,511,858
Increase in treasury bonds	(11,399,339)	(28,386,722)
Increase in loans to other banks	(5,538,599)	(5,414,827)
Increase in loans and advances	(6,899,202)	(2,812,772)
Increase in government bonds	(3,270,500)	(2,791,777)
(Increase)/decrease in other assets	2,926,891	(2,140,983)
Increase in deposits from customers	4,757,324	6,764,743
Increase in borrowings	23,358,311	5,046,926
Increase in other liabilities	217,676	2,416,454
Net Cash used in Operating	(12,431,523)	(3,807,100)
Income Tax Paid	(6,837,570)	(5,112,648)
Net Cash Flows From/ (used in) Operating Activities	(1,878,059)	3,975,115
Cash Flow From Investing Activities		
Proceeds from disposal of property, plant and equipment	34,533	26,336
Acquisition of property, plant and equipment	(178,846)	(143,489)
Net Cash Flow used in Investing Activities	(144,313)	(117,153)
Cash Flow From Financing Activities		
Profit transferred to Head Office	(1,573,000)	-
Net Cash Flow used in Financing Activities	(1,573,000)	-
Net Increase/(Decrease) in Cash and Cash Equivalents	(3,595,372)	3,857,960
Cash and Cash Equivalents at the Beginning of period	20,942,883	16,610,883
Exchange Adjustment	170,205	474,040
Cash and Cash Equivalents at the end of the year (Note A)	17,517,716	20,942,883
Note A		
Analysis of Cash and Cash Equivalents at the end of the year		
Cash in Hand and Balances with Banks	1,367,826	1,233,687
Balances with Other Banks	8,103,943	9,230,438
Balances with Central Bank	8,045,947	10,478,758
	17,517,716	20,942,883

Figures in brackets indicate deductions.

The Financial Statements are to be read in conjunction with the related notes, which form a part of the Financial Statement of the Branch set out on pages 2 to 60. The audit report is given on page 1.

**THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS**

1. CORPORATE INFORMATION

1.1 Domicile and Legal form

The Hongkong and Shanghai Branching Corporation Limited is a Public company incorporated in Hongkong SAR with the limited liability and carries out Branching activities in Sri Lanka through HSBC Sri Lanka Branch. The registered office of HSBC Sri Lanka Branch is located at No. 24, Sir Baron Jayatilaka Mawatha, Colombo 1.

1.2 Principal Activities and Nature of Operations

The principal activities of the Branch, which is carrying out Banking Activities through branches remained unchanged during the year. However HSBC re-entered the Primary Dealership in October 2013 and this provide HSBC the direct access to the primary auctions for government securities and Central Branch securities.

1.3 Parent Company and Ultimate Parent Company

The immediate parent entity is the Hongkong and Shanghai Branching Corporation Limited and the ultimate parent entity is HSBC Holding Plc. (incorporated in Great Britain and registered in England and Wales).

2. BASIS OF PREPARATION

2.1 Statement of Compliance

The financial statements of the Bank which comprise the statement of financial position, statement of comprehensive income, statement of changes in equity, statement of cash flows and notes thereto have been prepared in accordance with relevant Sri Lanka Accounting Standards (SLFRSs and LKASs) laid down by the Institute of Chartered Accountants of Sri Lanka and comply with the requirements of the Banking Act No. 30 of 1988 and subsequent amendments thereto.

2.2 Basis of Measurement

The Financial Statements have been prepared on the historical cost basis and applied consistently with no adjustments being made for inflationary factors affecting the Financial Statements, except for the following;

- Assets and liabilities held for trading are measured at fair value
- Derivative financial instruments are measured at fair value
- Available for sale financial assets are measured at fair value
- Liability for defined benefit obligations is recognized as the present value of the defined benefit obligation.

2.3 Functional and Presentation Currency

Financial Statements are presented in Sri Lankan Rupees, which is the Branch's functional currency.

2.4 Use of Estimates and Judgment

The preparation of Financial Statements require management to make judgment estimates and assumptions that effects the application of accounting policies and the reported amount of assets, liabilities, income and expenses. Actual results may differ from these estimates.

THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

2. BASIS OF PREPARATION (CONTINUED)

2.4 Use of Estimates and Judgment (Continued)

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period of which the estimate is revised and in any future period affected.

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these Financial Statements.

3.1 Foreign Currency Translation

Assets and liabilities denominated in foreign currencies are translated at the spot rate of exchange ruling on the reporting date. Translation gains and losses are dealt with through the income statement.

Transactions in foreign currencies are translated to Sri Lankan Rupees at the spot rate of exchange ruling at the date of transaction.

Forward exchange contracts are valued at the forward market rates ruling on the reporting date. Both unrealised losses and gains are reflected in the income statement.

3.2 Interest

Interest income and expense is recognized in profit or loss using the effective interest method. 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 liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. When calculating the effective interest rate, the Branch estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses.

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

Interest income and expense presented in the Statement of Comprehensive Income include;

- interest on financial assets and financial liabilities measured at amortized cost calculated on an effective interest basis;
- fair value changes in qualifying derivatives;

3.3 Fees and commissions

Fees and commission income and expense that are integral to the effective interest rate on financial asset or liability are included in the measurement of the effective interest rate.

**THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.3 Fees and commissions (Continued)

Other fees and commission income, including account servicing fees, Trade fees are recognized as the related services are performed. Other fees and commission expense relate mainly to transaction and service fees, which are expensed as the services are received.

3.4 Taxation

Income Taxation

The provision for income tax is based on the element of the income and expenditure as reported in the Financial Statements and computed in accordance with the provisions of the Inland Revenue Act No.10 of 2006 and subsequent amendments thereto.

Relevant details are disclosed in the Notes to the Financial Statements.

Deferred Tax

Deferred tax is provided using the liability method on temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax assets and liabilities are recognised for all temporary differences. Deferred tax assets are recognised for all deductible temporary differences, carry-forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry-forward of unused tax credits and unused tax losses can be utilized.

The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilised. Unrecognized deferred tax assets are assessed at each reporting date and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the year when the asset is realised or liability is settled, based on the tax rates and tax laws that have been enacted or substantively enacted as at the reporting date.

Deferred Tax relating to items recognised directly in equity is recognised in equity.

Deferred tax assets and deferred tax liabilities are offset if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

**THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial Assets and Financial Liabilities

3.5.1 Initial Recognition and Measurement

3.5.1.1 Financial Assets

All financial instruments are recognised initially at fair value.

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, HSBC recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value.

When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value from the transaction price as indicated by the valuation model is not recognised immediately in the income statement. Instead, it is recognised over the life of the transaction on an appropriate basis, when the inputs become observable, the transaction matures or is closed out, or when HSBC enters into an offsetting transaction.

Financial assets are classified into following categories at the initial recognition:

- Financial investments - Held for trading
- Loans and Advances
- Financial investments Available-for-sale

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with HSBC's valuation methodologies.

• **Financial Investments-Held for Trading**

Financial assets at fair value through profit or loss include financial assets held for trading. Financial assets are classified as held for trading if they are acquired for the purpose of selling or repurchasing in the near term. This category includes derivative financial instruments entered into by the Branch that are not designated as hedging instruments in hedge relationships as defined by LKAS 39. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments. Financial assets at fair value through profit and loss are carried in the statement of financial position at fair value with changes in fair value recognized in finance income or finance costs in the income statement.

• **Loans and Advances**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method

**THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial Assets and Financial Liabilities (Continued)

3.5.1 Initial Recognition and Measurement (Continued)

3.5.1.1 Financial Assets (Continued)

(EIR), less impairment. Amortized 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 amortization is included in interest income in the income statement. The losses arising from impairment are recognized in the income statement in impairment charges for loans and other losses.

- **Available for Sale Financial Investments**

Available-for-sale investments are non-derivative investments that were designated as available-for-sale or are not classified as another category of financial assets. All available-for-sale investments are carried at fair value.

Interest income on AFS financial assets is recognized in profit or loss on straight line basis. However, the year to date gap between the straight line basis and the effective interest rate is monitored using a set threshold (currently, 2.5% of total year to date NII) and accounted for if the gap is material. Foreign exchange gain or loss on available-for-sale debt security investments are recognized in profit or loss.

Other fair value changes are recognized in other comprehensive income until the investment is sold or impaired, whereupon the cumulative gains and losses previously recognized as in other comprehensive income are reclassified to profit or loss as a reclassification adjustment.

3.5.1.2 Financial liabilities measured at amortised cost

Financial liabilities not classified as fair value through profit or loss are classified as amortised cost instruments. Deposits liabilities including non interest bearing deposits, savings deposits, term deposits, deposits redeemable at call and certificates of deposit and borrowings are classified as financial liabilities measured at amortised cost.

3.5.2 Derecognition

3.5.2.1 Financial Assets

A financial asset (or, where applicable a part of a financial asset or part of a Branch of similar financial assets) is derecognized when:

- The right to receive cash flows from the asset have expired.

THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial Assets and Financial Liabilities (Continued)

3.5.2 Derecognition (Continued)

3.5.2.1 Financial Assets (Continued)

- The Branch has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and either
 - a) The Branch has transferred substantially all the risks and rewards of the asset, or
 - b) The Branch has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

3.5.2.2 Financial Liabilities

A financial liability is derecognized when the obligation under the liability is 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 recognized in profit or loss.

3.5.3 Offsetting

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Branch has a legal right to set off the recognized amounts and it intends either to settle on a net basis or to realize the asset and settle the liability 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 Branch's trading activity.

3.5.4 Amortized Cost Measurement

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

3.5.5 Fair Value Measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Branch measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily

THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial Assets and Financial Liabilities (Continued)

3.5.5 Fair Value Measurement (Continued)

and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, then the Branch establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses and option pricing models. The chosen valuation technique makes maximum use of market inputs, relies as little as possible on estimates specific to the Branch, incorporates all factors that market participants would consider in setting a price, and is consistent with accepted economic methodologies for pricing financial instruments. Inputs to valuation techniques reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument. The Branch calibrates valuation techniques and tests them for validity using prices from observable current market transactions in the same instrument or based on other available observable market data.

Assets and long positions are measured at a bid price; liabilities and short positions are measured at an asking price. Where the Branch has positions with offsetting risks, mid-market prices are used to measure the offsetting risk positions and a bid or asking price adjustment is applied only to the net open position as appropriate. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Branch and the counterparty where appropriate.

3.5.6 Impairment of Financial Assets

The Branch assesses at each reporting date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated.

Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, the probability that they will enter Branchruptcy or other financial reorganization, default or delinquency in interest or principal payments and where observable data indicates that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

3.5.6.1 Financial Assets Carried at Amortized Cost

For financial assets carried at amortized cost (such as amounts Loans and Receivables from Branches, loans and advances to customers as well as held-to-maturity investments), the Branch first assesses individually whether objective evidence of impairment exists for financial assets

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SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial Assets and Financial Liabilities (Continued)

3.5.6 Impairment of Financial Assets (Continued)

3.5.6.1 Financial Assets Carried at Amortized Cost (Continued)

that are individually significant, or collectively for financial assets that are not individually significant. If the Branch determines that no objective evidence of impairment exists for an individually assessed financial asset, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be recognized, are not included in the collective assessment for impairment.

If there is an objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the assets's carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not yet been incurred). The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognized in the Statement of Comprehensive Income. Interest income continues to be accrued on the reduced carrying amount 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 is recorded as part of 'Interest and similar income'.

Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realized or has been transferred to the Branch. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a future write-off is later recovered, the recovery is credited to the 'Impairment charges for loans and other losses'.

The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. If the Branch has reclassified trading assets to loans and advances, the discount rate for measuring any impairment loss is the new effective interest rate determined at the reclassification date. The calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purpose of a collective evaluation of impairment, financial assets are grouped based on the nature and type of the asset. It also considers credit risk characteristics such as asset collateral type, past-due status and other relevant factors.

Future cash flows on a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect, and are directionally

THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.5 Financial Assets and Financial Liabilities (Continued)

3.5.6 Impairment of Financial Assets (Continued)

3.5.6.1 Financial Assets Carried at Amortized Cost (Continued)

consistent with, changes in related observable data from year to year (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

3.5.6.2 Available-For-Sale Financial Investments

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

In the case of debt instruments classified as available-for-sale, the Branch assesses individually whether there is objective evidence of impairment based on the same criteria as financial assets carried at amortized cost. However, the amount recorded for impairment is the cumulative loss measured as the difference between the amortized cost and the current fair value, less any impairment loss on that investment previously recognized in the Comprehensive Income. Future interest income is based on the reduced carrying amount 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 is recorded as part of 'Interest and similar income'. If, in a subsequent period, the fair value of a debt instrument increases and the increase can be objectively related to a credit event occurring after the impairment loss was recognized in the Comprehensive Income, the impairment loss is reversed through Comprehensive Income.

3.5.8 Re-structured Loans

Where possible, the Branch seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated any impairment is measured using the original effective interest rate as calculated before the modification of terms and the loan is no longer considered past due. Management continually reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment, calculated using the loan's original effective interest rate, unless there is a significant modification.

3.6 Events occurring after Reporting Date

All material events occurring after the reporting date are considered and disclosed and where necessary, adjustments are made in the Financial Statements.

**THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.7 Cash Flow Statements

The Cash Flow has been prepared and presented using the "Direct Method" of preparing Cash Flow Statements in accordance with LKAS 7, Statements of Cash Flows.

Cash and cash equivalent comprise mainly of cash in hand, short-term placements with other Branches and highly liquid financial assets with original maturities of less than three months, which are subject to insignificant risk of changes in their fair value and are used by the Branch in the management of its short term commitments.

3.8 Comparative Figures

The comparative figures and phrases have been re-arranged wherever necessary to conform to the current year's presentation. The accounting policies have been consistently applied by the Branch and are consistent with those of previous year.

3.9 Assets and Bases of their Valuation

3.9.1 Property, Plant and Equipment

Initial measurement

The Property, Plant and Equipment are recorded at cost or revaluation. The cost of Property, Plant and Equipment is the cost of purchase or construction together with any incidental expenses thereon and valuation is carried out once a year for Land and Building by an independent valuer. The Property, Plant and Equipment are stated at cost (Land and Free hold buildings are carried at revalued amounts.) valuation less accumulated depreciation, which is provided for on the bases specified below and impairment losses.

All Property and Equipment costing less than USD 400/- and maintenance and repairs to machinery are charged to the income statement. All major renovations and renewals are capitalized.

Depreciation

The provision for depreciation is calculated on the cost or valuation of Property, Plant and Equipment has been provided on straight line basis over the periods appropriate to estimated useful lives of the different types of Property, plant and equipment as shown below. The Freehold land is not depreciated.

Assets	No of Years
Freehold Buildings and improvements to building	over 50 years
Equipment and Office Machinery	over 5 years
Furniture and Equipment	over 5 years
ATM Machines	over 7 years
Motor Vehicles and Boats	over 4 years
Computer Equipment including AS 400 system	over 5 years
Computer Terminals	over 5 years
PC and Local Area Networks	over 4 years

Depreciation is charged on monthly basis from the date of acquisition and no depreciation is charged on the month of disposal of the asset.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.9 Assets and Bases of their Valuation (Continued)

3.9.1 Property, Plant and Equipment (Continued)

Disposals

Gain or loss on disposal of Property, Plant and Equipment have been accounted for in the income statement by considering sales proceeds, cost and accumulated depreciation of such disposed item of Property, Plant and Equipment.

Impairment of Assets

An impairment loss is recognized if the carrying amount of an asset or its cash generating unit exceeds its recoverable amount. A cash generating unit is the smallest identifiable asset group that generates cash flows that largely are independent from other assets & groups. Impairment losses are recognized in profit or loss.

3.9.2 Bills negotiated and discounted

The bills are shown in the books at their face values. Bills in foreign currencies are converted at the year end exchange rates. The resulting gain or loss is dealt with in the income statement.

3.9.3 Cash and Cash Equivalents

Cash and short term funds are regarded as cash and cash equivalents as these are funds held for the purpose of meeting short term cash commitments. Further, these funds have a short maturity of less than three months.

3.9.4 Statutory Deposits with Central Branch

The Monetary Law Act requires that all commercial Branchs operating in Sri Lanka maintain a reserve against all deposit liabilities denominated in Sri Lankan Rupees. The reserve should be maintained for an amount equal to 6% of the total of such rupee deposit liabilities.

3.10 Employee share plans

Share options and discretionary awards of shares granted under HSBC Group share plans align the interests of employees with those of shareholders. HSBC Sri Lanka's employee share plan is also aligned to group policy.

3.10.1 Share save Scheme

The HSBC Holdings savings-related share option plans are all-employee share plans under which eligible employees may be granted options to acquire HSBC Holdings ordinary shares. This has been extended to HSBC Sri Lanka employees as well. Employees may make contributions of up to £250 (or equivalent) each month over a period of one, three or five years which may be used on the first, third or fifth anniversary of the commencement of the

THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.10 Employee share plans (Continued)

3.10.1 Share save Scheme (Continued)

relevant savings contract, at the employee's election, to exercise the options. The plans help align the interests of employees with the creation of shareholder value. The options were awarded for nil consideration and are exercisable at a 20% discount to the average market value of the ordinary shares on the five business days immediately preceding the invitation date. There are no performance criteria conditional upon which the outstanding options are exercisable and there have been no variations to the terms and conditions since the awards were made.

The fair values of share options at the date of grant of the option are calculated using a Black-Scholes model. The fair value of a share award is based on the share price at the date of the grant.

3.10.2 Discretionary Awards

In line with the HSBC Group share awards system, the Branch has entered into equity-settled share-based payment arrangements with its employees as compensation for services provided by employees. Equity-settled share-based payment arrangements entitle employees to receive equity instruments of HSBC Holdings.

The cost of equity-settled share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Liability to HSBC Holdings'. The vesting period is the period during which all the specified vesting conditions of the arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions of the award. Vesting conditions include service conditions and performance conditions; any other features of the arrangement are non-vesting conditions. Market performance conditions and non-vesting conditions are taken into account when estimating the fair value of the award at the date of grant, so that an award is treated as vesting irrespective of whether these conditions are satisfied, provided all other vesting conditions are satisfied.

3.11 Liabilities and Provisions

3.11.1 Employee Retirement Benefit Obligation

Pension Fund

All the employees of the Branch are eligible for the pension Fund. The Fund has been established under Trust Deed dated 7 December 1992 to fund the retirement benefits accruing to employees.

THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.11 Liabilities and Provisions (Continued)

3.11.1 Employee Retirement Benefit Obligation (Continued)

Pension Fund

Up to 31 December 2008, the Branch operates the Pension Fund outside the Financial Statements of the Branch. Accordingly, no asset or liability was recognized in the financial statements of the Branch.

Upto 2012, the Fund was a funded, non-contributory, defined benefit plan. In 2012, the Branch introduced an optional pension scheme which is defined contribution scheme. Therefore, currently the Branch operates two separate pension funds. Namely, the defined benefit plan and defined contributory plan.

Adoption of LKAS 19

Sri Lanka Accounting Standard 19 (LKAS 19) – “Employee Benefit”, applies to financial statements covering annual periods beginning on or after 1 July 2007 and was adapted by the Branch with effect from 1 January 2008.

Accordingly, net of present value of defined benefit obligation and fair value of plan assets has been recognized in the balance sheet. Current service cost, interest cost, expected return on plan assets are charged / credited to income statement and the and all actuarial gains/losses are recognised through other comprehensive income statement. The Division carries out an actuarial valuation of the fund annually. The actuarial valuation is carried out by Messers. Piyal S Goonetilleke and Associates. The actuary has used the “Projected Unit Credit Method” in determining the Present Value of defined benefit obligation and the contribution rate required to fund or provide for the promised benefits under the Fund.

In 2012, the Branch introduced an optional pension scheme which is defined contribution scheme. Employees who opt for Defined Contribution scheme will be credited with an “opening balance” on the date of commencement of the new scheme, which is calculated taking factors such as service period, current pensionable salary, etc. The Branch will contribute 10% of the gross salary thereon, on a monthly basis. The lump sum accrued (Branch’s contribution plus interest) will be payable at the time of staff retirement or leaving service.

Provident Fund

The Branch contributes to the approved Provident Fund, which is maintained outside the Financial Statements of the Branch. This is a defined contribution plan.

Trust Fund

The Branch contributes to the Employees Trust Fund, which is a defined contribution plan.

**THE HONGKONG AND SHANGHAI BRANCHING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.11 Liabilities and Provisions (Continued)

3.11.2 Commitment and Contingencies

All discernible risks are accounted for in determining the amount of other liabilities and all capital commitments and contingent liabilities are disclosed in the financial statements.

3.11.3 Off-Balance Sheet Transactions

The Branch enters into off- balance sheet transactions such as forward exchange contracts, currency swaps, Interest rate swaps and options. All these transactions are currently recorded in the trading position and the Mark to Mark is recognized in the Income Statement.

3.12 Segment Reporting

Segment information is presented for the identifiable operative business lines of the Branch and classified accordingly, which are the primary segments identified by the Branch.

4. NEW ACCOUNTING STANDARDS ISSUED BUT NOT EFFECTIVE AS AT REPORTING DATE

4.1 Sri Lanka Accounting Standard - SLFRS 13, "Fair Value Measurement"

This SLFRS defines fair value, sets out in a single SLFRS a framework for measuring fair value; and requires disclosures about fair value measurements.

This SLFRS will become effective for the Company from 1 April 2014. Earlier application is permitted.

This SLFRS shall be applied prospectively as of the beginning of the annual period in which it is initially applied. The disclosure requirements of this SLFRS need not be applied in comparative information provided for periods before initial application of this SLFRS.

4.2 Sri Lanka Accounting Standard – SLFRS 9 "Financial Instruments"

The objective of this SLFRS is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

An entity shall apply this SLFRS to all items within the scope of LKAS 39 Financial Instruments: Recognition and Measurement. The application of this standard has been currently deferred by the Institute of Chartered Accountants of Sri Lanka consequent to the International Accounting Standards Board's (IASB) decision, to defer the mandatory effective date of IFRS 9.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

5 Net interest income	2013	2012
	Rs.'000	Rs.'000
Interest income		
Other financial assets held-for-trading	1,394,654	651,260
Loans and receivables to banks	814,815	485,152
Loans and receivables to other customers	13,497,529	12,571,868
Financial investments - Available-for-sale	10,120,535	8,334,627
Others	11,728	14,201
Total Interest Income	<u>25,839,261</u>	<u>22,057,108</u>
Interest expenses		
Due to banks	(362,355)	(55,809)
Due to other customers	(6,989,813)	(6,142,086)
Others	(508,156)	(811,017)
Total Interest Expenses	<u>(7,860,324)</u>	<u>(7,008,912)</u>
	<u>17,978,937</u>	<u>15,048,196</u>
Net Interest Income from Sri Lanka Government Securities		
Interest income	11,515,189	8,985,887
Net interest income	<u>11,515,189</u>	<u>8,985,887</u>
6 Net fee and commission income	2013	2012
	Rs.'000	Rs.'000
Fee and commission income	4,444,812	4,143,535
Fee and commission expenses	(660,675)	(805,565)
	<u>3,784,137</u>	<u>3,337,970</u>
6.1 Comprising		
Loans	542,171	246,806
Cards	1,848,142	1,762,246
Trade and remittances	1,085,872	1,249,390
Deposits	252,622	223,692
Others	55,330	(144,164)
Net fee and commission income	<u>3,784,137</u>	<u>3,337,970</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

7 Net gain from trading	2013 Rs.'000	2012 Rs.'000
Foreign exchange (excluding derivatives)	347,789	2,591,167
Government Securities	980,395	640,130
Derivatives	219,195	214,818
	<u>1,547,379</u>	<u>3,446,115</u>
8 Other operating income (net)	2013 Rs.'000	2012 Rs.'000
Profit on sale of property, plant and equipment	29,320	18,420
Loss on sale of investment properties	-	(50,473)
Others	88,376	125,915
	<u>117,696</u>	<u>93,862</u>
9 Impairment charges for loans and other losses	2013 Rs.'000	2012 Rs.'000
Individual significant impairment (charge)/reversal (Note 9.1)	(251,270)	21,450
Collective impairment (charge)/reversal (Note 9.2)	(556,372)	33,183
	<u>(807,642)</u>	<u>54,633</u>
9.1 Individual significant impairment (charge)/reversal		
Impairment provision (charge)/reversal		
- For customer balances	239,832	31,438
- For commitments and guarantees	(8,407)	-
Direct write-offs for the year	(588,085)	(12,353)
Recoveries during the year	105,390	2,365
	<u>(251,270)</u>	<u>21,450</u>
9.2 Collective impairment (charge)/reversal		
Impairment provision charge	(384,481)	(112,913)
Direct write-offs for the year	(891,685)	(639,653)
Recoveries during the year	719,794	785,749
	<u>(556,372)</u>	<u>33,183</u>
10 Personnel expenses	2013 Rs.'000	2012 Rs.'000
Salary and bonus	(2,051,998)	(2,091,081)
Others	(892,262)	(1,547,138)
	<u>(2,944,260)</u>	<u>(3,638,219)</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

11 Other expenses	2013	2012
	Rs.'000	Rs.'000
Auditors' remunerations	(3,233)	(2,200)
Non-audit fees to auditors	(3,546)	(2,620)
Professional and legal expenses	(50,216)	(48,512)
Depreciation of property, plant and equipment	(144,768)	(146,359)
Office administration and establishment expenses	(1,898,035)	(1,962,784)
Others	(2,894,697)	(2,638,345)
	<u>(4,994,495)</u>	<u>(4,800,820)</u>
12 Tax expense	2013	2012
	Rs.'000	Rs.'000
12.a Current Tax Expense		
Current tax on profit for the year	4,144,594	4,043,807
Over provision for the previous year	(80,243)	(19,774)
Tax of prior years paid in current year	273,880	-
Remittance Tax	138,653	-
	<u>4,476,884</u>	<u>4,024,033</u>
12.b Deferred Tax Expenses		
Deferred tax assets recognized/(reversed) during the year	(96,190)	(175,386)
Charge to Deferred tax liabilities	26,224	-
	<u>(69,966)</u>	<u>(175,386)</u>
Total Tax charge to Income statement	<u>4,406,918</u>	<u>3,848,647</u>
12.c Reconciliation Between the Tax Expense and the Accounting Profit		
Accounting Profit before Taxation	12,638,593	12,048,441
Add: Disallowable Expenses	5,104,703	3,471,204
Less: Allowable Expenses	(2,941,246)	(1,077,474)
Taxable Income	<u>14,802,050</u>	<u>14,442,171</u>
12.d Tax charge to the Statement of Comprehensive Income		
Income Tax	-	-
Deferred Tax	(946,975)	(375,299)
	<u>(946,975)</u>	<u>(375,299)</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

13 Analysis of Financial Instruments for Measurement Basis

13.1 As at 31st December 2013

	Held for Trading Rs.'000	Amortized Cost Rs.'000	Available for Sale Rs.'000	Total Rs.'000
ASSETS				
Cash and cash equivalents	-	9,471,769	-	9,471,769
Balances with central banks	-	8,045,947	-	8,045,947
Placements with banks	-	5,636,400	-	5,636,400
Derivative financial instruments	2,983,392	-	-	2,983,392
Financial assets held for trading	11,995,713	-	-	11,995,713
Loans and receivables to banks	-	30,559,850	-	30,559,850
Loans and receivables to other customers	-	129,012,751	-	129,012,751
Financial investments	-	-	107,011,206	107,011,206
Acceptances and endorsements	-	12,761,161	-	12,761,161
Total financial assets	14,979,105	195,487,878	107,011,206	317,478,189
LIABILITIES				
Due to banks	-	97,620,005	-	97,620,005
Derivative financial instruments	4,088,096	-	-	4,088,096
Due to other customers	-	154,946,963	-	154,946,963
Acceptances and endorsements	-	12,761,161	-	12,761,161
Total financial liabilities	4,088,096	265,328,129	-	269,416,225

13.2 As At 31st December 2012

	Held for Trading Rs.'000	Amortized Cost Rs.'000	Available for Sale Rs.'000	Total Rs.'000
ASSETS				
Cash and cash equivalents	-	10,464,125	-	10,464,125
Balances with central banks	-	10,478,758	-	10,478,758
Placements with banks	-	23,407,000	-	23,407,000
Derivative financial instruments	5,935,245	-	-	5,935,245
Financial assets held for trading	7,218,481	-	-	7,218,481
Loans and receivables to banks	-	7,131,914	-	7,131,914
Loans and receivables to other customers	-	123,081,468	-	123,081,468
Financial investments	-	-	77,452,338	77,452,338
Acceptances and endorsements	-	9,893,291	-	9,893,291
Total financial assets	13,153,726	184,456,556	77,452,338	275,062,620
LIABILITIES				
Due to banks	-	73,281,289	-	73,281,289
Derivative financial instruments	3,850,947	-	-	3,850,947
Due to other customers	-	149,647,020	-	149,647,020
Acceptances and endorsements	-	9,893,291	-	9,893,291
Total financial liabilities	3,850,947	232,821,600	-	236,672,547

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT

14 Cash and cash equivalents	31/12/2013 Rs.'000	31/12/2012 Rs.'000 (Restated)	1/1/2012 Rs.'000 (Restated)
Cash in hand	1,367,826	1,233,687	945,552
Balances with other banks	<u>8,103,943</u>	<u>9,230,438</u>	<u>6,857,964</u>
	<u>9,471,769</u>	<u>10,464,125</u>	<u>7,803,516</u>
15 Balances with Central banks		31/12/2013 Rs.'000	31/12/2012 Rs.'000
Balances with central banks		<u>8,045,947</u>	<u>10,478,758</u>
		<u>8,045,947</u>	<u>10,478,758</u>
As required by the provisions of Section 93 of the Monetary Law Act, a cash balance is maintained with the Central Bank of Sri Lanka. The minimum cash reserve requirement on Rupee deposit liabilities was 6% as at 31st December 2013 (2012 : 8%).			
16 Placements with banks	31/12/2013 Rs.'000	31/12/2012 Rs.'000 (Restated)	1/1/2012 Rs.'000 (Restated)
Placements	<u>5,636,400</u>	<u>23,407,000</u>	<u>14,867,267</u>
	<u>5,636,400</u>	<u>23,407,000</u>	<u>14,867,267</u>
17 Derivative financial instruments		31/12/2013 Rs.'000	31/12/2012 Rs.'000
Interest rate derivatives			
Interest rate swaps		146,372	177,963
Currency swaps		-	1,543,031
Currency options		323,530	471,116
Forward foreign exchange contracts		<u>2,513,490</u>	<u>3,743,135</u>
		<u>2,983,392</u>	<u>5,935,245</u>
18 Other Financial assets held-for-trading		31/12/2013 Rs.'000	31/12/2012 Rs.'000
Treasury bills		5,551,759	5,845,216
Treasury bonds		<u>6,443,954</u>	<u>1,373,265</u>
		<u>11,995,713</u>	<u>7,218,481</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT

19 Loans and receivables to banks	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
Gross loans and receivables (Note 19.1)	<u>30,559,850</u>	<u>7,131,914</u>
	30,559,850	7,131,914
19.1 Analysis		
a. By product		
Short-term loans	5,559,850	4,531,914
Reverse repo agreements	25,000,000	2,600,000
Gross Total	<u>30,559,850</u>	<u>7,131,914</u>
b. By currency		
Sri Lankan Rupee	25,000,000	2,600,000
United States Dollar	5,559,850	4,531,914
Gross Total	<u>30,559,850</u>	<u>7,131,914</u>
20 Loans and receivables to other customers	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
Gross loans and receivables (Note 20.1)	131,366,182	125,713,637
Less: Provision for impairment loss (Note 20.2)	<u>(2,353,431)</u>	<u>(2,632,169)</u>
Net loans and receivables	<u>129,012,751</u>	<u>123,081,468</u>
20.1 Analysis		
a. By product		
Overdrafts	15,735,932	20,206,312
Trade finance	41,335,937	37,253,015
Credit cards	19,987,344	19,038,921
Staff loans	2,053,091	2,220,189
Term loans - short term	4,734,904	5,747,639
Term loans - long term	45,938,121	33,333,676
Mortgages	1,580,853	4,028,593
Others	-	3,885,292
Gross Total	<u>131,366,182</u>	<u>125,713,637</u>
b. By currency		
Sri Lankan Rupee	68,450,112	70,989,124
United States Dollar	61,320,344	52,574,612
Great Britain Pound	719,497	645,425
Others	876,229	1,504,476
Gross Total	<u>131,366,182</u>	<u>125,713,637</u>
c. By industry		
Agriculture and fishing	5,349,301	4,013,880
Manufacturing	32,790,813	36,213,183
Tourism	5,915,119	6,952,923
Transport	10,125,123	5,304,857
Construction	3,458,525	3,749,833
Traders	20,837,705	15,815,706
Others	52,889,596	53,663,255
Gross Total	<u>131,366,182</u>	<u>125,713,637</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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AS AT

20.2 Provision for Impairment loss	31/12/2013 Rs.'000	31/12/2012 Rs.'000
a. Individual impairment charges		
Opening balance	2,142,122	1,956,596
Charge/(reversal) during the year	(242,390)	9,867
Write-off during the year	(330,760)	-
Exchange fluctuations and other movements	(4,259)	175,659
Closing balance	<u>1,564,713</u>	<u>2,142,122</u>
b. Collective impairment charges		
Opening balance	490,047	430,254
Charge for the year	384,481	112,913
Exchange fluctuations and other movements	(85,810)	(53,120)
Closing balance	<u>788,718</u>	<u>490,047</u>
Total	<u>2,353,431</u>	<u>2,632,169</u>
21 Financial investments – Available-for-sale	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
Treasury bills	30,738,233	10,267,266
Treasury bonds	76,272,973	67,185,072
	<u>107,011,206</u>	<u>77,452,338</u>

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22 Property, plant and equipment

	Land and buildings	Freehold buildings	Office equipment, furniture and fittings	Household equipment, furniture and fittings	Office Machines	Computer hardware and software	Motor Vehicle	Total
	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000
Cost/Revalued Amount								
Balance as at 1 st January 2012	681,000	239,000	437,342	17,267	189,174	421,706	276,509	2,261,998
Additions during the year	-	-	7,749	519	11,950	74,414	48,856	143,488
Disposals during the year	-	-	(76)	(193)	-	(105,909)	(45,626)	(151,804)
Transfers during the year	-	-	(66,631)	-	1,532	65,099	-	-
Revaluation Gain	107,500	152,500	-	-	-	-	-	260,000
Balance as at 31 st December 2012	788,500	391,500	378,384	17,593	202,656	455,310	279,740	2,513,683
Balance as at 1st January 2013	788,500	391,500	378,384	17,593	202,656	455,310	279,740	2,513,683
Additions during the year	-	-	43,437	214	3,663	57,935	73,598	178,847
Disposals during the year	-	-	-	(653)	-	(903)	(69,644)	(71,200)
Revaluation Gain	218,500	189,000	-	-	-	-	-	407,500
Balance as at 31 st December 2013	1,007,000	580,500	421,821	17,154	206,319	512,342	283,694	3,028,830
Accumulated depreciation								
Balance as at 1 st January 2012	-	-	377,668	12,354	159,460	335,108	149,223	1,033,813
Charge for the year	-	4,780	20,628	2,303	13,925	42,116	62,605	146,357
Disposals during the year	-	-	(76)	(193)	-	(105,909)	(37,290)	(143,468)
Transfers during the year	-	-	(56,913)	-	708	56,205	-	-
Revaluation Adjustment	-	(4,780)	-	-	-	-	-	(4,780)
Impairment Charge	-	-	-	-	-	-	9,703	9,703
Balance as at 31 st December 2012	-	-	341,307	14,464	174,093	327,520	184,241	1,041,625
Balance as at 1st January 2013	-	-	341,307	14,464	174,093	327,520	184,241	1,041,625
Charge for the year	-	8,900	13,927	1,819	13,219	49,916	56,987	144,768
Revaluation Adjustment	-	(8,900)	-	-	-	-	-	(8,900)
Disposals during the year	-	-	-	(653)	-	-	(65,333)	(65,986)
Balance as at 31 st December 2013	-	-	355,234	15,630	187,312	377,436	175,895	1,111,507
Carrying Value								
As at 31 st December 2012	788,500	391,500	37,077	3,130	28,563	127,790	95,499	1,472,059
As at 31 st December 2013	1,007,000	580,500	66,587	1,524	19,007	134,906	107,799	1,917,323

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AS AT

23	Deferred tax (assets)/ liabilities	31/12/2013	31/12/2012
		Rs.'000	Rs.'000
	Deferred tax assets	310,689	276,260
	Deferred tax liabilities	(994,558)	(186,865)
		(683,869)	89,395

23.1 Reconciliation of Deferred Tax

Deferred tax assets and liabilities are attributable to the following:

	31/12/2013		31/12/2012	
	Temporary Difference Rs. '000	Tax Effects Rs.'000	Temporary Difference Rs.'000	Tax Effects Rs.'000
Deferred tax assets on ;				
Accelerated Depreciation for tax				
- Owned assets	55,147	15,441	84,417	23,637
Provision for Employee benefit	394,549	110,474	551,067	141,991
Allowance for loans losses	659,909	184,774	395,115	110,632
	1,109,605	310,689	1,030,599	276,260
Deferred tax liabilities on ;				
Revaluation of buildings	(486,659)	(145,010)	296,140	(91,665)
Available for sale reserve	(3,034,101)	(849,548)	(349,641)	(95,200)
	(3,520,760)	(994,558)	(53,501)	(186,865)
Net (assets)/ liabilities as at 31st December	(2,411,155)	(683,869)	977,098	89,395

24	Other assets	31/12/2013	31/12/2012	1/1/2012
		Rs.'000	Rs.'000	Rs.'000
			(Restated)	(Restated)
	Receivables	4,622,026	4,522,239	2,417,906
	Deposits and prepayments	218,677	224,076	863,485
	Sundry debtors	2,349	5,630	8,366
	Acceptances and endorsements (Note 34.1)	12,761,161	9,893,291	12,040,401
	Others	1,920,146	1,803,690	2,475,466
		19,524,359	16,448,926	17,805,624

25	Due to banks	31/12/2013	31/12/2012
		Rs.'000	Rs.'000
	Borrowings	77,445,440	60,553,000
	Others	20,174,565	12,728,289
		97,620,005	73,281,289

26	Derivatives	31/12/2013	31/12/2012
		Rs.'000	Rs.'000
	Currency swaps	-	428,840
	Currency options	399,834	278,479
	Interest rate derivatives	151,259	180,089
	Forward foreign exchange contracts	3,537,003	2,963,539
		4,088,096	3,850,947

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AS AT

27 Due to other customers	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
Total amount due to other customers (Note 27.1)	154,946,963	149,647,020
	154,946,963	149,647,020
27.1 Analysis		
a. By product		
Demand deposits (current accounts)	25,081,772	24,741,824
Savings deposits	27,769,049	28,009,120
Fixed deposits	93,919,279	91,284,562
Other deposits	8,176,863	5,611,514
Total	154,946,963	149,647,020
b. By currency		
Sri Lanka rupee	94,462,425	88,974,100
United State dollar	41,709,727	44,751,557
Great Britain pound	6,585,255	6,840,381
Others	12,189,556	9,080,973
Total	154,946,963	149,647,011
28 Other liabilities	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
		1/1/2012
		Rs.'000
		(Restated)
Sundry creditors	1,383,600	742,637
Interest payable	3,939,543	3,623,912
Acceptances and endorsements (Note 34.1)	12,761,161	9,893,291
Defined Benefit Liability - Net (Note 28.1)	394,549	529,088
Other payables	4,606,693	5,076,529
	23,085,546	19,865,457
	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
28.1 Defined Benefit liability - Net		
Present Value of Defined Benefit Obligations (Note 28.1.a)	901,811	1,029,683
Fair Value of Plan Assets (Note 28.1.b)	(507,262)	(500,595)
	394,549	529,088
28.1.a Movement in the Present Value of Defined Benefit Obligations		
Opening balance	1,029,683	3,333,535
Current Service Cost	5,017	165,070
Interest Cost	119,923	369,803
Benefits Paid during the year	(79,750)	(803,674)
Actuarial (gain)/loss for the year	(173,062)	112,902
Transfer to defined contribution plan	-	(2,147,953)
Closing balance	901,811	1,029,683
28.1.b Movement in Fair Value of Plan Assets		
Opening balance	500,595	2,872,311
Expected return on Plan Assets	56,326	262,656
Contribution by Employers	2,554	114,112
Benefits Paid during the year	(79,750)	(803,674)
Actuarial gain for the year	27,537	203,142
Transfer to defined contribution plan	-	(2,147,952)
Closing balance	507,262	500,595

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28.1.c Sensitivity Analysis of the Defined Benefit Obligation - Discount rate

	Decrease -1%	Assumptions Used	Increase +1%
Discount rate	10.45%	11.45%	12.45%
Return on Assets	10.675%	10.675%	10.675%
Salary Increase Union/Non Union	6%/10%	6%/10%	6%/10%
COLA	8.11%	8.11%	8.11%
Turnover	None	None	None
Post retirement pension increases	8.00%	8.00%	8.00%
Active Members Benefit (Rs.'000)	66,997	50,468	38,505
Retired Members pension benefit (Rs.'000)	929,103	851,343	784,244
Total Present value of defined benefit obligation (Rs.'000)	<u>996,100</u>	<u>901,811</u>	<u>822,749</u>

29 Assigned capital	31/12/2013 Rs.'000	31/12/2012 Rs.'000
Assigned Capital	<u>3,152,358</u>	<u>3,152,358</u>
	3,152,358	3,152,358

30 Statutory reserve fund	31/12/2013 Rs.'000	31/12/2012 Rs.'000
Opening balance	1,625,952	1,216,792
Transferred during the year	164,633	409,160
Closing balance	<u>1,790,585</u>	<u>1,625,952</u>

The Statutory Reserve Fund is maintained as required by the section 20 (1) of the Banking Act No. 30 of 1988. The Bank appropriated 2% of the profit after tax to attain the minimum requirement under section 20(1) and the balance in the Statutory Reserve fund will be used only for the purposes specified in the section 20(2) of the banking act No 30. of 1988.

31 Other reserves	31/12/2013 Rs.'000	31/12/2012 Rs.'000 (Restated)	1/1/2012 Rs.'000 (Restated)
Exchange equalisation of capital (Note 31.1)	455,550	405,450	202,200
Exchange equalisation of reserve (Note 31.2)	2,137,535	1,824,232	540,000
Revaluation reserve (Note 31.3)	1,360,328	999,132	778,391
IFA reserves (Note 31.4)	4,583,499	2,376,085	903,314
SBP reserve (Note 31.5)	157,666	150,000	139,262
	<u>8,694,578</u>	<u>5,754,899</u>	<u>2,563,167</u>

31.1 Exchange equalisation of capital	31/12/2013 Rs.'000	31/12/2012 Rs.'000
Opening balance	405,450	202,200
Fluctuation of foreign exchange reserves	50,100	203,250
Closing balance	<u>455,550</u>	<u>405,450</u>

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AS AT

31 Other reserves (Continued)

	31/12/2013 Rs.'000	31/12/2012 Rs.'000
31.2 Exchange equalisation of reserve		
Opening balance	1,824,232	540,000
Fluctuation of foreign exchange reserves	313,303	1,284,232
Closing balance	<u>2,137,535</u>	<u>1,824,232</u>
31.3 Revaluation reserve		
Opening balance	999,132	778,391
Revaluation surplus for the year	361,196	220,741
Closing balance	<u>1,360,328</u>	<u>999,132</u>
31.4 IFA reserve		
Opening balance	2,376,085	903,314
Transferred during the year	2,207,414	1,472,771
Closing balance	<u>4,583,499</u>	<u>2,376,085</u>

According to the guidelines issued by Central Bank of Sri Lanka, Banks are required to transfer 8% of the profit calculated for the payment of Value Added Tax (VAT) on financial services and 5% profit before tax calculated for payment of income tax to Investment Fund Account.

	31/12/2013 Rs.'000	31/12/2012 Rs.'000 (Restated)	1/1/2012 Rs.'000 (Restated)
31.5 Share Based Payment Reserve			
Opening balance	150,000	139,262	139,262
Transferred during the year	7,666	10,738	-
Closing balance	<u>157,666</u>	<u>150,000</u>	<u>139,262</u>

HSBC Sri Lanka has a share based payment scheme available for its employees, which provides share options to the employees. HSBC Holdings Plc, registered in United Kingdom issues shares to the employees of HBC Sri Lanka and the scheme does not contain any recharge arrangement to HSBC Holdings PLC, accordingly the value of shares granted by HSBC Holdings Plc is accounted as a contribution from HSBC Holdings Plc under equity of the Branch.

	31/12/2013	31/12/2012
32 Share based payments and share option		
32.1 Restricted share awards - No of Shares ('000)		
Outstanding at the beginning	13,803	7,011
Awards during the year	1,516	16,080
Vested during the year	(7,715)	(9,288)
Outstanding at the end	<u>7,604</u>	<u>13,803</u>
32.2 Share-based payments income statement charge		
Restricted and performance share awards	8,240	19,708
Share award option plans	7,666	10,738
	<u>15,906</u>	<u>30,446</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT

33 Events occurring after the reporting date

Subsequent to the reporting date, no circumstances have arisen which would require adjustment to or disclosure in the financial statements.

34 Comparative figures

The comparative figures and phrases have been re-arranged wherever necessary to conform to the current year's presentation.

Following re-statements and re-classifications were made in the financial statements in conformity with LKAS 8 "Accounting policies, changes in accounting estimates and errors."

34.1 Acceptance and Endorsements

Acceptance transactions which should be recognized as Financial Assets and liabilities as per LKAS 39 "Financial Instruments" which were previously disclosed as Other Contingent Items under contingent liabilities and commitments have been restated during the year.

	31/12/2012	1/1/2012
	Rs.'000	Rs.'000
Other Assets		
Acceptances and endorsements	9,893,291	12,040,401
Other liabilities		
Acceptances and endorsements	9,893,291	12,040,401

34.2 Cash and Cash Equivalents

Nostro, Vostro account balances which were previously presented under Placements with Banks have been re-classified to Cash and Cash Equivalents in order for a better presentation.

	31/12/2012	1/1/2012
	Rs.'000	Rs.'000
Cash and cash equivalents	9,230,438	6,857,964
	<u>9,230,438</u>	<u>6,857,964</u>

34.3 Share Based Payments Reserve

Equity settled share based payment liabilities which were previously classified under Other liabilities have been reclassified to equity as per SLFRS 2 "Share based payments". Since there is no recharge arrangement between HSBC UK and HSBC Sri Lanka. This standard will be applied for the equity settled share based payment transaction entered into after 1st January 2012.

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AS AT

35 Contingent liabilities and commitments

- a. In the normal course of business, the Branch makes various commitments and incurs certain contingent liabilities with legal recourse to its customers. No material losses are anticipated as a result of these transactions.

	31/12/2013	31/12/2012	1/1/2012
	Rs.'000	Rs.'000	Rs.'000
		(Restated)	(Restated)
Performance bonds	3,777,065	4,285,455	4,061,386
Letters of credit	10,810,392	10,204,182	11,144,548
Other contingent items (Note 35.1)	23,690,131	25,381,047	23,096,916
Undrawn loan commitments	145,870,008	156,870,183	121,786,733
Foreign Exchange Contracts	401,838,797	328,902,456	310,198,875
Derivatives- Principal amount	139,168,453	70,369,123	49,851,939
Other contra accounts	16,438,385	12,394,530	10,100,476
Total	<u>741,593,231</u>	<u>608,406,976</u>	<u>530,240,873</u>

b. Pending litigations against the Branch as at 31st December 2013

1. Court action has been taken under (CIB/INV/102010/CCR/3675) where a third party clearing agent to which Branch has outsourced the clearing of imported IT related goods has defrauded Customs taxes. Branch has paid the clearing Agent in full including all the taxes to be paid to the SL Customs.
2. Law suit instituted by a former staff case no: DSP/214/2011; now terminated - praying for inter alia .
 - a. An interim injunction against the Branch to restraining the Branch from withholding his salary (case was instituted in year 2011 when the staff member was under suspension)
 - b. A permanent injunction in the form of a mandatory order directing the Branch to pay his full salaries and all allowances that are usually paid to the staff of his category during his period of
3. Court action has been initiated by Christy Lanka Apparels Pvt Ltd; a customer of the Branch in proceedings case no: 102/2007/MR; suing the Branch for loss of business and reputation as a result of the Branch purporting to grant increased facilities and later withdrawing them.
4. This is a case filed by the Plaintiff under proceeding case no: 69/12/Trust in the District Court of Mount Lavinia mainly against the 1st Defendant who is his spouse. Enjoining order issued against the Branch to freeze certain funds held under the name of the 1st Defendant.
5. Under proceedings in case no: 33/2012/CO; HSBC is the 6th Defendant, action filed mainly against the 1st and the 2nd defendant , under section 224,225 of the Companies Act (oppression against Minority).
6. Court action has been taken under HC/CIVIL/338/12 where transactions in account - suing for damages for pain of mind, reputational damage caused to the plaintiff due to a wrongful criminal action initiated by the 1st defendant in the year 1998 . Plaintiff was acquitted in 2010, Claiming USD 10 million plus interest until the conclusion of the present action from HSBC as HSBC failed to provide adequate evidence in the criminal case against the Plaintiff .
7. Plaintiff Millennium Teas Pvt Ltd is suing the Branch for breach of duty of care and for acting negligently under court proceeding (Case No. DMR/2275/2012)
8. Three court actions have been taken under case numbers LT 2/150/2010, LT 2/315/2012 and LT 8/648/12 by former staff members for alleged unfair termination.

There are no material contingent liabilities outstanding as at the reporting date other than those disclosed above which would require adjustments to or disclosure in Financial Statements.

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36 Related Party Disclosure

The Bank carries out transactions in the ordinary course of its business with parties who are defined as related parties in Sri Lanka Accounting Standard (LKAS 24) "Related Party Disclosures", the details of which are reported below.

36.1 Transactions with related parties

(a) Interest Paid to Other HSBC Branches and Group Companies	2013 Rs.'000	2012 Rs.'000
Other HSBC Branches		
HSBC Hongkong	36	79,998
HSBC Tokyo	-	3
HSBC Singapore	28	15,340
	<u>64</u>	<u>95,341</u>
Group Companies		
HSBC London	20	124
HSBC Markets	328,171	594,361
HSBC Canada	130	-
HSBC Melbourne	13	36
HSBC USA	74,133	-
HSBC Data processing Ltd	105,622	121,155
HSBC TUB Dusseldorf	3	-
	<u>508,092</u>	<u>715,676</u>
(b) Interest Received from Other HSBC Branches and Group Companies		
	2013 Rs.'000	2012 Rs.'000
Other HSBC Branches		
HSBC Hongkong	3,182	3,466
	<u>3,214</u>	<u>3,466</u>
Group Companies		
HSBC London	630	-
HSBC Markets	7,882	10,767
HSBC Data processing Ltd	34	(32)
	<u>8,549</u>	<u>10,767</u>
(c) Commission Paid to Other HSBC Branches and Group Companies		
	2013 Rs.'000	2012 Rs.'000
Other HSBC Branches		
HSBC Hongkong	87,515	175,784
HSBC Auckland	90	149
HSBC Tokyo	291	417
HSBC Singapore	226	295
HSBC Thailand	46	59
HSBC Male'	59,824	-
HSBC Malaysia	6	13
	<u>149,514</u>	<u>176,717</u>
Group Companies		
HSBC London	374	15
HSBC Canada	641	952
HSBC Australia	1,540	1,572
HSBC USA	92,106	282,958
HSBC TUB Dusseldorf	851	754
HSBC Dubai	-	12
	<u>95,684</u>	<u>286,263</u>

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

36 Related Party Disclosure (Continued)

36 Transactions with related parties (Continued)

(d) Assets of Other HSBC Branches and Group Companies	2013 Rs.'000	2012 Rs.'000
Other HSBC Branches		
HSBC Hongkong	252,009	19,480,464
HSBC Auckland	67,131	32,957
HSBC Tokyo	131,812	119,411
HSBC Singapore	59,175	87,748
HSBC India	463,013	28,834
HSBC Thailand	799	4,182
HSBC Male'	860,898	486,972
HSBC Malaysia	1,277	1,334
	<u>1,836,114</u>	<u>20,241,902</u>
Group Companies		
HSBC London	1,086,499	230,878
HSBC Markets	2,616,404	-
HSBC Canada	52,174	729,226
HSBC Melbourne	301,868	39,106
HSBC USA	4,321,610	6,421,735
HSBC Pakistan	121,217	103,590
HSBC UAE	2,926	14,175
	<u>8,502,698</u>	<u>7,538,710</u>
(e) Liabilities of Other HSBC Branches and Group Companies	2013	2012
	Rs.'000	Rs.'000
Other HSBC Branches		
HSBC Hongkong	79,972,181	63,364,823
HSBC Thailand	-	3,962
HSBC Singapore	7,378	21
HSBC India	248	802
HSBC Bangladesh	28,945	39,895
HSBC Baharain	618	1,126
HSBC Male'	578	177
HSBC Malaysia	13,667	7,127
	<u>80,023,615</u>	<u>63,417,933</u>
Group Companies		
HSBC London	169,909	130,251
HSBC Canada	24,819	12
HSBC Melbourne	19,416	39,933
HSBC USA	2,692,302	2,272,127
HSBC Data processing Ltd	1,679,104	2,434,149
HSBC Trinkaus and Burkhardt	190	190
HSBC Kuwait	437	111
HSBC Qatar	2,002	328
HSBC Dubai	803	14,757
	<u>4,588,982</u>	<u>4,891,858</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

36 Related Party Disclosure (Continued)

36.2 Transactions with Key Management Personnel (KMP)

According to Sri Lanka Accounting Standard No 24 - "Related Party Disclosures", Key Management Personnel are those having authority and responsibility for planning, directing and controlling the activities of the Branch. The Branch have identified its key management personnel based on the above

36.2.a Compensation of KMPs	2013	2012
	Rs.'000	Rs.'000
Aggregate remuneration paid for the year	<u>156,347</u>	<u>171,842</u>
	156,347	171,842
36.2.b Transactions with KMPs and Close Relations	As at	As at
	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
Total deposits	61,521	77,727
Total accommodation granted	<u>197,083</u>	<u>140,982</u>
	258,604	218,709

37 Segment Analysis by Line of Business

Business level performance

	Retail		Global		
	Banking and	Commercial	Banking and	Other	Total
	Wealth	Banking	Markets		
	Management	Rs.'000	Rs.'000	Rs.'000	Rs.'000
	Rs.'000				
Net Operating Income	7,896,693	5,551,382	8,393,229	1,586,845	23,428,149
Operating Expenses	(4,449,460)	(1,999,667)	(960,225)	(529,402)	(7,938,754)
Profit Before tax	2,511,696	2,821,671	6,329,789	975,437	12,638,593
Income tax expense	(814,942)	(920,241)	(2,205,733)	(466,003)	(4,406,919)
Profit after tax	<u>1,641,386</u>	<u>1,880,342</u>	<u>4,003,982</u>	<u>706,064</u>	<u>8,231,774</u>
Segment Assets	<u>51,302,877</u>	<u>98,565,899</u>	<u>160,396,462</u>	<u>15,893,472</u>	<u>326,158,710</u>
Segment Liabilities	<u>105,783,084</u>	<u>68,019,963</u>	<u>107,170,423</u>	<u>45,185,240</u>	<u>326,158,710</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31ST DECEMBER 2013

38 Investment Fund Account (IFA)

In terms of the guideline issued by the Central Bank of Sri Lanka dated 29 April 2011 on "Operations of the Investment Fund Account", the following is disclosed;

(a) Number of loans granted and total amount outstanding for each purpose, interest rates and tenure of loans : NIL

(b) Total investments in government securities as at 31 December 2013, interest rates and maturity :

Investment amount	Interest rate	Maturity
382,751,310	8.65%	15-Aug-11
113,566,289	8.85%	19-Aug-11
57,422,457	8.85%	25-Aug-11
74,344,569	8.92%	20-Sep-11
85,136,503	8.95%	20-Oct-11
89,501,687	9.75%	15-Nov-11
49,054,293	9.75%	18-Nov-11
50,928,959	10.00%	20-Dec-11
264,479,065	14.15%	11-May-12
111,565,023	14.20%	25-May-12
86,446,265	14.30%	20-Jun-12
110,836,480	14.50%	13-Jul-12
77,908,218	14.40%	9-Aug-12
100,399,598	14.40%	6-Aug-12
151,093,292	14.50%	17-Aug-12
101,709,709	14.50%	27-Aug-12
81,985,306	14.40%	20-Sep-12
81,073,800	12.90%	4-Oct-12
78,639,500	13.68%	22-Oct-12
3,225,386	13.40%	29-Nov-12
3,578,377	11.40%	4-Jan-13
12,480,705	11.00%	4-Jan-13
47,342,368	11.60%	18-Jan-13
92,402,230	12.00%	24-Jan-13
78,445,204	11.60%	24-Jan-13
96,997,512	11.60%	1-Feb-13
122,963,298	11.40%	15-Feb-13
144,465,650	11.55%	20-Feb-13
210,668,248	11.72%	22-Apr-13
122,963,298	11.45%	15-May-13
94,674,453	11.50%	20-May-13
74,625,964	11.53%	20-Jun-13
112,503,258	11.50%	19-Jul-13
179,504,200	11.56%	16-Aug-13
107,883,720	11.55%	19-Aug-13
32,670,648	11.60%	27-Sep-13
46,827,097	11.64%	30-Sep-13
78,434,640	8.35%	22-Oct-13
153,376,581	11.03%	12-Nov-13
44,729,200	11.23%	22-Nov-13
44,852,100	11.24%	26-Nov-13
44,785,250	11.20%	27-Nov-13
174,276,025	7.20%	27-Dec-13
<u>4,273,517,735</u>		

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management

39.1 Risk Management Framework

All of the Branch' activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks. An established risk governance framework and ownership structure ensures oversight of and accountability for the effective management of risk at Group, regional and global business levels. HSBC Sri Lanka Risk Function consists of Wholesale & Market Risk & Retail Banking & Wealth Management (RBWM) Risk, Security & Fraud Risk and Operational Risk.

39.2 Credit Risk

Credit risk is defined as the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. Credit risk arises principally from direct lending, trade finance and also from certain other products such as guarantees, derivatives.

Credit risk:

- Is measured as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark to market value to HSBC of the contract and the expected potential change in that value over time caused by movements in market rates;
- Is monitored within limits, approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which HSBC could be subjected should the customer or counterparty fail to perform its contractual obligations;
- Is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.

39.2.1 Credit Risk Management

The role of the independent credit control unit is fulfilled by the local Risk team which is a part of the Asia Pacific Risk function. Credit approval authorities are delegated by Regional Office (ASP) to Chief Risk Office (CRO) who in turn delegates limit to local risk executives.

The principle objectives of our credit risk management are;

- To maintain across HSBC a strong culture of responsible lending and a robust risk policy and control framework.
- To both partner and challenge Branch's businesses in defining, implementing and continually re-evaluating our risk appetite under actual and scenario conditions; and
- To ensure there is independent, expert scrutiny of credit risks, their costs and their mitigation.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit risk (Continued)

39.2.1 Credit Risk Management (Continued)

Credit Quality of Financial Instruments

Branch's credit risk rating systems and processes are differentiating exposures in order to highlight those with greater risk factors and higher potential severity of loss. In the case of individually significant accounts that are predominantly within our wholesale businesses, the risk ratings are reviewed regularly and any amendments are implemented promptly. Within Branch's retail businesses, risk is assessed and managed using a wide range of risk models to maintain Risk Reward balance.

Branch's risk rating system facilitates the internal ratings-based ('IRB') approach under Basel II adopted by the Group to support calculation of our minimum credit regulatory capital requirement. Special attention is paid to problem exposures in order to accelerate remedial action.

Group and regional Credit Review and Risk Identification teams regularly review exposures and processes in order to provide an independent, rigorous assessment of credit risk across the Group, reinforce secondary risk management controls and share best practice. Internal audit, as a tertiary control function, focuses on risks with a global perspective and on the design and effectiveness of primary and secondary controls, carrying out oversight audits via the sampling of global/regional control frameworks, themed audits of key or emerging risks and project audits to assess major change initiatives.

Impairment Assessment

It is the policy of HSBC Sri Lanka creates impairment allowances for impaired loans promptly and appropriately.

Impairment & Credit Risk Mitigation

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. When Branch no longer expect to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realizable value of the collateral will be taken into account when assessing the need for an impairment allowance. No impairment allowance is recognized in cases where all amounts due are expected to be settled in full on realization of the collateral.

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans. Methodologies used to calculate allowances on a collective basis: a roll rate methodology, discounted recovery methodology or a more basic formulaic approach based on historical losses. For individually assessed impairment the Discounted Cash Flow methodology is used.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit risk (Continued)

39.2.1 Credit Risk Management (Continued)

Impairment & Credit Risk Mitigation (Continued)

The historical loss methodology is typically used to calculate collective impairment allowances for secured or low default portfolios such as personal loans. For loans which are collectively assessed using historical loss methodology, the historical loss rate is derived from the average contractual write-off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after the realization of collateral and receipt of recoveries.

A roll rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models. In certain circumstances personal loan portfolios have a statistically significant number of defaults and losses available, enabling reliable roll rates to be generated. In these cases a roll rate methodology is applied, and the average loss rate for each delinquency bucket is adjusted to reflect the average loss expected following receipt of recoveries. The average loss expected is derived from average historical collateral realization values.

As an extended method to roll rate methodology, discounted recovery methodology uses the gross contractual loss of the portfolio from the roll rate methodology and determines the recovery out of the gross loss. The Discounted Recovery is then estimated for the recovery at the end of the realization period. Individual impairment is done for the non performing portion of the mortgage portfolio using the Discounted Cash Flow methodology where mortgage accounts are individually assessed to determine the impairment.

For wholesale portfolio, collectively assessed loans historical loss methodologies are applied to measure loss event impairments which have been incurred but not reported. Loss rates are derived from the observed contractual write off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after realization of collateral and receipt of recoveries. These historical loss rates are adjusted by an economic factor which adjusts the historical averages to better represent current economic conditions affecting the portfolio. In order to reflect the likelihood of a loss event not being identified and assessed an emergence period assumption is applied. This reflects the period between a loss occurring and its identification. The emergence period is estimated by regional management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behavior, portfolio management information, credit management techniques and collection and recovery experiences in the market. A fixed range for the period between a loss occurring and its identification is assessed empirically on a periodic basis, it may vary over time as these factors change. Given that credit management policies require all customers to be reviewed at least annually, Branch expect this estimated period would be at most 12 months.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit risk (Continued)

39.2.1 Credit Risk Management (Continued)

Write off of Loans & Advances

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realization of security. In circumstances where the net realizable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.

Unsecured personal facilities, including credit cards, are generally charge off at 180 days. It is done on the billing date of the month, the account reaches 180 days and the process is automated and any exception is tracked and manually done the next day. However early charge off could be triggered looking at the circumstance of the account for example on death, bankruptcy.

Usually Collections/Recovery activities may continue after charge off and Legal action would be taken if unable to come to an amicable settlement by both parties.

Collateral Management & Valuation

Although collateral can be an important mitigant of credit risk, it is the Branch's practice to lend on the basis of the customer's ability to meet their obligations out of cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. However, for other lending a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the Branch may utilize the collateral as a source of repayment. Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk.

39.2.2 Quantitative Disclosures

Gross Loans and Receivables

Gross loans, impairment and net loans are disclosed in Note 21 in the financial Statements.

Movements in Individual and Collective Impairment during the period are disclosed in Note 21.2 in the financial Statements.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit risk (Continued)

39.2.2 Quantitative Disclosures (Continued)

Gross Loans and Receivables - By product

Loans and Receivables to Other Customers		
	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
By product - Domestic currency		
Overdrafts	13,027,588	15,816,321
Term loans	35,435,179	36,106,671
Credit cards	19,987,344	19,038,921
Other loans	-	27,211
Sub total	<u>68,450,111</u>	<u>70,989,124</u>
By product - Foreign currency		
Overdrafts	2,708,344	4,389,991
Term loans	60,207,727	46,476,441
Other loans	-	3,858,081
Sub total	<u>62,916,071</u>	<u>54,724,513</u>
Total	<u>131,366,182</u>	<u>125,713,637</u>

Gross Loans and Receivables - By currency

Loans and Receivables to Other Customers		
	31/12/2013	31/12/2012
	Rs.'000	Rs.'000
By currency		
Sri Lanka Rupee	68,450,112	70,989,124
United States Dollar	61,320,344	52,574,612
Great Britain Pound	719,497	645,425
Others	876,229	1,504,476
Total	<u>131,366,182</u>	<u>125,713,637</u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2.1 Credit risk (Continued)

39.2.2 Quantitative Disclosures (Continued)

Individual impairment - sector wise analysis

	Specific Provision - Sector wise	
	31/12/2013 Rs.'000	31/12/2012 Rs.'000
Manufacturing	1,011,368	1,624,734
Traders	197,295	59,404
Tourism	-	2,103
Construction	251,946	331,460
New Economy	-	1,690
Financial & Business Services	35,579	44,948
Retail Banking	68,525	64,202
Others	-	13,581
Total	1,564,713	2,142,122

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit Risk (Continued)

39.2.2 Quantitative Disclosures (Continued)

Gross Loans and Receivables - sector wise analysis

Sector	Import bills Rs.'000	Export bills Rs.'000	Overdrafts Rs.'000	Credit card Rs.'000	Short term loans Rs.'000	Medium and long term loans Rs.'000	Mortgages Rs.'000	2013 Total Rs.'000	2012 Total Rs.'000
Agriculture & Fishing	-	4,781,963	404,283	-	18,000	87,892	57,163	5,349,301	4,013,880
Manufacturing	5,427,985	13,328,611	4,160,537	-	805,420	9,068,259	-	32,790,812	36,213,183
Tourism	-	-	403,704	-	-	5,511,415	-	5,915,119	6,952,923
Transport	12,610	21,585	61,285	-	-	10,029,642	-	10,125,122	5,304,857
Construction	-	-	40,724	-	-	1,898,038	1,519,764	3,458,526	3,749,833
Traders	3,249,048	13,244,423	1,309,780	-	1,678,965	1,355,490	-	20,837,706	15,815,706
New Economy	428,177	-	781,480	-	-	585,319	-	1,794,976	1,301,320
Financial and Business Services	551,746	98,151	528,211	-	2,232,520	3,898,716	-	7,309,344	8,312,315
Infrastructure	-	-	1,593,588	-	-	1,897,477	-	3,491,065	6,346,692
Other Services	180,649	10,989	380,331	-	-	2,281,392	-	2,853,361	2,991,885
Credit card	-	-	-	19,987,344	-	-	-	19,987,344	19,038,921
Other	-	-	6,072,009	-	-	11,377,571	3,926	17,453,506	15,672,122
Total	9,850,215	31,485,722	15,735,932	19,987,344	4,734,905	47,991,211	1,580,853	131,366,182	125,713,637

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit Risk (Continued)

39.2.2 Quantitative Disclosures (Continued)

Total Gross Loans and receivables including acceptances - Residual Contractual Maturity

	Less than 7 Days Rs.'000	7-30 Days Rs.'000	1-3 Months Rs.'000	3-6 Months Rs.'000	6-12 Months Rs.'000	1-3 Years Rs.'000	3-5 Years Rs.'000	Over 5 Years Rs.'000	2013 Total Rs.'000	2012 Total Rs.'000
Overdrafts	15,735,932	-	-	-	-	-	-	-	15,735,932	20,206,312
Term Lending	4,755,194	9,203,059	22,460,870	2,616,408	947,538	13,294,710	30,326,651	-	83,604,430	74,371,562
Non-Eligible Bills	1,111,473	1,127,715	1,870,402	517,892	792	-	-	-	4,628,274	3,885,292
Money Market Term Placements	4,893,036	173,185	80,000	-	-	-	-	-	5,146,221	5,747,639
Credit Card Advances	19,987,344	-	-	-	-	-	-	-	19,987,344	19,038,921
Mortgages	642	-	1,496	12,887	30,596	139,343	136,292	1,942,724	2,263,980	2,463,911
Total Gross Loans and Receivables	46,483,421	10,503,959	24,412,769	3,147,187	978,926	13,434,053	30,462,943	1,942,724	131,366,182	125,713,637
Acceptances	1,379,847	2,626,513	3,414,567	2,669,947	1,841,752	828,535	-	-	12,761,161	9,983,291
Total	47,863,468	13,130,472	27,827,336	5,817,134	2,820,678	14,262,588	30,462,943	1,942,724	144,127,343	135,696,298

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit Risk (Continued)

39.2.2 Quantitative Disclosures (Continued)

Distribution of financial instruments by credit quality

	Strong Rs.'000	Good Rs.'000	Satisfactory Rs.'000	Sub Standard Rs.'000	Past due but not impaired Rs.'000	Impaired Rs.'000	Impairment Allowance Rs.'000	2013 Total Rs.'000	2012 Total Rs.'000
Cash and cash equivalents	1,367,825	8,103,944	-	-	-	-	-	9,471,769	10,464,125
Balances with central banks	8,045,947	-	-	-	-	-	-	8,045,947	10,478,758
Placements with banks	-	5,636,400	-	-	-	-	-	5,636,400	23,407,000
Derivative financial instruments	28,334	2,184,180	770,575	303	-	-	-	2,983,392	5,935,245
Other financial assets held-for-trading	11,995,713	-	-	-	-	-	-	11,995,713	7,218,481
Loans and receivables to banks	20,000,000	10,559,850	-	-	-	-	-	30,559,850	7,131,914
Loans and receivables to other customers	1,432,152	11,901,892	97,580,327	2,462,284	13,296,018	4,693,509	(2,353,431)	129,012,751	123,081,468
Financial investments	107,011,206	-	-	-	-	-	-	107,011,206	77,452,338
Acceptances	38,304	297,391	8,860,469	3,534,408	-	30,589	-	12,761,161	9,893,291
Total	149,919,481	38,683,657	107,211,371	5,996,995	13,296,018	4,724,098	(2,353,431)	317,478,189	275,062,620

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.2 Credit Risk (Continued)

39.2.2 Quantitative Disclosures (Continued)

Ageing analysis of days past due but not impaired

Less than 7 Days Rs.'000	7-30 Days Rs.'000	1-3 Months Rs.'000	3-6 Months Rs.'000	6-12 Months Rs.'000	Total Rs.'000
-	12,174,834	1,119,539	1,645	-	13,296,018

Collateral held and other credit enhancements, and their financial effect

	Carrying Amount Rs.'000	Collateral Value Rs.'000
Loans and receivable to banks	30,559,850	-
Loans and receivable to other customers	129,012,751	54,595,734

39.3 Liquidity Risk

Liquidity and funding risk is the risk that the Branch does not have sufficient financial resources to meet its obligations as they fall due or that it can only do so at excessive cost. Liquidity risk arises from mismatches in the timing of cash flows. Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

Liquidity and funding risk is:

- **Measured** using internal metrics including stressed operational cash flow projections, coverage ratio and advances to core funding ratios;
- **Monitored** against the Group's liquidity and funding risk framework and overseen by Regional and local Asset and Liability Management Committees ('ALCO's); and
- **Managed** on a stand-alone basis with no reliance on any related party (unless pre-committed) or CBSL unless this represents routine established business as usual market practice.

39.3.1 Management of liquidity and funding risk

HSBC's liquidity and funding risk management framework ('LFRF') employs two key measures to define, monitor and control the liquidity and funding risk of each of its operating entities. The advances to core funding ratio is used to monitor the structural long-term funding position, and the stressed cash flow projection, incorporating Group-defined stress scenarios, is used to monitor the resilience to severe liquidity stresses.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

39 Financial Risk Management (Continued)

39.3 Liquidity Risk (Continued)

39.3.1 Management of liquidity and funding risk (Continued)

The advances to core funding ratio (ACF) and Stressed cash flow project (OCP) are monitored on a daily by the local management team, with monthly monitoring carried out by the Regional Office.

Advances to core funding ratio

Core funding represents the core component of customer deposits and any term professional funding with a residual contractual maturity beyond one year. Capital is excluded from our definition of core funding.

Stressed cash flow projection

HSBC monitors stressed cash inflows as against stressed cash outflows over both one-month and three-month time horizons, under Group specified and locally defined scenarios. The Bank is required to maintain a positive variance out to three months. Inflows included are generated from liquid assets net of assumed haircuts, and cash inflows related to assets contractually maturing within the time period.

In general, customer advances are assumed to be renewed and as a result do not generate a cash inflow.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

39 Financial Risk Management (Continued)

39.3 Liquidity Risk (Continued)

39.3.2 Quantitative Disclosures

A maturity analysis of financial liabilities

	Less than 7 Days	7-30 Days	1-3 Months	3-6 Months	6-12 Months	1-3 Years	3-5 Years	2013 Total	2012 Total
Due to banks	20,153,882	24,222,383	24,201,700	14,521,020	14,521,020	-	-	97,620,005	73,281,289
Derivative financial instruments	1,086,401	505,717	701,559	408,120	1,377,412	8,887	-	4,088,096	3,850,947
Due to other customers	72,886,761	14,727,548	17,705,928	15,682,067	22,405,205	2,341,813	9,197,641	154,946,963	149,647,020
Acceptances	1,379,847	2,626,513	3,414,567	2,669,947	1,841,752	828,535	-	12,761,161	9,893,291
Total	95,506,891	42,082,161	46,023,754	33,281,154	40,145,389	3,179,235	9,197,641	269,416,225	236,672,547

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.4 Market Risk

The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, which will reduce our income or the value of Branch's portfolios.

Exposure to market risk is separated into two portfolios:

- Trading portfolios comprise positions arising from market-making and warehousing of customer derived positions
- Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale.

39.4.1 Monitoring and limiting market risk exposures

Branch's objective is to manage and control market risk exposures while maintaining a market profile consistent with our risk appetite.

Branch uses a range of tools to monitor and limit market risk exposures, including:

- Sensitivity analysis, the sensitivities of the net present values of asset and expected liability cash flows, in total and by currency, to a one basis point parallel shift in the discount curves used to calculate the net present values.
Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.
- For foreign exchange risk, the total net short foreign exchange position and the net foreign exchange positions by currency
- Value at risk ('VAR') which is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence and
- In recognition of VAR's limitations we augment VAR with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables.

39.4.2 Risk Management

Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk, an independent unit within Group Head Office, is responsible for our market risk management policies and measurement techniques. Each of major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.4 Market Risk (Continued)

39.4.2 Risk Management (Continued)

Both the VAR and Stressed VAR models we use are based predominantly on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account interrelationships between different markets and rates such as interest rates and foreign exchange rates.

The historical simulation models used incorporate the following features:

- Historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- Potential market movements utilized for VAR are calculated with reference to data from the past two years,
- Potential market movements employed for stressed VAR calculations are based on a continuous one year period of stress for the trading portfolio

Branch routinely validates the accuracy of the VAR models by back-testing the actual daily profit and loss results, adjusted to remove non-modeled items such as fees and commissions, against the corresponding VAR numbers.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Risk Management Structure (Continued)

39.4 Market Risk (Continued)

Foreign Currency Exposures

Currency	2013 USD '000	2012 USD '000
CHF	(26.56)	(22.78)
EUR	(96.88)	0.67
GBP	(107.82)	(33.31)
HKD	261.77	110.69
JPY	21.95	(81.63)
USD	379.35	1,900.70
AUD	9.91	83.88
LKR	(467.06)	(2,022.60)
CAD	14.08	44.99
DKK	4.17	30.22
CNY	7.90	(2.33)
MYR	10.26	10.50
NOK	0.47	0.42
NZD	(14.94)	4.60
SEK	(19.58)	(22.41)
SGD	(0.53)	(12.17)
THB	6.43	1.97
ZAR	(0.00)	-
AED	17.08	8.33

Sensitivity of reported reserves to Interest rate movements

AFS Reserves (Currency Wise)	31/12/2013			31/12/2012		
	Month end balance	+100 bps	-100 bps	Month end balance	+100 bps	-100 bps
USD	(1,817)	(555)	555	(1,704)	(587)	587
LKR	23,369	(9,812)	9,812	3,574	(8,158)	8,158
AFS Total	21,552	(10,367)	10,367	1,870	(8,745)	8,745

NII Sensitivity Calculations

The Branch has two standard scenarios; the parallel movement in the yield curve by +/-100 bps (the 100bps bullet scenario) and the +/-100bps ramp scenario, whereby rates are assumed to rise/fall in parallel by 25bps on the first day of each quarter.

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)**

39 Risk Management Structure (Continued)

39.4 Market Risk (Continued)

NII Sensitivity Calculations (Continued)

The interest rate sensitivity of the Trading book and the rest of the Branch must be separately analyzed. The split should take account of internal transfer pricing deals and is important for management analysis and reporting.

The sensitivity calculations should reflect the sites' best estimates of the future movements in NII under the prescribed scenarios.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Risk Management Structure (Continued)

39.4 Market Risk (Continued)

Interest rate sensitivity analysis

USD'000

Projected NII of the next twelve months

Incremental NII of the next twelve months

Parallel Movements in Yield Curve

+100 bps

- 100 bps

Ramp Movements in Yield Curve*

+100 bps

- 100 bps

Base Case

With +100 bps in 1st year

Difference

With -100 bps in 1st year

Difference

	Retail Banking	Corporate Banking	Global Banking	Total Commercial Banking	ALCO Pool	Treasury /Global Markets	Intersegment Elimination	Total
	18,887	16,950	27,227	63,064	13,792	59,502	3,493	139,851
	(1,194)	1,291	1,126	1,223	1,646	5,319	(9)	8,178
	787	(1,441)	(1,112)	(1,767)	(1,214)	(5,677)	(12)	(8,670)
	(755)	754	715	714	998	3,497	(6)	5,203
	548	(892)	(698)	(1,042)	(741)	(3,654)	(7)	(5,445)
	20,992	18,453	28,972	68,417	16,489	64,399	3,835	153,140
	19,854	20,128	30,210	70,192	19,754	68,170	3,825	161,941
	(1,136)	1,675	1,238	1,775	3,265	3,771	(10)	8,801
	21,593	16,626	27,758	65,977	14,565	59,350	3,822	143,714
	602	(1,827)	(1,214)	(2,440)	(1,924)	(5,049)	(13)	(9,426)

* Rates are assumed to rise / fall in parallel by 25bps on the first day of each quarter.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Risk Management Structure (Continued)

39.5 Operational Risk

The objective of our operational risk management is to manage and control operational risk in a cost effective manner within targeted levels of operational risk consistent with our risk appetite.

A formal governance structure provides oversight over the management of operational risk. A country level Risk Management Committee, meets on a monthly basis to discuss key risk issues and review the effective implementation of our operational risk management framework.

Business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework helps managers to fulfill these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

A centralized database is used to record the results of the operational risk management process. Operational risk self-assessments are input and maintained by business units. To ensure that operational risk losses are consistently reported and monitored at Group level, all Group companies are required to report individual losses in excess of a particular threshold.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.5 Operational Risk (Continued)

Capital Management

Qualitative disclosures

The Bank's capital is segregated into Tier 1 and Tier 2 Capital:

Tier 1 Capital – Core Capital

This includes assigned capital, statutory reserve fund, published retained profits, general and other reserves. The assigned capital is the amount provided by HSBC Asia Pacific to conduct its operation in Sri Lanka.

Tier 2 Capital – Supplementary capital

Revaluation reserves is the main constituent of supplementary capital for the Bank. As per the CBSL regulations a prudential revaluation is done reflecting the full possibility of price fluctuations and forced sale, with prior approval from CBSL, which is then subject to a discount of 50%.

Upon the introduction of LKAS 32/39, general provision/collective impairment is not included in the accounts, hence Tier 2 will reflect NIL provision amounts from 2012 onwards.

Composition of regulatory capital (Audited)	31/12/2013	31/12/2012
	Rs'000	Rs'000
Assigned Capital	3,152,358	3,152,358
Statutory Reserve Fund	1,790,585	1,625,952
Published Retained Profits	32,003,444	25,336,956
General and Other Reserves	4,740,064	2,376,085
Total qualifying tier 1 capital prior to deductions	41,686,451	32,491,351
Deductions to tier 1 capital	1,863,163	566,527
Net deferred tax assets	-	89,395
Amounts due to head office and branches outside Sri Lanka in Sri Lanka Rupees (-)	(186,295)	(718,934)
Amounts due from head office and branches outside Sri Lanka in Foreign Currency (Net)	2,049,458	1,196,066
Tier 1 Capital	39,823,288	31,924,824
Components of tier 2 capital		
Revaluation Reserves (as approved by CBSL)	356,917	356,917
General Provisions*	-	-
Total qualifying tier 2 capital prior to deductions	356,917	356,917
Tier 3 capital	-	-
Total capital	40,180,205	32,281,741

* Note: As per the LKAS 32/39 which came into effect on 1 January 2012, instructs to exclude general provision from accounts, hence Tier 2 general provision is zero.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (Continued)

39.5 Operational Risk (Continued)

Capital Structure (Continued)

Capital Adequacy

HSBC Sri Lanka follows the Capital Planning and Guidance as set out by its Group Office, while ensuring that all requirements as set out by the local regulator are complied with. In the matter of capital planning, the Branch relies on the monthly stress testing carried out in form of the Economic Value of Equity (EVE) calculation, as well as the Value at Risk (VaR) stress testing to evaluate capital adequacy. An annual stress testing on credit risk is also carried out to establish the relevant impact on capital.

The Branch maintains records of Risk Weighted Assets (RWA) based on both the local regulatory requirement as set out by CBSL as well as on the basis set out by the Prudential Regulatory Authority (PRA) of the United Kingdom. Growth of the balance sheet is subject to RWA limits on the PRA basis, which are set and monitored by the Regional Office. Assets, Liabilities and Capital Management (ALCM) monitors growth against these limits and works closely with the Businesses to ensure that any increased growth meets with the expected returns on such growth.

All growth measures as targeted in the Annual Operating Plan (AOP) are reviewed in line with impact to Capital Adequacy Ratio (CAR) limits set by CBSL. Any remittance of profit to Regional offices is evaluated in terms of impact to CAR. Further, exchange rate fluctuations to a maximum of 20% are taken into account when forecasting CAR, which is carried out on a monthly basis. HSBC Sri Lanka will ensure that all business growth and profit remittances are carried out in full compliance with the prudential limits set by CBSL, while ensuring sufficient capital to absorb the impact of a 20% movement in foreign exchange rates. The minimum expected CAR will ensure optimal Single Borrower Limits, optimal Deposit Insurance fee levels and also ensure ability to continue Derivative Trading activity.

Risk-weighted assets (Un-audited)	2013	2012
	Rs.'000	Rs.'000
Credit risk	137,621,446	130,975,342
Market risk	8,665,665	1,119,057
Operational risk	31,042,239	25,416,889
Total risk-weighted assets	177,329,350	157,511,288
Capital ratios (Audited)		
Tier 1 ratio	22.46%	20.27%
Total capital ratio	22.66%	20.49%

40 Exposure to Stock Market (Un-audited)

In terms of the Central Branch of Sri Lanka Direction no 03 of 2011 on "Exposure to Stock Market", the following are outstanding exposures as at the reporting date:

	2013	2012
	Rs. '000	Rs. '000
On Balance sheet exposure	805,252	Nil
Off Balance sheet exposure	Nil	Nil

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

41 Fair values of financial instruments not carried at fair value

	Carrying Value Rs.'000	Fair Value Rs.'000
Assets		
Cash and cash equivalents	9,471,769	9,471,769
Balances with central banks	8,045,947	8,045,947
Placements with banks	5,636,400	5,636,400
Loans and receivables to banks	30,559,850	30,559,850
Loans and receivables to other customers	131,366,182	135,032,423
Acceptances	12,761,161	12,761,161
Liabilities		
Due to banks	97,620,005	97,620,005
Due to other customers	154,946,963	154,946,963
Acceptances	12,761,161	12,761,161

Excluding "Loans and Receivables to other customers", the above list of financial instruments whose carrying amount is a reasonable approximation of fair value because, for example, they are short term in nature or re-price to current market rates frequently.