

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

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED
31ST DECEMBER 2015**



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

FOR THE YEAR ENDED 31ST DECEMBER 2015

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**Independent Auditor's Report
To the head office management of Hongkong & Shanghai Banking
Corporation Limited Sri Lanka Branch**

Report on the Financial Statements

1 We have audited the accompanying financial statements of Hongkong & Shanghai Banking Corporation Limited Sri Lanka Branch ("the Branch"), which comprise the statement of financial position as at 31 December 2015, and the statements of income, other comprehensive income, changes in equity and cash flow for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information as set out in pages 2 to 68.

Branch Management's responsibility for the financial statements

2 Branch Management is responsible for the preparation and the presentation of financial statements that give a true and fair view in accordance with Sri Lanka Accounting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

Auditor's Responsibility

3 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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

4 An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers the internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

5 In our opinion the financial statements give a true and fair view of the financial position of Hongkong & Shanghai Banking Corporation Limited Sri Lanka Branch as at 31 December 2015 and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

COLOMBO

CHARTERED ACCOUNTANTS

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

FOR THE YEAR ENDED 31ST DECEMBER

	Note	2015 Rs.'000	2014 Rs.'000
Interest income		23,548,828	24,121,085
Interest expenses		(7,217,254)	(7,136,321)
Net interest income	5	16,331,574	16,984,764
Fee and commission income		3,781,024	3,931,030
Fee and commission expenses		(661,297)	(670,334)
Net fee and commission income	6	3,119,727	3,260,696
Net gain from trading	7	1,509,156	1,447,165
Net gain from financial investments	8	705,274	357,473
Other operating income (net)	9	61,065	496,989
Total operating income		21,726,796	22,547,087
Impairment reversal/(charge) for loans and other losses	10	620,603	(515,658)
Net operating income		22,347,399	22,031,429
Personnel expenses	11	(3,431,337)	(3,246,473)
Other expenses	12	(6,181,330)	(5,940,957)
Operating profit before Value Added Tax		12,734,732	12,843,999
Value Added Tax on financial services		(1,535,048)	(1,626,600)
Profit before tax		11,199,684	11,217,399
Income tax expense	13	(3,676,034)	(3,746,544)
Profit for the year		7,523,650	7,470,855

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 Statements of the Branch set out on pages 3 to 68. The Report of the Auditors is given on page 1.

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

FOR THE YEAR ENDED 31ST DECEMBER

	Note	2015 Rs.'000	2014 Rs.'000
Profit for the year		7,523,650	7,470,855
Other comprehensive income/(expenses)			
<i>Items that may be reclassified to profit or loss</i>			
(Loss) / gain on re-measuring available-for-sale financial assets		(5,224,000)	1,480,503
Gain / (loss) from the financial statements of foreign currency operation		1,739,423	(292,898)
Tax relating to components of other comprehensive income	13.d	1,454,386	(414,490)
		(2,030,191)	773,115
<i>Items that may not be reclassified to profit or loss</i>			
Actuarial gain/(loss) on defined benefit plans		363,329	(14,148)
Gain on revaluation of property plant and equipment		89,050	438,728
Tax relating to components of other comprehensive income	13.d	175,785	(13,433)
Other comprehensive income for the year		628,164	411,147
Total comprehensive income for the year		6,121,623	8,655,117

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 Statements of the Branch set out on pages 3 to 68. The Report of the Auditors is given on page 1.

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

AS AT 31ST DECEMBER

	Note	2015 Rs.'000	2014 Rs.'000
ASSETS			
Cash and cash equivalents	15	5,813,230	17,170,378
Balances with the Central Bank of Sri Lanka	16	6,724,825	6,845,170
Placements with banks	17	19,469,700	15,444,288
Derivative financial instruments	18	2,078,082	1,140,619
Other Financial assets held-for-trading	19	330,826	1,722,700
Loans and receivables from banks	20	15,784,400	26,321,100
Loans and receivables from other customers	21	184,328,632	168,934,941
Financial investments – Available-for-sale	22	131,828,703	142,316,265
Property, plant and equipment	23	3,644,899	3,282,332
Deferred tax asset	24	360,117	-
Other assets	25	16,316,284	21,438,471
Total Assets		386,679,698	404,616,264
LIABILITIES			
Due to banks	26	129,362,756	149,200,815
Derivative financial instruments	27	1,814,183	609,806
Due to other customers	28	182,887,530	176,346,760
Current tax liabilities		1,548,753	1,445,077
Deferred tax liabilities	24	-	998,463
Other liabilities	29	22,071,366	27,840,553
Total Liabilities		337,684,588	356,441,474
EQUITY			
Assigned capital	30	3,152,358	3,152,358
Statutory reserve fund	31	2,090,475	1,940,002
Other reserves	32	10,788,010	12,629,876
Retained earnings		32,964,267	30,452,554
Total Equity		48,995,110	48,174,790
Total equity and liabilities		386,679,698	404,616,264
Contingent liabilities and commitments	35	616,100,548	582,340,237

The Financial Statements are to be read in conjunction with the related notes, which form a part of the Financial Statements of the Branch set out on pages 3 to 68. The Report of the Auditors is given on page 1.

The Management is responsible for the preparation and presentation of these Financial Statements. The Financial Statements have been prepared in compliance with the requirements of the Central Bank of Sri Lanka regulations and guidelines.

Approved and signed for and on behalf of the Management.

Patrick J Gallagher
(Signed) Chief Executive Officer

Kanchana Hewavitharana
(Signed) Chief Financial Officer

23rd March 2016
Colombo

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

FOR THE YEAR ENDED 31ST DECEMBER 2015

	Assigned Capital	Exchange Equalisation of Capital	Exchange Equalisation of Reserves	IFA Reserve	AFS Reserve	SBP Reserve	Statutory Reserve Fund	Revaluation Reserve	Retained Earnings	Total Equity
	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000
Balance as at 1st January 2014	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
Total comprehensive income for the year										
Profit for the year	-	-	-	-	-	-	-	-	7,470,855	7,470,855
Other comprehensive income (net of tax)	-	(455,550)	162,652	-	1,066,013	-	-	421,354	(10,207)	1,184,262
Total comprehensive income for the year	-	(455,550)	162,652	-	1,066,013	-	-	421,354	7,460,648	8,655,117
Transactions with equity holders, recognised directly in equity										
Transfers to reserves during the year	-	-	-	-	-	-	149,417	-	(149,417)	-
Cost of share options granted during the year	-	-	-	-	-	1,736	-	-	-	1,736
Change in fair value of restricted share awards	-	-	-	-	-	-	-	-	2,158	2,158
Transfer to IFA reserve	-	-	-	524,960	-	-	-	-	(524,960)	-
Profit transferred to head office	-	-	-	-	-	-	-	-	(3,531,000)	(3,531,000)
Total transactions with equity holders	-	-	-	524,960	-	1,736	149,417	-	(4,203,219)	(3,527,106)
Balance as at 31st December 2014	3,152,358	-	2,300,185	5,108,459	3,280,148	159,402	1,940,002	1,781,682	30,452,554	48,174,790
Balance as at 1st January 2015	3,152,358	-	2,300,185	5,108,459	3,280,148	159,402	1,940,002	1,781,682	30,452,554	48,174,790
Total comprehensive income for the year										
Profit for the year	-	-	-	-	-	-	-	-	7,523,650	7,523,650
Super gains tax paid as per Part III of the Finance Act	-	-	-	-	-	-	-	-	(3,764,383)	(3,764,383)
Other comprehensive income (net of tax)	-	-	1,739,423	-	(3,769,614)	-	-	206,431	421,733	(1,402,027)
Total comprehensive income for the year	-	-	1,739,423	-	(3,769,614)	-	-	206,431	4,181,000	2,357,240
Transactions with equity holders, recognised directly in equity										
Transfers to reserves during the year	-	-	-	-	-	12,796	150,473	-	(156,889)	6,380
Cost of share options granted during the year	-	-	-	-	-	-	-	-	-	-
Change in fair value of restricted share awards	-	-	-	-	-	-	-	-	-	-
Transfer to IFA reserve	-	-	-	-	-	-	-	-	-	-
Depreciation on revaluation reserve	-	-	-	-	-	-	-	(30,902)	30,902	-
Profit transferred to head office	-	-	-	-	-	-	-	-	(1,543,300)	(1,543,300)
Total transactions with equity holders	-	-	-	-	-	12,796	150,473	(30,902)	(1,669,287)	(1,536,920)
Balance as at 31st December 2015	3,152,358	-	4,039,608	5,108,459	(489,466)	172,198	2,090,475	1,957,211	32,964,267	48,995,110

Figures in brackets indicate deductions.

As per provisions of Part III of the Finance Act, No 10 of 2015 which was certified on 30 October 2015, the Branch was liable for Super Gain Tax of Rs. 3,764,383,000. According to the Act, the Super Gain Tax shall be deemed to be an expenditure in the financial statements relating to the year of assessment which commenced on 1 April 2013. The Act supersedes the requirement of the Sri Lanka Accounting Standards, hence the expense of Super Gain Tax is accounted in accordance with the requirements of the said Act as recommended by the Statement of Alternative Treatment on Super Gain Tax issued by the Institute of Chartered Accountants of Sri Lanka, dated 24 November 2015.

The Financial Statements are to be read in conjunction with the related notes, which form a part of the Financial Statements of the Branch set out on pages 3 to 68. The Report of the Auditors is given on page 1.

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

FOR THE YEAR ENDED 31ST DECEMBER

	2015	2014
	Rs.'000	Rs.'000
Cash Flow From Operating activities		
Interest received	24,378,459	24,359,423
Interest paid	(5,833,182)	(6,684,049)
Recoveries on previously written off loans	622,847	642,774
Fees and commission received	3,119,727	3,260,696
Dividends received	-	-
Net receipts from trading activities	1,509,156	1,804,638
Net receipts from investing activities	705,274	-
Operating expenses paid	(8,960,048)	(7,910,900)
Operating profit before changes in operating assets and liabilities	15,542,233	15,472,582
Changes In Operating Assets and Liabilities		
Decrease / (Increase) in treasury bills and other eligible bills	18,835,968	(27,591,368)
Decrease in treasury bonds	3,684,981	8,104,192
Decrease / (Increase) in loans to other banks	6,511,288	(5,569,138)
Increase in loans and advances	(16,597,499)	(40,284,934)
Increase in government bonds	(14,137,912)	(5,507,247)
(Increase) / Decrease in other assets	(727,782)	1,272,617
Increase in deposits from customers	6,540,770	21,399,797
(Decrease) / Increase in borrowings	(19,838,059)	51,580,810
Decrease in other liabilities	(1,449,675)	(1,133,471)
Cash (used in) / from Operating Activities	(17,177,920)	2,271,258
Income Tax Paid	(8,988,007)	(6,885,579)
Net Cash Flows (used in) / generated from Operating Activities	(10,623,693)	10,858,261
Cash Flow From Investing Activities		
Proceeds from disposal of property, plant and equipment	17,747	13,485
Acquisition of property, plant and equipment	(1,044,317)	(547,906)
Net Cash Flow used in Investing Activities	(1,026,570)	(534,421)
Cash Flow From Financing Activities		
Profit transferred to Head Office	(1,543,300)	(3,531,000)
Net Cash Flow used in Financing Activities	(1,543,300)	(3,531,000)
Net (Decrease) / Increase in Cash and Cash Equivalents	(13,193,563)	6,792,841
Cash and Cash Equivalents at the Beginning of period	24,015,548	17,517,716
Exchange Adjustment	1,716,070	(295,009)
Cash and Cash Equivalents at the end of the year (Note A)	12,538,055	24,015,548
Note A		
Analysis of Cash and Cash Equivalents at the end of the year		
Cash in Hand and Balances with Banks	1,016,228	1,222,493
Balances with Other Banks	4,797,002	15,947,885
Balances with Central Bank	6,724,825	6,845,170
	12,538,055	24,015,548

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 Statements of the Branch set out on pages 3 to 68. The Report of the Auditors is given on page 1.

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

2. BASIS OF PREPARATION (CONTINUED)

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.

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. The significant estimates and judgements are disclosed in Note 4.

2.5 Changes in accounting standards

The Branch has adopted following accounting standards and amendments during the year.

- (i) SLFRS 13 - Fair Value Measurement', confirms that short-term receivables and payables can continue to be measured at invoice amounts if the impact of discounting is immaterial. SLFRS 13 also clarifies that the portfolio exception in the standard (measuring the fair value of a group of financial assets and financial liabilities on a net basis) applies to all contracts within the scope of LKAS 39 'Financial Instruments: Recognition and Measurement'.
- (ii) LKAS 19, 'Employee Benefits', clarifies the accounting for defined benefit plans that require employees or third parties to contribute towards the cost of the benefits. The amendment distinguishes between contributions that are linked to service only in the period in which they arise and those linked to service in more than one period. The objective of the amendment is to simplify the accounting for contributions that are independent of the number of years of employee service. Entities with plans that require contributions that vary with service will be required to recognise the benefit of those contributions over employee's working lives.

New accounting standards, amendments and interpretations issued but not yet adopted.

Certain new accounting standards and interpretations have been published that are not mandatory for 31 December 2015 reporting periods and have not been early adopted by the Branch. The Branch is yet to assess the impact of these new standards that are set out below.

- (i) SLFRS 9 'Financial Instruments', addresses the classification, measurement and recognition of financial assets and financial liabilities. The complete version of SLFRS 9 was issued in July 2014. It replaces the guidance in LKAS 39 that relates to the classification and measurement of financial instruments. SLFRS 9 retains but simplifies the mixed measurement model and establishes three primary measurement categories for financial assets: amortised cost, fair value through OCI and fair value through profit or loss. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset. Investments in equity instruments are required to be measured at fair value through profit or loss with the irrevocable option at inception to present changes in fair value in OCI not recycling. There is a new expected credit losses model that replaces the incurred loss impairment model used in LKAS 39. For financial liabilities there were no changes to classification and measurement except for the recognition of changes in own credit risk in other comprehensive income, for liabilities designated at fair value through profit or loss.

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

2. BASIS OF PREPARATION (CONTINUED)

2.5 Changes in accounting standards (continued)

SLFRS 9 relaxes the requirements for hedge effectiveness by replacing the bright line hedge effectiveness tests. It requires an economic relationship between the hedged item and hedging instrument and for the 'hedged ratio' to be the same as the one management actually use for risk management purposes. Contemporaneous documentation is still required but is different to that currently prepared under LKAS 39. The standard is effective for accounting periods beginning on or after 1 January 2018. Early adoption is permitted.

- (ii) SLFRS 15, 'Revenue from Contracts with Customers', deals with revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised when a customer obtains control of a good or service and thus has the ability to direct the use and obtain the benefits from the good or service. The standard replaces LKAS 18 and LKAS 11 and related interpretations. This standard will be effective for annual periods beginning on or after 1 January 2018 and earlier application is permitted.
- (iii) SLFRS 14 Regulatory Deferral Accounts, establishes the financial reporting requirements for regulatory deferral account balances that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulation. SLFRS 14 is effective for annual reporting periods beginning on or after 1 January 2016, with early adoption permitted.

2.6 Rounding of amounts

All amounts disclosed in the financial statements and notes have been rounded off to the nearest thousand Sri Lankan Rupees unless otherwise stated.

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

Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at year end exchange rates are generally recognised in profit or loss.

Foreign exchange gains and losses are presented in the income statement under net gains from trading with customers and others.

The results and financial position of foreign currency operation (Foreign Currency Banking Unit) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.1 Foreign Currency Translation (continued)

- assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet
- income and expenses for each statement of profit or loss and statement of comprehensive income are translated at spot exchange rates, and
- all resulting exchange differences are recognised in other comprehensive income.

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.

When a receivable is impaired, the Branch reduces the carrying amount to its recoverable amount, being the estimated future cash flow discounted at the original effective interest rate of the instrument, and continues unwinding the discount as interest income. Interest income on impaired loans is recognised using the original effective interest rate.

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 Income Statement 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

The 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. Other fees and commissions are recognised in the period in which the services are rendered. The fees and commissions for services relating to periods after the reporting date is deferred in the Statement of Financial Position.

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.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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. The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at end of the reporting period. Management periodically evaluate positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. It established provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

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 in full for all temporary differences. Deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss.

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.

Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the end of the reporting period and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

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.

Current and deferred tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity. In this case, the tax is also recognised in other comprehensive income or directly in equity, respectively.

THE HONGKONG AND SHANGHAI BANKING 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 Investments and Other Financial Assets

Classification and Reclassification

The Branch classifies its financial assets in the following categories:

- Financial investments held for trading (at fair value through profit or loss)
- Loans and receivables,
- Financial investments available-for-sale.

The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition. There were no held to maturity financial assets at the reporting date.

The Branch may choose to reclassify a non-derivative trading financial asset out of the held for trading category if the financial asset is no longer held for the purpose of selling it in the near term. Financial assets other than loans and receivables are permitted to be reclassified out of the held for trading category only in rare circumstances arising from a single event that is unusual and highly unlikely to recur in the near term. In addition, the Branch may choose to reclassify financial assets that would meet the definition of loans and receivables out of the held for trading or available-for-sale categories if the Branch has the intention and ability to hold these financial assets for the foreseeable future or until maturity at the date of reclassification.

Recognition

Regular way purchases and sales of financial assets are recognised on trade-date, the date on which the Branch commits to purchase or sell the asset.

Measurement

At initial recognition, the Branch measures a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset. Transaction costs of financial assets carried at fair value through profit or loss are expensed in profit or loss.

Loans and receivables and held-to-maturity investments are subsequently carried at amortised cost using the effective interest method.

Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Gains or losses arising from changes in the fair value are recognised as follows:

- for 'financial assets at fair value through profit or loss' – in profit or loss within other income or other expenses.

THE HONGKONG AND SHANGHAI BANKING 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 Investments and Other Financial Assets (continued)

- for available-for-sale financial assets that are monetary securities denominated in a foreign currency – translation differences related to changes in the amortised cost of the security are recognised in profit or loss and other changes in the carrying amount are recognised in other comprehensive income
- for other monetary securities classified as available-for-sale – in other comprehensive income.

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, the Branch 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 the Branch enters into an offsetting transaction.

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. They mainly represent loans to customers, banks and others. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method (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 HONGKONG AND SHANGHAI BANKING 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 Investments and Other Financial Assets (continued)

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.

When the Branch purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ("reverse repo"), the arrangement is accounted for as a loan or receivable, and the underlying asset is not recognized in the Branch's financial statements. The carrying value of the securities purchased under agreement to sell is recorded at cost. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest rate method.

Available for Sale Financial Investments

Available-for-sale investments (AFS) 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.

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

Financial assets (or, where applicable a part of a financial asset or part of a group of similar financial assets) are derecognised when the rights to receive cash flows from the financial assets have expired or have been transferred and the Branch has transferred substantially all the risks and rewards of ownership. When securities classified as available-for-sale are sold, the accumulated fair value adjustments recognised in other comprehensive income are reclassified to profit or loss as gains and losses from investment securities.

THE HONGKONG AND SHANGHAI BANKING 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.

When the Branch enters into an agreement to repurchase an asset (or a substantially similar asset) at a fixed price on a future date ("repo"), the counterparty liability is included as securities sold under repurchase agreements, as appropriate and the underlying asset will continued to be recognised in the Branch's financial statements. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreement using the effective interest method.

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.

THE HONGKONG AND SHANGHAI BANKING 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

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 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 bankruptcy 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.

THE HONGKONG AND SHANGHAI BANKING 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 Impairment of Financial Assets Carried at Amortized Cost

For financial assets carried at amortized cost (such as loans and receivables from other HSBC branches, loans and receivables from customers as well as reverse repo investments), the Branch first assesses individually whether objective evidence of impairment exists for similar credit risk characteristics and collectively assesses them for impairment. 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 asset'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 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.

THE HONGKONG AND SHANGHAI BANKING 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)

3.5.6.2 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.

3.5.7 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.

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.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 or valuation (Land, Freehold buildings and improvements to buildings are carried at revalued amounts.) 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 buildings	over 50 years
Fixed assets relating to Head Office refurbishment project	over 10 years/over 20 years
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.

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 and groups. Impairment losses are recognized in profit or loss.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.9 Assets and Bases of their Valuation (Continued)

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 the Central Branch of Sri Lanka

The Monetary Law Act requires that all commercial banks operating in Sri Lanka to 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. The Branch employee share plans are also aligned to group policy.

3.10.1 Share Save scheme

Under the Share Save scheme, eligible employees may be granted options to acquire HSBC Holdings plc ordinary shares. This scheme has been extended to the Branch employees where they 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 relevant savings contract, at the employee's election, to exercise the options. The options are 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 plc.

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

1. CORPORATE INFORMATION

1.1 Domicile and Legal form

The Hongkong and Shanghai Banking Corporation Limited is a public limited liability company incorporated in Hong Kong SAR. It carries out banking activities in Sri Lanka through HSBC Sri Lanka Branch (“the Branch”) a licensed commercial bank registered under the Banking Act No 30 of 1988 as amended by the Banking Amendment Act No 33 of 1995. 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 its branches remained unchanged during the year. The primary banking services include corporate and retail banking including credit cards and global trade finance. The Branch re-entered the primary dealer business in 2013 and deals in Government and Central Bank of Sri Lanka securities through the primary auctions.

1.3 Parent Company and Ultimate Parent Company

The immediate parent entity is the Hongkong and Shanghai Banking Corporation Limited and the ultimate parent entity is HSBC Holding plc. (Incorporated in Great Britain and registered in England and Wales). The ultimate parent is listed on the Hong Kong and London Stock Exchanges.

2. BASIS OF PREPARATION

2.1 Statement of Compliance

The financial statements of the Branch 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.
- Certain freehold land and building are measured at fair value

2.3 Functional and Presentation Currency

The Financial Statements are presented in Sri Lankan Rupees, which is the Branch’s presentation and functional currency. The items in the Financial Statements are measured using the currency of the primary economic environment in which the Branch operates (the functional currency).

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.10 Employee share plans (continued)

3.10.1 Share Save scheme (continued)

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.

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.

Up to 2012, the Pension 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.

The net of present value of defined benefit obligation, net of fair value of plan assets has been recognized in the Statement of Financial position. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using a discount rate based on the interest rates of Government bonds that are denominated in the currency in which the benefits will be paid, and that have terms approximating to the terms of the related obligation. Current service cost, interest cost, expected return on plan assets are charged / credited to income statement and the actuarial gains/losses are recognised through other comprehensive income statement. Remeasurement gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised in the period in which they occur, directly in other comprehensive income.

THE HONGKONG AND SHANGHAI BANKING 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 (continued)

The Branch carries out an actuarial valuation of the fund annually. The actuarial valuation is carried out by Towers Watson India Private Limited. The actuary has used the “Projected Unit Credit (PUC) 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 Pension 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 contributes 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. The Branch contributes 12% of the employees’ gross salary to this fund whilst the employees contribute 8% of the gross salary. The Branch has no further payment obligations once the contributions have been paid.

Trust Fund

The Branch contributes 3% of the gross salary of employees to the Employees Trust Fund, which is a defined contribution plan. The Branch has no further payment obligations once the contributions have been paid.

3.11.2 Borrowings

Borrowings are initially recognised at fair value, net of transaction costs incurred. Borrowings are subsequently measured at amortised cost. Any difference between the proceeds (net of transaction costs) and the redemption amount is recognised in profit or loss over the period of the borrowings using the effective interest method. Borrowings are removed from the balance sheet when the obligation specified in the contract is discharged, cancelled or expired.

3.11.3 Other payables

These amounts represent liabilities for goods and services provided to the Branch prior to the end of financial year which are unpaid. The amounts are unsecured. Other payables are presented as other liabilities.

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

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3.11 Liabilities and Provisions (continued)

3.11.4 Provisions

Provisions are recognised when the Branch has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Provisions are not recognised for future operating losses. Provisions are measured at the present value of management's best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

3.11.5 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. Contingent liabilities are possible obligations whose existence will be confirmed only by uncertain future events or present obligations where the transfer of economic benefit is not probable or cannot reliably measured. To meet the financial needs of customers, the Branch enters into various irrevocable commitments and contingent liabilities. These consist of guarantees, letters of credit, and other undrawn commitments. These instruments commit the Branch to make payments on behalf of customers in the event of a specific act, generally related to import and export. They carry credit risk similar to loans and receivables. These contingent liabilities are disclosed in the financial statements as Off Balance Sheet transactions.

3.11.6 Other Off-Balance Sheet Transactions

The Branch enters into off- balance sheet transactions such as forward exchange contracts, currency swaps, interest rate swaps and options, the principle amounts of which are recorded as Off Balance Sheet transactions. The financial derivatives in connection with these transactions are recorded in the trading position at fair value. The movement in fair value 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.

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

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Critical accounting estimates and assumptions

The Branch makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

Income and other taxes

The Branch is subject to income tax and other tax such as Value Added Tax, Nation Building Tax and Crop Levy specifically levied on the banking and financial sector. The calculations are based on the provisions enacted as per the relevant Acts and guidelines published by Inland Revenue Department. The Branch recognises liabilities for any pending tax matters with the tax authorities based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the current and deferred income tax assets and liabilities in the period in which such determination is made.

The recognition of a deferred tax asset relies on an assessment of the probability and sufficiency of future taxable profits, future reversals of existing taxable temporary differences and ongoing tax planning strategies.

Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded principal market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. When a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and the quoted price. The judgement as to whether a market is active may include, but is not restricted to, consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing derivative products.

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

Valuation of financial instruments (continued)

A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. 'Projection' utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products is dependent on more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may affect the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations and prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, the Branch uses a discounting curve that reflects the overnight interest rate. The majority of valuation techniques employ only observable market data. However, LKR Options are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental.

Pension benefits

The present value of the pension obligations depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include the discount rate. Any changes in these assumptions will impact the carrying amount of pension obligations. The Branch determines the appropriate discount rate at the end of each year. This is the interest rate that should be used to determine the present value of estimated future cash outflows expected to be required to settle the pension obligations. In determining the appropriate discount rate, the Branch considers the interest rates of Government bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity approximating the terms of the related pension obligation. Other key assumptions for pension obligations are based in part on current market conditions.

Impairment of loans and advances

Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date. Management is required to exercise judgement in making assumptions and estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances. Collective impairment allowances are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis due to the large number of individually insignificant loans in the portfolio. The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgement, to assess whether current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than historical experience. Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

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

4. SIGNIFICANT MANAGEMENT ESTIMATES AND JUDGEMENTS (CONTINUED)

Impairment of loans and advances (continued)

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical concentrations, loan product features, economic conditions such as trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations and other influences on customer payment patterns.

The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

For individually assessed loans, judgement is required in determining whether there is objective evidence that a loss event has occurred and, if so, the measurement of the impairment allowance. In determining whether there is objective evidence that a loss event has occurred, judgement is exercised in evaluating all relevant information on indicators of impairment, including the consideration of whether payments are contractually past-due and the consideration of other factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay. A higher level of judgement is required for loans to borrowers showing signs of financial difficulty in market sectors experiencing economic stress, particularly where the likelihood of repayment is affected by the prospects for refinancing or the sale of a specified asset. For those loans where objective evidence of impairment exists, management determine the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer's business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations.

The Branch might provide loan restructuring to borrowers experiencing financial difficulties by agreeing to modify the contractual payment terms of loans in order to improve the management of customer relationships, maximise collection opportunities or avoid default or repossession. Where restructuring activities are significant, higher levels of judgement and estimation uncertainty are involved in determining their effects on loan impairment allowances. Judgements are involved in differentiating the credit risk characteristics of restructured loans, including those which return to performing status following renegotiation.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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FOR THE YEAR ENDED 31ST DECEMBER

5 Net interest income	2015	2014
	Rs.'000	Rs.'000
Interest income		
Other financial assets held-for-trading (Note 5.1)	149,772	533,635
Loans and receivables to banks	1,032,178	1,948,280
Loans and receivables to other customers	11,447,476	11,393,985
Financial investments - available-for-sale (Note 5.1)	10,896,288	10,228,216
Others	23,114	16,969
Total Interest Income	23,548,828	24,121,085
Interest expenses		
Due to banks	(155,741)	(64,129)
Due to other customers	(6,124,653)	(6,441,300)
Others	(936,860)	(630,892)
Total Interest Expenses	(7,217,254)	(7,136,321)
	16,331,574	16,984,764
5.1 Net Interest Income from Sri Lanka Government Securities		
Interest income	11,046,060	10,761,851
6 Net fee and commission income	2015	2014
	Rs.'000	Rs.'000
Fee and commission income	3,781,024	3,931,030
Fee and commission expenses	(661,297)	(670,334)
	3,119,727	3,260,696
6.1 Comprising		
Loans	202,081	192,172
Credit cards	1,997,775	1,705,618
Trade and remittances	1,093,299	1,089,747
Deposits	159,305	181,740
Others	(332,733)	91,419
Net fee and commission income	3,119,727	3,260,696
7 Net gain from trading	2015	2014
	Rs.'000	Rs.'000
Foreign exchange (excluding derivatives)		
- Gain from transaction with customers	1,696,638	2,115,168
- Loss from transactions with others	(515,030)	(1,143,656)
Government securities	143,769	375,726
Derivatives	183,779	99,927
	1,509,156	1,447,165

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

FOR THE YEAR ENDED 31ST DECEMBER

8 Net gain from financial investments	2015	2014
	Rs.'000	Rs.'000
Net gain from financial investments	705,274	357,473
	705,274	357,473
9 Other operating income (net)	2015	2014
	Rs.'000	Rs.'000
Profit on sale of property, plant and equipment	17,747	13,485
Foreign exchange gain from capital transfer to DBU from FCBU	-	450,000
Others	43,318	33,504
	61,065	496,989
10 Impairment charges for loans and other losses	2015	2014
	Rs.'000	Rs.'000
Individual significant impairment reversal (Note 10.1)	181,606	508,837
Collective impairment reversal / (charge) (Note 10.2)	438,997	(1,024,495)
	620,603	(515,658)
10.1 Individual significant impairment (charge)/reversal		
Impairment provision reversal		
- For customer balances	241,583	468,870
- For commitments and guarantees	-	8,424
Direct write-offs for the year	(80,208)	(19,665)
Recoveries during the year	20,231	51,208
	181,606	508,837
10.2 Collective impairment charge		
Impairment reversal /(provision) for the year	833,228	(514,412)
Direct write-offs for the year	(996,848)	(1,101,649)
Recoveries during the year	602,617	591,566
	438,997	(1,024,495)
11 Personnel expenses	2015	2014
	Rs.'000	Rs.'000
Salary and bonus	(2,331,758)	(2,255,148)
Others	(1,099,579)	(991,325)
	(3,431,337)	(3,246,473)

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

FOR THE YEAR ENDED 31ST DECEMBER

12 Other expenses	2015	2014
	Rs.'000	Rs.'000
Auditors' remunerations	(3,037)	(3,316)
Non-audit fees to auditors	(1,202)	(1,838)
Professional and legal expenses	(55,146)	(62,050)
Depreciation of property, plant and equipment	(260,650)	(164,770)
Office administration and establishment expenses	(2,178,354)	(2,223,188)
Others	(3,682,941)	(3,485,795)
	<u>(6,181,330)</u>	<u>(5,940,957)</u>
13 Tax expense	2015	2014
	Rs.'000	Rs.'000
13.a Current Tax Expense		
Current tax on profit for the year (Note 13.c)	(3,499,656)	(3,825,670)
Over provision for the previous year	198,005	156,434
Tax of prior years paid in current year	-	(48,724)
Remittance Tax	(169,394)	(141,913)
	<u>(3,471,045)</u>	<u>(3,859,873)</u>
13.b Deferred Tax Expenses		
- Provision for employee benefit	9,864	-
- Allowance for loans losses	-	123,087
- Depreciation on revaluation of building	5,556	3,314
Deferred tax assets reversed during the year	<u>15,420</u>	<u>126,401</u>
- Allowance for loans losses	(214,410)	(10,474)
- Provision for employee benefit	(5,999)	(2,598)
- Others	-	-
Deferred tax liabilities recognized during the year	<u>(220,409)</u>	<u>(13,072)</u>
	<u>(204,989)</u>	<u>113,329</u>
Total Tax charge to Income statement	<u>(3,676,034)</u>	<u>(3,746,544)</u>
13.c Reconciliation Between the Tax Expense and the Accounting Profit		
Accounting profit before taxation	11,199,685	11,217,400
Add: Disallowable items	4,431,443	5,171,137
Less: Allowable items	(1,695,713)	(2,725,430)
Exempted income	(1,436,643)	-
Taxable Income	<u>12,498,772</u>	<u>13,663,107</u>
Income tax @ 28%	<u>(3,499,656)</u>	<u>(3,825,670)</u>
13.d Tax charge to the Statement of Other Comprehensive Income		
-Provision for employee benefit	58,405	3,941
-AFS reserve	1,454,386	(414,490)
-Revaluation of buildings	117,380	(17,374)
	<u>1,630,171</u>	<u>(427,923)</u>

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

AS AT 31ST DECEMBER

14 Analysis of Financial Instruments on Measurement Basis

14.1 As at 31st December 2015

	Held for Trading Rs.'000	Amortized Cost Rs.'000	Available for Sale Rs.'000	Total Rs.'000
ASSETS				
Cash and cash equivalents	-	5,813,230	-	5,813,230
Balances with central bank	-	6,724,825	-	6,724,825
Placements with banks	-	19,469,700	-	19,469,700
Derivative financial instruments	2,078,082	-	-	2,078,082
Financial assets held for trading	330,826	-	-	330,826
Loans and receivables from banks	-	15,784,400	-	15,784,400
Loans and receivables from other customers	-	184,328,632	-	184,328,632
Financial investments	-	-	131,828,703	131,828,703
Acceptances and endorsements	-	10,395,323	-	10,395,323
Total financial assets	2,408,908	242,516,110	131,828,703	376,753,721
LIABILITIES				
Due to banks	-	129,362,756	-	129,362,756
Derivative financial instruments	1,814,183	-	-	1,814,183
Due to other customers	-	182,887,530	-	182,887,530
Acceptances and endorsements	-	10,395,323	-	10,395,323
Total financial liabilities	1,814,183	322,645,609	-	324,459,792

14.2 As At 31st December 2014

	Held for Trading Rs.'000	Amortized Cost Rs.'000	Available for Sale Rs.'000	Total Rs.'000
ASSETS				
Cash and cash equivalents	-	17,170,378	-	17,170,378
Balances with central bank	-	6,845,170	-	6,845,170
Placements with banks	-	15,444,288	-	15,444,288
Derivative financial instruments	1,140,619	-	-	1,140,619
Financial assets held for trading	1,722,700	-	-	1,722,700
Loans and receivables from banks	-	26,321,100	-	26,321,100
Loans and receivables from other customers	-	168,934,941	-	168,934,941
Financial investments	-	-	142,316,265	142,316,265
Acceptances and endorsements	-	14,719,102	-	14,719,102
Total financial assets	2,863,319	249,434,979	142,316,265	394,614,563
LIABILITIES				
Due to banks	-	149,200,815	-	149,200,815
Derivative financial instruments	609,806	-	-	609,806
Due to other customers	-	176,346,760	-	176,346,760
Acceptances and endorsements	-	14,719,102	-	14,719,102
Total financial liabilities	609,806	340,266,677	-	340,876,483

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

AS AT 31ST DECEMBER

15 Cash and cash equivalents	2015	2014
	Rs.'000	Rs.'000
Cash in hand	1,016,228	1,222,493
Balances with other banks	4,797,002	15,947,885
	<u>5,813,230</u>	<u>17,170,378</u>

16 Balances with the Central Bank of Sri Lanka	2015	2014
	Rs.'000	Rs.'000
Balances with central bank	6,724,825	6,845,170
	<u>6,724,825</u>	<u>6,845,170</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 2015 (2014 : 6%).

17 Placements with banks	2015	2014
	Rs.'000	Rs.'000
Placements	19,469,700	15,444,288
	<u>19,469,700</u>	<u>15,444,288</u>

18 Derivative financial instruments	2015	2014
	Rs.'000	Rs.'000
Interest rate derivatives		
Interest rate swaps	167,443	186,730
Currency options	102,096	52,391
Forward foreign exchange contracts	1,808,543	901,498
	<u>2,078,082</u>	<u>1,140,619</u>

19 Other Financial assets held-for-trading	2015	2014
	Rs.'000	Rs.'000
Treasury bills	110,947	734,685
Treasury bonds	219,879	988,015
	<u>330,826</u>	<u>1,722,700</u>

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

AS AT 31ST DECEMBER

20 Loans and receivables from banks	2015	2014
	Rs.'000	Rs.'000
Gross loans and receivables (Note 20.1)	15,784,400	26,321,100
	15,784,400	26,321,100
20.1 Analysis		
a. By product		
Short-term loans	2,884,400	1,321,100
Reverse repo agreements	12,900,000	25,000,000
Gross Total	15,784,400	26,321,100
b. By currency		
Sri Lankan Rupee	12,900,000	25,000,000
United States Dollar	2,884,400	1,321,100
Gross Total	15,784,400	26,321,100
21 Loans and receivables from other customers	2015	2014
	Rs.'000	Rs.'000
Gross loans and receivables (Note 21.1)	185,361,144	171,113,828
Less: Provision for impairment loss (Note 21.2)	(1,032,512)	(2,178,887)
Net loans and receivables	184,328,632	168,934,941
21.1 Analysis		
a. By product		
Overdrafts	15,073,915	11,870,082
Trade finance	42,745,177	44,705,679
Credit cards	19,317,096	19,704,899
Staff loans	2,280,864	2,205,311
Term loans - short term	16,925,334	25,304,821
Term loans - long term	88,008,077	65,818,187
Mortgages	1,010,681	1,504,849
Gross Total	185,361,144	171,113,828
b. By currency		
Sri Lankan Rupee	65,336,192	61,857,205
United States Dollar	118,661,642	107,817,359
Great Britain Pound	524,535	520,253
Others	838,775	919,011
Gross Total	185,361,144	171,113,828
c. By industry		
Agriculture and fishing	4,289,665	5,105,732
Manufacturing	51,764,868	62,042,166
Tourism	16,941,550	8,878,456
Transport	13,523,675	4,976,432
Construction	4,327,920	5,399,372
Traders	27,278,362	22,973,156
New economy	14,208,398	-
Others	53,026,706	61,738,514
Gross Total	185,361,144	171,113,828

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

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21.2 Provision for Impairment loss	2015 Rs.'000	2014 Rs.'000
a. Individual impairment charges		
Opening balance	950,637	1,564,713
Reversal during the year	(242,554)	(480,861)
Exchange fluctuations and other movements	(9,328)	(133,215)
Closing balance	<u>698,755</u>	<u>950,637</u>
b. Collective impairment charges		
Opening balance	1,228,250	788,718
Charge for the year	(833,228)	514,411
Exchange fluctuations and other movements	(61,265)	(74,879)
Closing balance	<u>333,757</u>	<u>1,228,250</u>
Total	<u><u>1,032,512</u></u>	<u><u>2,178,887</u></u>
22 Financial investments – Available-for-Sale	2015 Rs.'000	2014 Rs.'000
Treasury bills	45,248,956	61,880,519
Treasury bonds	86,579,747	80,435,746
	<u><u>131,828,703</u></u>	<u><u>142,316,265</u></u>

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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AS AT 31ST DECEMBER

23 Property, plant and equipment

	Land	Freehold buildings and improvements	Office equipment, furniture and fittings	Household equipment, furniture and fittings	Office Machines	Computer hardware and software	Motor Vehicle	Capital Work in Progress	Total
	Rs.'000	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 2014	1,007,000	580,500	421,821	17,154	206,319	512,342	283,694	543,468	3,572,298
Additions during the year	-	-	20,233	-	4,266	147,678	54,381	321,347	547,905
Disposals during the year	-	-	-	-	-	-	(23,399)	-	(23,399)
Transfers during the year	-	394,549	3,944	-	-	-	-	(398,493)	-
Revaluation Gain	354,000	63,951	-	-	-	-	-	-	417,951
Balance as at 31 st December 2014	1,361,000	1,039,000	445,998	17,154	210,585	660,020	314,676	466,322	4,514,755
Balance as at 1st January 2015	1,361,000	1,039,000	445,998	17,154	210,585	660,020	314,676	466,322	4,514,755
Additions during the year	-	525,716	425,500	162	15,040	77,618	281	-	1,044,318
Disposals during the year	-	-	(114,719)	-	(39,400)	(157,513)	(46,122)	-	(357,754)
Transfers during the year	-	(18,316)	18,316	-	-	-	-	(466,322)	(466,322)
Revaluation Gain	337,000	(269,399)	-	-	-	-	-	-	67,601
Balance as at 31st December 2015	1,698,000	1,277,001	775,095	17,316	186,225	580,125	268,835	-	4,802,597
Accumulated depreciation									
Balance as at 1 st January 2014	-	-	355,234	15,630	187,312	377,436	175,895	-	1,111,507
Charge for the year	-	14,094	29,815	863	8,484	57,061	54,453	-	164,770
Disposals during the year	-	-	-	-	-	-	(23,077)	-	(23,077)
Reclassified during the year	-	6,683	(6,683)	-	-	-	-	-	-
Revaluation Adjustment	-	(20,777)	-	-	-	-	-	-	(20,777)
Balance as at 31 st December 2014	-	-	378,366	16,493	195,796	434,497	207,271	-	1,232,423
Balance as at 1st January 2015	-	-	378,366	16,493	195,796	434,497	207,271	-	1,232,423
Charge for the year	-	22,106	113,112	435	5,929	76,530	42,539	-	260,651
Reclassified during the year	-	72,628	(65,970)	-	82	(57)	-	-	6,683
Revaluation Adjustment	-	(94,734)	-	-	-	-	-	-	(94,734)
Disposals during the year	-	-	(11,561)	-	(39,355)	(150,285)	(46,124)	-	(247,325)
Balance as at 31st December 2015	-	-	413,947	16,928	162,452	360,685	203,686	-	1,157,698
Carrying Value									
As at 31st December 2014	1,361,000	1,039,000	67,632	661	14,789	225,523	107,405	466,322	3,282,332
As at 31st December 2015	1,698,000	1,277,001	361,148	388	23,773	219,440	65,149	-	3,644,899

a) As at 31 December 2015, property plant and equipment include fully depreciated assets of amounting to Rs 796,664,538 which are still in used.

b) Carrying amounts that would have been recognised if land and buildings were stated at cost.

	Land		Buildings	
	2015 Rs.	2014 Rs.	2015 Rs.	2014 Rs.
Cost	4,970,000	4,970,000	113,004,440	113,004,440
Accumulated depreciation	-	-	(22,553,802)	(20,293,713)
Net book amount as at 31 December	4,970,000	4,970,000	90,450,638	92,710,727

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31ST DECEMBER

23 Property, plant and equipment (Continued)

23.1 Methods and Assumptions used in the Fair Valuation of Property, Plant and Equipment

The Lands and buildings of the branch as at 31st December 2015 have been revalued and the revalued amounts have been incorporated in the financial statements for the year. This is considered as a level 3 valuation and the details of the valuation are given below.

Property	Name and Qualifications of the valuer	Valuation Technique	Significant unobservable inputs	Inter-relationship between key unobservable inputs and fair value measurement
Sir Baron Jayatilaka Mawatha, Colombo 01	Mr.Siri Nissanka - FIV, FSVA, MSIZ, IRRV, FIABIC. Diploma in Valuation Registered and Incorporated Valuer	The Open Market Value, the Income Basis and the Depreciated Replacement Cost (DRC) Basis techniques have been used.	The comparable market values of lands situated in the area.	Estimated fair value would increase if the market value of the land increases
			The expected rent from the buildings.	Reduction of market rents cause negative impact on estimated fair value. Estimated fair value would increase if the value of the expected rent gets higher
Independence Avenue, Colombo 07	Mr.Siri Nissanka - FIV, FSVA, MSIZ, IRRV, FIABIC. Diploma in Valuation Registered and Incorporated Valuer	The Open Market Value, the Income Basis and the Depreciated Replacement Cost (DRC) Basis techniques have been used.	The comparable market values of lands situated in the area.	Estimated fair value would increase if the market value of the land increases
			The expected rent from the buildings.	Reduction of market rents cause negative impact on estimated fair value. Estimated fair value would increase if the value of the expected rent gets higher

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24 Deferred tax assets / (liabilities)	2015	2014
	Rs.'000	Rs.'000
Deferred tax assets	462,853	424,645
Deferred tax liabilities	(102,736)	(1,423,108)
	360,117	(998,463)

24.1 Reconciliation of Deferred Tax

Deferred tax assets and liabilities are attributable to the following:

	2015		2014	
	Temporary Difference	Tax Effects	Temporary Difference	Tax Effects
	Rs. '000	Rs.'000	Rs.'000	Rs.'000
Deferred tax assets on ;				
Accelerated Depreciation for tax				
- Property, Plant and Equipment	52,970	14,832	17,741	4,968
Provision for Retirement Benefit Obligation	586,505	164,221	399,343	111,816
Allowance for loan losses	333,757	93,452	1,099,506	307,861
Available for sale reserve	679,814	190,348	-	-
	1,653,046	462,853	1,516,590	424,645
Deferred tax liabilities on ;				
Revaluation of buildings	(366,914)	(102,736)	(568,108)	(159,070)
Available for sale reserve	-	-	(4,514,422)	(1,264,038)
	(366,914)	(102,736)	(5,082,530)	(1,423,108)
Net assets / (liabilities) as at				
31st December	1,286,132	360,117	(3,565,940)	(998,463)

Deferred tax is computed using the effective tax rate of 28%.

25 Other assets	2015	2014
	Rs.'000	Rs.'000
Receivables	4,028,970	4,475,353
Deposits and prepayments	501,350	467,932
Sundry debtors	953	13,249
Acceptances and endorsements	10,395,323	14,719,102
Others	1,389,688	1,762,835
	16,316,284	21,438,471
26 Due to banks	2015	2014
	Rs.'000	Rs.'000
Borrowings	125,510,099	140,213,210
Others	3,852,657	8,987,605
	129,362,756	149,200,815
27 Derivative financial instruments	2015	2014
	Rs.'000	Rs.'000
Currency options	8,283	60,316
Interest rate derivatives	177,078	196,499
Forward foreign exchange contracts	1,628,822	352,991
	1,814,183	609,806

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AS AT 31ST DECEMBER

28 Due to other customers	2015	2014
	Rs.'000	Rs.'000
Total amount due to other customers (Note 28.1)	182,887,530	176,346,760
	182,887,530	176,346,760
28.1 Analysis		
a. By product		
Demand deposits (current accounts)	37,085,862	26,501,632
Savings deposits	45,228,426	42,739,651
Fixed deposits	95,873,451	99,537,764
Other deposits	4,699,791	7,567,713
Total	182,887,530	176,346,760
b. By currency		
Sri Lankan Rupees	113,826,481	109,434,679
United State Dollar	51,435,728	49,489,857
Great Britain Pound	6,548,841	5,776,845
Others	11,076,480	11,645,379
Total	182,887,530	176,346,760
29 Other liabilities	2015	2014
	Rs.'000	Rs.'000
Sundry creditors	878,664	1,119,458
Interest payable	5,630,724	4,422,150
Acceptances and endorsements	10,395,323	14,719,102
Defined benefit liability - Net (Note 29.1)	19,138	399,418
Other payables	5,147,517	7,180,425
	22,071,366	27,840,553
	2015	2014
	Rs.'000	Rs.'000
29.1 Defined Benefit liability - Net		
Present value of Defined Benefit Obligations (Note 29.1.a)	586,505	934,107
Fair value of Plan Assets (Note 29.1.b)	(567,367)	(534,689)
	19,138	399,418
29.1.a Movement in the Present Value of Defined Benefit Obligations		
Opening balance	934,107	901,811
Current service cost	11,357	5,544
Interest cost	84,070	107,439
Benefits Paid during the year	(71,691)	(69,286)
Actuarial gain for the year	(371,338)	(11,401)
Closing balance	586,505	934,107
29.1.b Movement in Fair Value of Plan Assets		
Opening balance	534,689	507,262
Expected return on Plan Assets	48,209	62,262
Contribution by employers	74,000	60,000
Benefits Paid during the year	(71,691)	(69,286)
Actuarial loss for the year	(17,840)	(25,549)
Closing balance	567,367	534,689

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

a. Discount Rate

Discount Rate as at 31 December 2015

1. Effect on DBO due to the change in the discount rate 14.20%	13.20%
	(37,994,425)
2. Effect on DBO due to the change in the discount rate 12.20%	
	43,992,204

b. Salary escalation rate and post retirement pension increase

Increase as at 31 December 2015

Salary escalation rate	
Union members	10%
Non-union members	5%
Post retirement pension	3%

Salary escalation rate and post retirement pension

1. Effect on DBO due to an increase in the salary escalation and post retirement pension rate by 1% p.a.	41,481,355
2. Effect on DBO due to a decrease in the salary escalation and post retirement pension rate by 1% p.a.	(36,960,425)

30	Assigned capital	2015	2014
		Rs.'000	Rs.'000
	Assigned Capital	<u>3,152,358</u>	<u>3,152,358</u>
		<u>3,152,358</u>	<u>3,152,358</u>

31	Statutory reserve fund	2015	2014
		Rs.'000	Rs.'000
	Opening balance	1,940,002	1,790,585
	Transferred during the year	<u>150,473</u>	<u>149,417</u>
	Closing balance	<u>2,090,475</u>	<u>1,940,002</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.

32	Other reserves	2015	2014
		Rs.'000	Rs.'000
	Exchange equalisation of reserve (Note 32.1)	4,039,608	2,300,185
	Available for sale reserve (Note 32.2)	(489,466)	3,280,148
	Revaluation reserve (Note 32.3)	1,957,211	1,781,682
	IFA reserve (Note 32.4)	5,108,459	5,108,459
	SBP reserve (Note 32.5)	<u>172,198</u>	<u>159,402</u>
		<u>10,788,010</u>	<u>12,629,876</u>

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31ST DECEMBER

32 Other reserves (Continued)

32.1 Exchange equalisation of reserve

	2015	2014
	Rs.'000	Rs.'000
Opening balance	2,300,185	2,137,533
Fluctuation of foreign exchange reserves	1,739,423	162,652
Closing balance	4,039,608	2,300,185

32.2 Available for sale reserve

	2015	2014
	Rs.'000	Rs.'000
Opening balance	3,280,148	2,214,135
Net gain on revaluation	(3,769,614)	1,066,013
Closing balance	(489,466)	3,280,148

32.3 Revaluation reserve

	2015	2014
	Rs.'000	Rs.'000
Opening balance	1,781,682	1,360,328
Revaluation surplus for the year	175,529	421,354
Closing balance	1,957,211	1,781,682

32.4 IFA reserve

	2015	2014
	Rs.'000	Rs.'000
Opening balance	5,108,459	4,583,499
Transferred during the year	-	524,960
Closing balance	5,108,459	5,108,459

According to the guidelines issued by the 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. Operations of IFA ceased with effect from 01 October 2014 and the above indicates the balance accrued up to that date.

32.5 Share Based Payment Reserve

	2015	2014
	Rs.'000	Rs.'000
Opening balance	159,402	157,666
Transferred during the year	12,796	1,736
Closing balance	172,198	159,402

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 HSBC 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.

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32.7 Share based payments and share option	2015	2014
32.7.1 Restricted share awards - <i>No of Shares ('000)</i>		
Outstanding at the beginning	23,002	7,604
Awards during the year	15,639	24,951
Vested during the year	(15,246)	(9,553)
Outstanding at the end	23,395	23,002
32.7.2 Share-based payments income statement charge	Rs.'000	Rs.'000
Restricted and performance share awards	14,977	26,614
Share award option plans	1,087	1,736
	16,064	28,350

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.

35 Commitments and contingencies

- 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.

	2015	2014
	Rs.'000	Rs.'000
Performance bonds	5,690,799	1,831,642
Letters of credit	9,055,949	11,765,364
Other contingent items	16,299,295	26,356,056
Undrawn loan commitments	176,926,467	141,787,808
Foreign Exchange Contracts	262,960,580	259,238,116
Derivatives- Principal amount	131,051,481	126,112,035
Other contra accounts	14,115,977	15,249,216
Total	616,100,548	582,340,237

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AS AT 31ST DECEMBER

35 Commitments and contingencies (continued)

b. Pending litigations against the Branch as at 31st December 2015

1. Law suit instituted by a former staff case no: DSP/214/2011; now terminated - praying for inter alia
 1. an interim injunction against the Branch for restraining the Branch from withholding his salary (case was instituted in year 2011 when the staff member was under suspension)
 2. 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 suspension.
2. 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.
3. 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.
4. 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).
5. Court action has been taken under case no. HC/CIVIL/338/12 where case filed by the plaintiff against other three defendants for alleged malicious prosecution. The Branch has been enlisted as the 4th defendant for giving evidence on certain transactions of the plaintiff.
6. 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)
7. Four Labour Tribunal actions have been taken under case numbers LT 2/150/2010, LT 2/315/2012, LT 8/648/12 and LT 13/25/2014 by former staff members for alleged unfair termination.
8. Case no. 254/2014/DSP filed in District Court of Colombo where the plaintiff Cargills PLC alleges that the recent installation of air condition cooling towers by the Branch in the space between two buildings of has caused them inconveniences and nuisance.
9. Travel Club V HSBC , case no - WP/HCCA/Col 180/10(f), Travel Club Ltd has appealed against a verdict given by the District Court of Colombo in favour of HSBC in a case instituted by HSBC for payments due from Travel Club.
10. Aitken Spence V HSBC , case no CBC/ 88/15/ MR , in the High Court (Civil) Western Province, Aitken Spence , being the Applicant to a Counter Guarantee issued by HSBC Sri Lanka to Jamuna Bank in Bangladesh, has instituted this case to prevent us from honouring the counter guarantee to Jamuna Bank. The Branch is of the view that the above litigations will not have any material impact on the Financial Statements.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

36 Related Party Disclosure

The Branch 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		2015	2014
		Rs.'000	Rs.'000
Other HSBC Branches			
HSBC Hongkong		386,415	188,167
		386,415	188,167
Group Companies			
HSBC London		75	16
HSBC Markets		398,166	297,127
HSBC Melbourne		7	1
HSBC USA		99,744	87,948
HSBC Data Processing Ltd		52,303	57,633
HSBC Middle East		152	1
		550,447	442,726
(b) Interest Received from Other HSBC Branches and Group Companies		2015	2014
		Rs.'000	Rs.'000
Other HSBC Branches			
HSBC Hongkong		14,685	4,139
		14,685	4,139
Group Companies			
HSBC London		23	4
HSBC Markets		8	2,722
HSBC Data Processing Ltd		126	5
		157	2,731
(c) Commission Paid to Other HSBC Branches and Group Companies		2015	2014
		Rs.'000	Rs.'000
Other HSBC Branches			
HSBC Hongkong		84,339	441
HSBC Auckland		142	128
HSBC Tokyo		202	202
HSBC Singapore		306	386
HSBC India		-	2
HSBC Thailand		115	56
HSBC Malaysia		14	-
		85,118	1,215
Group Companies			
HSBC London		(43)	255
HSBC Canada		651	588
HSBC Australia		1,634	1,672
HSBC USA		68,450	155,713
HSBC TUB Dusseldorf		(343)	92
HSBC Dubai		-	41
		70,349	158,361

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

FOR THE YEAR ENDED 31ST DECEMBER

36 Related Party Disclosure (Continued)

36.1 Transactions with related parties (Continued)

(d) Assets of Other HSBC Branches and Group Companies		2015	2014
		Rs.'000	Rs.'000
Other HSBC Branches			
HSBC Hongkong	19,691,997	13,092,713	
HSBC Auckland	28,172	34,536	
HSBC Tokyo	22,176	32,770	
HSBC Singapore	35,335	100,429	
HSBC India	168,030	380,538	
HSBC Thailand	493	1,124,329	
HSBC Male'	108,056	1,212,081	
HSBC Malaysia	1,076	1,211	
	20,055,335	15,978,607	
Group Companies			
HSBC London	366,290	628,107	
HSBC Canada	30,107	31,871	
HSBC USA	3,578,537	6,341,837	
HSBC UAE	2,757	4,172	
HSBC Australia	60,580	101,929	
	4,038,271	7,107,916	
(e) Liabilities of Other HSBC Branches and Group Companies		2015	2014
		Rs.'000	Rs.'000
Other HSBC Branches			
HSBC Hongkong	128,596,478	130,400,536	
HSBC Tokyo	5,798	-	
HSBC Singapore	8,769	2,880	
HSBC India	19,345	101,380	
HSBC Bangladesh	191,199	84,275	
HSBC Bahrain	666	841	
HSBC Male'	839	744	
HSBC Malaysia	1,043	4,850	
	128,824,137	130,595,506	
Group Companies			
HSBC London	86,880	161,734	
HSBC Canada	12	12	
HSBC USA	626,334	2,432,068	
HSBC Data Processing Ltd	2,216,865	1,987,234	
HSBC Kuwait	499	437	
HSBC Qatar	1,111	322	
HSBC Dubai	228	3,204	
HSBC Australia	6,888	31,679	
	2,938,817	4,616,690	

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 has identified Chief Executive Officer, Chief Operating Officer, Head of Commercial Banking, Country Head of Retail Banking and Wealth Management, Head of Global Markets, General Counsel and Area Compliance Officer, Head of Human Resources, Chief Financial Officer, Chief Risk Officer, Senior Marketing and Communications Manager, Financial Controller, Chief Information Officer and Global Standard Program Country Execution Lead as its key management personnel based on the above requirements.

36.2.a Compensation of KMPs

	2015 Rs.'000	2014 Rs.'000
Aggregate remuneration paid for the year	310,276	236,904
	310,276	236,904

36.2.b Transactions with KMPs and Close Relations

	2015 Rs.'000	2014 Rs.'000
Total deposits	105,525	73,087
Total accommodation granted	237,813	212,435
	343,338	285,522

37 Segment Analysis by Line of Business

Business level performance

	Retail Banking and Wealth Management Rs.'000	Commercial Banking Rs.'000	Global Banking and Markets Rs.'000	Others Rs.'000	Total Rs.'000
Net Operating Income	7,569,149	5,736,342	7,687,239	1,354,669	22,347,399
Operating Expenses	(5,517,177)	(2,451,597)	(1,181,062)	(462,831)	(9,612,667)
Profit Before tax	1,741,364	2,951,494	5,755,805	751,021	11,199,684
Income tax expense	(789,677)	(701,072)	(1,803,836)	(381,449)	(3,676,034)
Profit after tax	951,687	2,250,422	3,951,969	369,572	7,523,650
Segment Assets	41,433,492	149,238,521	170,020,166	25,987,519	386,679,698
Segment Liabilities	118,411,454	80,322,445	133,967,740	53,978,059	386,679,698

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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 31st December 2015, interest rates and maturity :

Investment amount Rs.	Interest rate	Maturity
382,751,310	8.65%	15-Aug-18
113,566,289	8.85%	15-Jan-19
57,422,457	8.85%	15-Jan-19
74,344,569	8.92%	15-Jan-19
85,136,503	8.95%	15-Jan-19
89,501,687	9.75%	15-Jan-19
49,054,293	9.75%	15-Jan-19
50,928,959	10.00%	1-May-19
264,479,065	14.15%	1-Nov-19
111,565,023	14.20%	1-Nov-19
86,446,265	14.30%	1-Nov-19
110,836,480	14.50%	1-Nov-19
77,908,218	14.40%	1-Nov-19
100,399,598	14.40%	1-Nov-19
151,093,292	14.50%	1-Nov-19
101,709,709	14.50%	1-Nov-19
81,985,306	14.40%	1-Nov-19
81,073,800	12.90%	1-Nov-19
78,639,500	13.68%	1-Nov-19
3,225,386	13.40%	1-Aug-20
3,578,377	11.40%	1-Aug-20
12,480,705	11.00%	1-Jan-22
47,342,368	11.60%	1-May-21
92,402,230	12.00%	1-May-21
78,445,204	11.60%	1-May-21
96,997,512	11.60%	1-May-21
122,963,298	11.40%	1-May-21
144,465,650	11.55%	1-May-21
210,668,248	11.72%	1-May-21
122,963,298	11.45%	1-May-21
94,674,453	11.50%	1-May-21
74,625,964	11.53%	1-May-21
112,503,258	11.50%	1-May-21
179,504,200	11.56%	1-May-21
107,883,720	11.55%	1-May-21
32,670,648	11.60%	1-May-21
46,827,097	11.64%	1-May-21
153,376,581	11.03%	1-May-21
44,729,200	11.23%	1-May-21
44,852,100	11.24%	1-May-21
44,785,250	11.20%	1-May-21
541,072,950	10.00%	1-May-21
109,433,500	9.50%	1-Jul-22
27,431,625	9.45%	1-Jul-22
121,113,600	7.78%	1-Jul-22
60,491,400	7.80%	1-Jul-22
60,524,100	7.79%	1-Jul-22
60,556,800	7.78%	1-Jul-22
60,524,100	7.79%	1-Jul-22
62,873,150	7.30%	1-Jul-22
5,124,828,295		

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39. Financial Risk Management

39.1 Risk Management Framework

All of the Branch's 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. It also provides for the compliance with the Banking Act No 30 of 1988 as amended by the Banking Amendment Act No 33 of 1995, Directions, Determinations, and Circulars issued to Licensed Commercial Banks by the Central Bank of Sri Lanka. The Branch's Risk Function consists of Wholesale & Market Risk & Retail Banking & Wealth Management (RBWM) Risk, Security & Fraud Risk, CRO & Administration which encapsulate Risk Strategy, Enterprise Wide Stress Testing and Operational Risk. The HSBC Group provides overall written policies and procedures on risk management covering specific areas such as credit risk, liquidity risk, market risk and operational risks. The local management through Executive Committee and Risk Management Committee monitor the execution of risk management policies and procedures.

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 cash and cash equivalents, direct lending, trade finance and also from certain other products such as derivative instruments and off balance sheet transactions such as letters of credit and guarantees.

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 the branch 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 the branch 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 Executive Officer (CEO) who in turn delegates limit to local risk executives.

The principle objectives of our credit risk management are;

- To maintain across the branch 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
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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 designed to differentiate 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 the 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 HSBC Group to support calculation of our minimum credit regulatory capital requirement. Credit quality of customers are assessed taking into account their financial position, past experience and other factors. Special attention is paid to problem exposures in order to accelerate remedial action.

HSBC 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 HSBC 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

The branch creates impairment allowances for impaired loans promptly and appropriately.

Impairment and Credit Risk Mitigation

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. When the 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.

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

39 Financial Risk Management (continued)

39.2 Credit risk (continued)

39.2.1 Credit Risk Management (continued)

Impairment and Credit Risk Mitigation (Continued)

The historical loss methodology is typically used to calculate collective impairment allowances for secured or low default portfolios for which are collectively assessed. 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 also known as the net flow 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 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 behaviour, 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 expects 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 and Receivables

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.

Credit cards, personal loans and auto loans are generally written off at 180 days. It is done on the billing date of the month, the account reaches 180 days and non performing home loans are to be written off after 60 months of non recovery. The process is automated and any exception is tracked and manually done the next day. However early write off could be triggered by circumstance of the account for example on death, bankruptcy etc.

Usually Collections/Recovery activities may continue after write off and legal action would be taken if the parties are unable to reach an amicable settlement.

Collateral Management and Valuation

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 collateral which is an important credit risk mitigation mechanism. 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 and receivables, impairment and net loans and receivables from customers 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		
	31/12/2015	31/12/2014
	Rs.'000	Rs.'000
By product - Domestic currency		
Overdrafts	11,717,421	9,271,529
Term loans	33,667,278	32,786,376
Credit cards	19,317,096	19,704,899
Other loans	634,397	94,402
Sub total	65,336,192	61,857,206
By product - Foreign currency		
Overdrafts	3,356,495	2,598,552
Term loans	113,593,639	103,236,808
Other loans	3,074,818	3,421,262
Sub total	120,024,952	109,256,622
Total	185,361,144	171,113,828

Gross Loans and Receivables - By currency

Loans and Receivables to Other Customers		
	31/12/2015	31/12/2014
	Rs.'000	Rs.'000
By currency		
Sri Lanka Rupee	65,336,192	61,857,205
United States Dollar	118,661,642	107,817,359
Great Britain Pound	524,535	520,253
Others	838,775	919,011
Total	185,361,144	171,113,828

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)

Individual impairment - sector wise analysis

Specific Provision - Sector wise		
	31/12/2015	31/12/2014
	Rs.'000	Rs.'000
Manufacturing	590,615	607,478
Traders	4,188	64,312
Transport	25,416	-
Construction	-	208,203
Financial & Business Services	39,018	39,042
Others	39,518	31,602
Total	698,755	950,637

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	2015 Total Rs.'000	2014 Total Rs.'000
Agriculture & Fishing	6,231	658,250	521,714	-	3,103,470	-	-	4,289,665	5,105,731
Manufacturing	3,420,079	16,968,203	3,910,565	-	4,025,152	23,440,869	-	51,764,868	62,042,166
Tourism	34,180	-	791,713	-	82,350	16,033,308	-	16,941,550	8,878,456
Transport	12,961	-	284,057	-	3,105,229	10,121,428	-	13,523,675	4,976,433
Construction	32,919	-	198,405	-	115,231	1,473,063	2,508,302	4,327,920	5,399,372
Traders	19,879,117	1,721,358	1,526,856	-	2,236,911	1,914,121	-	27,278,362	22,973,156
New Economy	-	-	37,766	-	864,631	13,306,001	-	14,208,398	14,351,502
Financial and Business Services	-	-	736,666	-	3,057,240	3,710,117	-	7,504,023	5,105,891
Infrastructure	-	-	124,559	-	-	-	-	124,559	901,337
Other Services	11,879	-	2,065,225	-	334,977	2,962,189	-	5,374,270	2,454,897
Credit card	-	-	-	19,317,096	-	-	-	19,317,096	19,704,899
Other	-	-	4,876,389	-	-	15,830,369	-	20,706,757	19,219,987
Total	23,397,366	19,347,811	15,073,915	19,317,096	16,925,190	88,791,464	2,508,302	185,361,144	171,113,828

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	2015 Total Rs.'000	2014 Total Rs.'000
Overdrafts	15,073,915	-	-	-	-	-	-	-	15,073,915	11,870,082
Term Lending	5,560,933	16,371,004	30,483,381	4,223,713	2,551,066	18,225,388	53,162,468	9,195,455	139,773,409	130,034,369
Non-Eligible Bills	776,774	906,042	1,378,655	227,807	-	-	-	-	3,289,278	3,515,663
Money Market Term Placements	3,090,488	2,308,768	-	-	-	-	-	-	5,399,256	3,403,076
Credit Card Advances	19,317,096	-	-	-	-	-	-	-	19,317,096	19,704,899
Mortgages	461,890	1,035	2,486	9,579	14,608	65,148	137,556	1,816,000	2,508,302	2,585,740
Total Gross Loans and Receivables	44,281,032	19,586,817	31,864,515	4,461,091	2,565,674	18,290,536	53,300,024	11,011,455	185,361,144	171,113,828
Acceptances	817,981	2,489,074	3,425,178	1,293,720	1,535,405	833,964	-	-	10,395,323	14,719,102
Total	45,099,014	22,075,891	35,289,693	5,754,811	4,101,080	19,124,500	53,300,024	11,011,455	195,756,467	185,832,929

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	2015 Total Rs.'000	2014 Total Rs.'000
Cash and cash equivalents	1,016,228	4,797,002	-	-	-	-	-	5,813,230	17,170,378
Balances with central banks	6,724,825	-	-	-	-	-	-	6,724,825	6,845,170
Placements with banks	-	19,469,700	-	-	-	-	-	19,469,700	15,444,288
Derivative financial instruments	773,270	932,841	371,971	-	-	-	-	2,078,082	1,140,619
Other financial assets held-for-trading	330,825	-	-	-	-	-	-	330,826	1,722,700
Loans and receivables to banks	12,900,000	2,884,400	-	-	-	-	-	15,784,400	26,321,100
Loans and receivables to other customers	1,567,519	10,822,913	161,110,231	662,832	9,248,360	1,949,329	(1,032,512)	184,328,632	168,934,941
Financial investments AFS	131,828,703	-	-	-	-	-	-	131,828,703	142,316,265
Acceptances	-	-	10,101,663	-	293,660	-	-	10,395,323	14,719,102
Total	155,141,370	38,906,856	171,583,865	662,832	9,542,020	1,949,329	(1,032,512)	376,753,721	394,614,563

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)

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	1 – 3 Years Rs.'000	3 – 5 Years Rs.'000	More than 5 Years Rs.'000	Total Rs.'000
2015	1,545,829	143	4,562	12,616	28,848	715,022	3,966,078	2,975,261	9,248,360
2014	1,223,548	934	1,030	12,816	27,879	1,820,233	1,503,122	430,371	5,019,935

The individually impaired loans and receivables comprise of corporate loans of customers who are experiencing financial and economic difficulties. The Branch expects that a portion of these receivables will be recovered and has recognised a reversal of impairment losses of Rs. 242,547 (2014 Rs. 480,861).

The impairment charges for loans and receivables is disclosed in Note 10. The movement in provision for impairment is disclosed in Note 21.1.

Collateral held and other credit enhancements and their financial effect

	2015		2014	
	Carrying Amount LKR'000	Collateral Value LKR'000	Carrying Amount LKR'000	Collateral Value LKR'000
Loans and receivable to banks	15,784,400	-	26,321,100	-
Loans and receivable to other customers	184,328,632	67,473,431	168,934,941	62,422,492

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 the Central Bank of Sri Lanka unless this represents routine established business as usual market practice.

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
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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

The Branch uses the HSBC's liquidity and funding risk management framework ('LFRF') that 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 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

The Branch 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
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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

Maturity analysis of financial liabilities

	Less than 7 Days LKR'000	7-30 Days LKR'000	1-3 Months LKR'000	3-6 Months LKR'000	6-12 Months LKR'000	1-3 Years LKR'000	3-5 Years LKR'000	More than 5 Years LKR'000	2014 Total LKR'000	2013 Total LKR'000
Due to banks	10,342,605	7,932,100	5,768,800	18,027,500	8,742,616	59,079,435	19,469,700	-	129,362,756	149,200,815
Derivative financial instruments	1,814,183								1,814,183	609,806
Due to other customers	99,093,310	13,986,761	19,808,750	15,198,825	19,199,667	10,931,203	4,669,014	-	182,887,530	176,346,760
Acceptances	817,920	2,489,076	3,425,178	1,293,720	1,535,405	834,024	-	-	10,395,323	14,719,102
Total	112,068,018	24,407,937	29,002,728	34,520,045	29,477,688	70,844,662	24,138,714	-	324,459,792	340,876,483

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
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 the income or the value of Branch's portfolios is considered as market risk.

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, the Branch 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 HSBC 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.

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 (continued)

39.4.2 Risk Management (continued)

Both the VAR and Stressed VAR models the Branch uses 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-modelled items such as fees and commissions, against the corresponding VAR numbers.

FX Currency open positions

Currency '000	CHF	EUR	GBP	HKD	JPY	USD	AUD	LKR	CAD	DKK	CNY	MYR	NZD	SEK	SGD	THB	AED
2015	(60.67)	35.42	(24.58)	118.26	(2.26)	12,068.57	3.03	(12,203.57)	3.17	12.27	38.33	7.46	4.60	31.16	(31.86)	(2.12)	2.78
2014	(10.65)	16.30	(69.02)	106.01	(42.16)	10,343.21	17.82	(10,498.89)	34.21	10.83	(10.96)	9.16	(1.04)	43.59	(1.46)	7.51	45.47

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

39 Financial Risk Management (continued)

39.4 Market Risk (continued)

39.4.2 Risk Management (continued)

Sensitivity of reported reserves to interest rate movements

AFS Reserves (Currency Wise) USD'000	31/12/2015			31/12/2014		
	Month end balance	+100 bps	-100 bps	Month end balance	+100 bps	-100 bps
USD	(1,269)	(913)	913	(324)	(838)	838
LKR	(3,445)	(5,257)	5,257	34,733	(9,253)	9,253
AFS Total	(4,714)	(6,170)	6,170	34,409	(10,094)	10,094

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

The sensitivity calculations should reflect the 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 Financial Risk Management (continued)

39.4 Market Risk (continued)

Interest rate sensitivity analysis

USD'000	Retail Banking	Corporate Banking	Global Banking	Total Retail and Commercial Banking	ALCO Pool	Treasury /Global Markets	Intersegment Elimination	Total
Projected NII of the next twelve months	49,812	28,311	7,130	85,553	17,183	29,525	-	131,962
Incremental NII of the next twelve months								
Parallel Movements in Yield Curve								
+100 bps	(872)	1,611	801	1,540	2,778	5,318	-	9,636
- 100 bps	641	(2,375)	(889)	(2,622)	(2,016)	(5,499)	-	(10,137)
Ramp Movements in Yield Curve*								
+100 bps	(563)	949	501	888	1,698	3,449	-	6,034
- 100 bps	434	(1,315)	(541)	(1,422)	(1,242)	(3,659)	-	(6,323)
Projected NII of the thirteenth month to twenty fourth month								
Base Case	51,773	29,415	7,345	88,533	18,181	30,142	-	136,856
With +100 bps in 1st year	51,063	31,368	8,153	90,584	22,389	33,732	-	146,704
Difference	(710)	1,953	808	2,051	4,208	3,589	-	9,848
With -100 bps in 1st year	52,224	26,685	6,436	85,345	15,591	25,504	-	126,440
Difference	451	(2,730)	(909)	(3,188)	(2,590)	(4,638)	-	(10,416)

* 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 Financial Risk Management (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 fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

A centralised 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 HSBC Group level, all branches are required to report individual losses in excess of a particular threshold.

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

AS AT 31ST DECEMBER

39 Financial Risk Management (Continued)

39.5 Operational Risk (Continued)

39.5.1 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)	2015 Rs'000	2014 Rs'000
Assigned Capital	3,152,358	3,152,358
Statutory Reserve Fund	2,090,476	1,940,003
Published Retained Profits	32,964,267	30,452,554
General and Other Reserves	9,320,265	7,568,046
Total qualifying tier 1 capital prior to deductions	47,527,366	43,112,961
Deductions to tier 1 capital	203,461	(153,104)
Net deferred tax assets	360,117	-
Amounts due to head office and branches outside Sri Lanka in Sri Lanka Rupees (-)	(156,656)	(153,104)
Amounts due from head office and branches outside Sri Lanka in Foreign Currency (Net)		
Tier 1 Capital	47,323,905	43,266,065
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	47,680,822	43,622,982

* 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
SRI LANKA BRANCH
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

AS AT 31ST DECEMBER

39 Financial Risk Management (Continued)

39.5 Operational Risk (Continued)

39.5.1 Capital Management(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, 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)

	2015	2014
	Rs.'000	Rs.'000
Credit risk	171,525,469	158,479,122
Market risk	14,036,015	10,647,430
Operational risk	33,289,367	33,765,813
Total risk-weighted assets	218,850,851	202,892,365

Capital ratios (Audited)

Tier 1 ratio	21.62%	21.32%
Total capital ratio	21.79%	21.50%

39.5.2 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:

	2015	2014
	Rs. '000	Rs. '000
On Balance sheet exposure	191,544	117,086
Off Balance sheet exposure	Nil	Nil

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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40 Fair value of Financial Assets and Liabilities

40.1 Fair value of financial instruments not carried at fair value

	Carrying Value Rs'000	Fair Value Rs'000
Assets		
Cash and Cash Equivalents	5,813,230	5,813,230
Balances with Central Bank	6,724,825	6,724,825
Placements with banks	19,469,700	19,469,700
Loans and receivables to banks	15,784,400	15,784,400
Loans and receivables to other customers	184,328,632	188,122,738
Acceptances and endorsements	10,395,323	10,395,323
Liabilities		
Due to banks	129,362,756	129,362,756
Due to customers	182,887,530	182,887,530
Acceptances and endorsements	10,395,323	10,395,323

Note:

The above list of financial instruments excluding “Loans and receivables to other customers” whose carrying amount is reasonable approximation of fair value because, for example, they are short term in nature or re-price to current market rates frequently.

The following table sets out the fair values of financial instruments not carried at fair value and analyses them by the level in the fair value hierarchy into which each fair value measurement is categorised.

	Carrying Value Rs'000	Level 1 Rs'000	Level 2 Rs'000	Level 3 Rs'000
Assets				
Cash and Cash Equivalents	5,813,230	-	5,813,230	-
Balances with Central Bank	6,724,825	-	6,724,825	-
Placements with banks	19,469,700	-	19,469,700	-
Loans and receivables from banks	15,784,400	-	-	15,784,400
Loans and receivables from other customers	184,328,632	-	-	184,328,632
Acceptances and endorsements	10,395,323	-	-	10,395,323
Liabilities				
Due to banks	129,362,756	-	-	129,362,756
Due to customers	182,887,530	-	-	182,887,530
Acceptances and endorsements	10,395,323	-	-	10,395,323

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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40 Fair value of Financial Assets and Liabilities (Continued)

40.2 Fair value of financial instruments carried at fair value

40.2.1 Fair Value Hierarchy

Fair values of financial assets and liabilities are determined according to the following hierarchy:

- Level 1 – valuation technique using quoted market price: financial instruments with quoted prices for identical instruments in active markets that the branch can access at the measurement date.
- Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or valued using models where all significant inputs are observable. Similar instruments in inactive markets and financial instruments.
- Level 3 – valuation technique with significant unobservable inputs: financial instruments valued using valuation.

Financial instruments carried at fair value and bases of valuation

As at 31st December 2015	Level 1 Rs'000	Level 2 Rs'000	Level 3 Rs'000
Assets			
Other Financial assets held-for-trading	-	330,826	-
Derivative financial instruments	32,133	1,950,688	95,261
Financial investments : Available-for-sale	-	131,828,703	-
	<u>32,133</u>	<u>134,110,217</u>	<u>95,261</u>
Liabilities			
Derivatives	5,324	1,808,516	343
	<u>5,324</u>	<u>1,808,516</u>	<u>343</u>
As at 31st December 2014			
Assets			
Other Financial assets held-for-trading	-	1,722,700	-
Derivative financial instruments	1,172	1,026,503	112,944
Financial investments : Available-for-sale	-	142,316,265	-
	<u>1,172</u>	<u>145,065,468</u>	<u>112,944</u>
Liabilities			
Derivative financial instruments	4,061	492,027	113,718
	<u>4,061</u>	<u>492,027</u>	<u>113,718</u>

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AS AT 31ST DECEMBER

40 Fair value of Financial Assets and Liabilities (Continued)

40.2 Fair value of financial instruments carried at fair value (Continued)

40.2.1 Fair Value Hierarchy (Continued)

Movement in Level 3 financial instruments

	2015	
	Assets	Liabilities
	Rs'000	Rs'000
As at 1 st January	112,944	113,718
Total gains/(losses) recognised in profit or loss	(9,247)	(104,257)
Settlements	(8,436)	(9,118)
As at 31 st December	95,261	343

	2014	
	Assets	Liabilities
	Rs'000	Rs'000
As at 1 st January	49,973	134,614
Total gains/(losses) recognised in profit or loss	67,890	(20,896)
Settlements	(4,919)	-
As at 31 st December	112,944	113,718

40.2.2 Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded principal market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. The judgment as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate;

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40 Fair value of Financial Assets and Liabilities (Continued)

40.2 Fair value of financial instruments carried at fair value (Continued)

40.2.2 Valuation of financial instruments (Continued)

- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products. A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap.

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur.

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets branch will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date;
- the manner in which the data was sourced.

Fair value adjustments

Fair value adjustments are adopted when HSBC considers that there are additional factors that would be considered by a market participant which are not incorporated within the valuation model. HSBC classifies fair value adjustments as either 'risk-related' or 'model-related'. Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.