

Handbook for Borrowers on the
**Financial Management
and Analysis of Projects**



2006

Foreword

Sound financial management arrangements help ensure that investment projects are successfully implemented and are operationally sustainable. This Handbook contains information and instructions for borrowers on the financial management of projects financed by the Asian Development Bank (ADB).

This Handbook reflects ADB policies as set out in the *Financial Management and Analysis of Projects* (the Guidelines) as updated in 2005. It supersedes all previous handbooks on financial management and takes effect immediately.

To ensure that financial management arrangements for investment projects meet ADB requirements, borrowers and project executing agency staff should study this Handbook, particularly during project preparation.

Acknowledgements

The original publication entitled, Handbook for Borrowers on the *Financial Governance and Management of Investment Projects financed by the Asian Development Bank* was prepared by Sarath Lakshman Athukorala (Financial Management Specialist, ADB) and Barry Reid (consultant).

The original handbook has been updated to conform with the revised *Financial Management and Analysis of Projects, 2005*. This was undertaken by a team comprising Kathleen Moktan, Director, Capacity Development and Governance Division, with assistance from Andrew Head, Principal Financial Management Specialist, Anouj Mehta, Financial Management Specialist, Lizzette Francisco, Yvonne Osonia, Ma. Carolina Faustino-Chan, and Portia Gonzales.

Acronyms

ADB	Asian Development Bank
ADTA	advisory technical assistance
AFS	audited financial statements
APA	audited project accounts
DMC	developing member country
EA	executing agency
FI	financial institution
IA	implementing agency
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards ¹
IASB	International Accounting Standards Board
IFAC	International Federation of Accountants
INTOSAI	International Organization of Supreme Audit Institutions
ISA	International Standards on Auditing
MDFI	multilateral development finance institution
MFI	microfinance institution
OGAU	Anticorruption Unit of the Office of the General Auditor
PAI	project administration instruction
PCR	project completion report
PMR	project management report
PPAR	project performance audit report
PPTA	project preparatory technical assistance
RETA	regional technical assistance
RRP	report and recommendation of the President
SOE	statement of expenditures
TA	technical assistance
TOR	terms of reference

¹ In 2001, the IASB assumed responsibility from the International Accounting Standards Committee for promulgating IAS. While the IASB standards are called International Financial Reporting Standards (IFRS), this Handbook uses the term IAS (in the interest of continuity).

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1. Introduction

The Asian Development Bank

1.01. ADB is a multilateral development finance institution (MDFI) dedicated to reducing poverty in Asia and the Pacific. Our Charter (Articles of Agreement) requires us to take measures to ensure that the proceeds of any loan made, guaranteed or participated in by ADB are “used only for the purposes for which the loan was approved with due attention to consideration of economy and efficiency.” Moreover, ADB’s operations must be guided by sound banking principles. Accordingly, we have developed specific financial management and reporting requirements for our borrowing members, including their executing agencies (EAs), where applicable.

Our poverty-fighting operations in Asia and the Pacific ...

... are guided by sound banking principles

The Guidelines

1.02. *Financial Management and Analysis of Projects, 2005* (the Guidelines) sets out ADB’s requirements and procedures for the financial management of ADB-Financed projects (see Appendix 1). They also provide guidance on applying these requirements.

We have internal financial management policies and guidelines ...

1.03. The Guidelines are primarily for internal ADB use, but are available to external parties in hard copy, via the Internet (www.adb.org/documents/guidelines/financial), and on CD-ROM.

... and are working hard to harmonize these policies with other MDFIs to reduce compliance burdens on our DMCs

MDFI Harmonization Efforts

1.04. ADB and the other MDFIs—including the World Bank—have similar objectives and engage in similar activities, but have different financial management approaches and requirements. These variances create confusion among our developing member countries (DMCs). They also impose unnecessary compliance costs and divert limited resources away from key priorities. In 2000, the work began to reduce these differences. As of 2006, agreements have been reached on common diagnostics, auditing arrangements, financial reporting arrangements, definitions of key ratios and commitment to work together to improve financial management of DMCs.

ADB Approach to Anticorruption

Corruption places a burden on governments and economies

1.05. ADB defines corruption as the abuse of public or private office for personal gain. This means any behavior in which people in the public or private sectors improperly and unlawfully enrich themselves or those close to them, or induce others to do so, by abusing their positions.

which ADB's anticorruption approach is intended to reduce

1.06. The purpose of ADB's *Anticorruption Policy* is to reduce the burden corruption exacts from the governments and economies of the region. The policy has three objectives: (i) support competitive markets and effective public administration; (ii) support explicit anticorruption efforts; and (iii) ensure ADB-financed projects and its staff adhere to the highest ethical standards.

1.07. The requirements and procedures set out in this Handbook support the implementation of our *Anticorruption Policy*, which is available at www.adb.org.

1.08. ADB's integrity is one of its strongest assets. ADB affirms a zero tolerance policy when credible evidence of fraud and corruption exists among ADB-financed projects or its staff. You may report allegations of fraud and corruption by contacting the Anticorruption Unit of the Office of the General Auditor (OGAU) by e-mail, telephone or facsimile. Communication sent by these methods is accessible only by OGAU staff:

E-mail : anticorruption@adb.org
 Telephone : (632) 632-5004
 Fax : (632) 636-2152

1.09. You may also contact OGAU at the following addresses. Please mark correspondence "Strictly Confidential".

Anticorruption Unit (OGAU)
 Office of the General Auditor
 Asian Development Bank
 6 ADB Avenue
 Mandaluyong City
 1550 Metro Manila, Philippines
 Mailing Address : P.O. Box 789, 0980 Manila
 Philippines

This Handbook

1.10. This Handbook reflects progress on MDFI harmonization, explains ADB financial management policies and procedures, and is aimed at borrowers and their EAs. These policies and procedures are fully consistent with our anticorruption approach.

1.11. The provisions of this Handbook apply to investment projects and project EAs and implementing agencies (IAs). For the purposes of this Handbook, investment projects include ADB-

The requirements and procedures set out in this Handbook support the implementation of our Anticorruption Policy

This Handbook explains our financial management policies and requirements

loan-financed projects and the identifiable investment components of program and sector loans. Please note that—unless stated otherwise—the requirements for EAs also apply to IAs.

1.12. This Handbook is cross-referenced to the Guidelines. For instance, [5.2.3.1.1] refers to that Guidelines' paragraph or section.

Further Assistance

Further guidance on applying these requirements is available

1.13. For further information and guidance, readers are encouraged to refer to the Guidelines in the first instance; see

<http://www.adb.org/documents/guidelines/financial>

1.14. If you cannot resolve your question, please contact the responsible ADB project officer. Otherwise contact:

The Principal Financial Management Specialist
Regional and Sustainable Development Department
Asian Development Bank
Manila, Philippines
General Information : fmguidelines@adb.org
Telephone : (632) 632-4444
Fax : (632) 636-2193
Mailing Address : P.O. Box 789, 0980 Manila
Philippines

2. User Instructions

ADB Lending and Technical Assistance

2.01. Our Charter permits us to make, participate in, or guarantee loans to our DMCs, to any of their agencies or political subdivisions, and to public or private enterprises operating within such countries, as well as to international or regional entities concerned with economic development in the region. Loans are made only for projects or programs of high development priority [2.2.1–2.2.2].

ADB gives technical assistance and loans for projects and programs of high-development priority

2.02. We have four primary lending types: (i) project loans; (ii) sector loans; (iii) program loans; and (iv) private sector loans, equities, and guarantees. ADB’s technical assistance (TA) operations are classified into three development activities: (i) project preparatory technical assistance (PPTA) to prepare a project, program loan, or sector loan for financing by ADB and other external sources; (ii) advisory technical assistance (ADTA) to finance institution-building; plan-formulation; or implementation, operation and management of an ADB-financed project; or a sector-, policy-, or issues-oriented study; and (iii) regional technical assistance (RETA). We encourage cofinancing from official funding agencies, export credit agencies and commercial finance institutions [2.2.3–2.2.5].

2.03. In order to sharpen ADB’s capacity to mobilize development finance and knowledge for its DMCs, ADB has also recently introduced several new financial instruments and modalities under the “Innovation and Efficiency Initiative”. These are

aimed at reinforcing flexibility and client orientation of ADB's financial products.

EA Classifications and General Treatments

ADB classifies EAs on the basis of their autonomy from government...

2.04. EAs are agencies that may be involved in designing, implementing, and/or operating a project. Such agencies may be broadly classified as:

- public sector agencies, which include central government line ministries, departments, or agencies; and provincial or state government departments or agencies; and local governments; or
- semiautonomous government agencies, public sector enterprises, or parastatal bodies such as agriculture or industrial credit banks, fertilizer corporations, public utilities, railways, and port authorities.

... and whether they are commercially oriented or generate substantial revenues

2.05. ADB also classifies projects and EAs into two distinct groups: nonrevenue-earning and revenue-earning.

Although ADB treats revenue-earning and nonrevenue-earning EAs and projects differently...

2.06. The term revenue-earning is applied to EAs and projects that are implemented, and in most cases operated, by autonomous or semiautonomous EAs that are commercially oriented, or that generate substantial revenues either by consumer charges or by forms of sector-specific local taxation (such as water supply or drainage taxes, and have authority to decide the use of these funds). EAs and projects that do not meet these criteria are termed nonrevenue-earning.

2.07. Together with other MDFIs, ADB encourages borrowers and EAs to adopt uniform accounting and financial reporting standards. However, some time will be required to achieve a high level of uniformity. The following table illustrates these categories and associated treatments [2.4].

...we encourage the adoption of uniform accounting and financial reporting standards

Sector	State-Owned (Public Sector)	Private Sector
Type of Project, Executing Agency or Implementing Agency	Nonrevenue-Earning (e.g., Health, Education)	Revenue-Earning (e.g., Power Supply) Financial Institutions
Broad Approach and Requirements	<ul style="list-style-type: none"> • Sound financial policies • Adequate accounting records • Proper internal control systems • Timely reporting to management • Sound and timely auditing • Gradual improvements in financial reporting as capacity allows 	<ul style="list-style-type: none"> • Move toward best practice private sector management, internal control and governance arrangements • Ensure that ongoing operations are sustainable • Comply with National Accounting Standards • Move toward reporting in accordance with International Accounting Standards

3. Preparing and Appraising Investment Projects

Introduction

3.01. In some cases, ADB will appraise (review) investment projects to ensure that they are technically, financially and economically viable. We consider: (i) national, sectoral, and local needs for the investment; (ii) economic and financial justifications for the proposed project; (iii) sustainability; (iv) the extent to which the project contributes to human and technological advancement; (v) good governance aspects; and (vi) whether we will be fulfilling our own responsibilities as set out in the ADB Charter [3.1.1].

Once investment projects have been designed, ADB generally appraises them to ensure that they are viable

Forecasting

3.02. Forecasts are prepared of project expenses, revenues, cash flows and other financial items. ADB works with borrower's agencies during project identification, preparation and appraisal to ensure that these forecasts are meaningful.

The forecasts of project costs and revenues ...

3.03. These forecasts should, ideally, be prepared by the borrower's agencies. However, where ADB staff or PPTA consultants prepare forecasts, it is essential that the borrower's agencies

... are the borrower's responsibility

These forecasts will be revised periodically...

...so that potential problems can be identified and addressed in a timely manner

All project costs are presented in the Project Cost Estimates Table...

own these forecasts because they are ultimately responsible for their accuracy [3.4.1.1].

3.04. ADB requires EAs to provide updated forecasts after loan signing and at the start of project implementation. These will be updated forecasts-to-completion or—in the case of revenue-earning projects—updated forecasts for a specified period. The updated forecasts provide early warnings of project problems so that timely corrective actions can be taken. For revenue-earning projects, ADB will determine the period during which EAs will be required to provide updated forecasts, and the requirement will be specified in the loan agreement [3.4.1.2].

The Project Cost Estimates Table

3.05. A Project Cost Estimates Table, which includes all project costs, is prepared at the PPTA stage (see Appendix 2). It should provide an understanding of the principal project cost components during appraisal, and useful information for project cost control purposes during implementation. It includes an allowance for contingencies. The information provided in the Project Cost Estimates Table is considered at project appraisal and during implementation by the borrower, the EA and ADB [3.4.3.1–3.4.4.5].

Eligible Cost Under ADB Guidelines

3.06. Under amended cost eligibility guidelines, ADB can now finance reasonable costs of taxes and duties related to project expenditures, acquisition of land and rights of way, late payment charges imposed by suppliers and contractors, bank charges, food expenditures, interest during construction on non-ADB loans, second hand goods, lease financing costs and local transport and insurance costs.

However, ADB financing of these is subject to the requirements as laid out in the Cost Sharing and Eligibility of Expenditures for ADB Financing, Staff Instructions paper, 15 March 2006.

Local and Foreign Costs

3.07. There is no longer a distinction between local and foreign currency costs for purposes of ADB financing and disbursement. However, for the purpose of presentation, a summary of the costs by component is to be provided in the main Report and Recommendation of the President (RRP), as “Project Investment Plan”, while detailed costs breakdown, by local and foreign currency and per component and/or expenditure category, is to be shown in the core RRP appendices as “Detailed Cost Estimates” [3.4.3.1.1].

There is no longer a distinction between local and foreign currency costs ...

Date of the Base Cost Estimates

3.08. The date of the estimates presented in the Project Cost Estimates Table will be specified in the project RRP. ADB requires that these estimates are reasonably current. If the date of the estimates:

The Project Cost Estimates Table may have to be revised so that the estimates are up-to-date

- is less than 6 months before the loan is presented to ADB’s Board of Directors—the estimates are acceptable.
- is 6-18 months before Board presentation—the estimates should be revised by indexation.
- is more than 18 months before Board presentation—the costs should be re-appraised [3.4.3.3.1].

Treatment of Financial Charges During Development

3.09. Financial charges during development (FCDDs) can include interest, commitment charges and front-end fees. FCDDs must be shown in the Project Cost Estimates Table [3.4.3.4.1].

We may agree to retroactively finance project expenditures

... on the basis of prior agreement and a special clause in the loan agreement

The Project Cost Estimates Table will include allowances for contingencies, comprising ...

... physical contingencies and ...

Requests for Retroactive Financing

3.10. Retroactive financing refers to ADB financing of project expenditures incurred and paid for by the borrower or recipient during or after appraisal but before an ADB loan or TA agreement becomes effective.

3.11. Generally, no funds can be disbursed for expenses incurred before the loan agreement becomes effective. However, based on a prior agreement between ADB and the borrower, a special clause authorizing the financing of certain expenses incurred before this date may be included in the loan agreement. This clause will show the amount of the retroactive financing, the category of expenses concerned, and the date from which the expenses may be incurred [3.4.3.5].

Determining Contingencies

3.12. Contingencies are an integral part of the expected total project cost and normally are necessary for all project items involving significant expenditures. Contingency allowances should reflect probable (forecast) physical and price changes and costs arising from special risks that can reasonably be expected to increase the base cost estimate. Contingency allowances should be separately identified in the Project Cost Estimates Table [3.4.4.1].

3.13. Allowances for physical contingencies reflect expected increases in the base cost estimates due to changes in quantities, methods, and period of implementation. Physical contingencies should be calculated in foreign and local cost terms, and expressed as percentages of the foreign and local base costs in the Project Cost Estimates Table [3.4.4.2].

3.14. Allowances for price contingencies reflect forecast increases in project base costs and physical contingencies due to changes in unit costs for the various project components beyond the date of the base cost estimates. Price contingencies should be expressed as percentages of the base costs plus physical contingencies, separately for the local and foreign expenditures of the project, and for the project as a whole [3.4.4.3].

... price contingencies

The Project Financing Plan

3.15. The Project Cost Estimates Table identifies the total financing required for a project. The Project Financing Plan illustrates project-funding requirements and identifies proposed funding sources (see Appendix 3) [3.4.6].

The Project Financing Plan ...

3.16. Funds required for the proposed project will typically be classified into:

... illustrates project-funding requirements

- capital expenditures,
- operating expenditures, and
- financial charges during development [3.4.6.6].

3.17. Proposed project-funding sources may include:

... and identifies proposed funding sources

- the proposed ADB loan,
- other loans,
- equity or capital contributions,
- subsidies for operations, and
- internally-generated cash [3.4.6.6].

Financial Cost-Benefit Analyses

ADB-financed projects must be financially and economically viable ...

... because DMCs should not take on unproductive debt

ADB has a systematic approach to financial cost-benefit analyses

3.18. ADB requires that financial and economic analyses be undertaken of projects. Both analyses have the same objective—to assess whether the proposed investment is viable. Project financial analysis examines the adequacy of returns to the project-operating entity and to the project participants. Economic analysis measures the effect of the project on the national economy, as a whole [3.5.1.1].

3.19. In financial analysis, all project-related expenditures and revenues are considered. This is necessary to: (i) assess the degree to which a project will generate revenues sufficient to meet its financial obligations; (ii) assess the incentives for producers; and (iii) ensure that demand or output forecasts on which the economic analysis is based are consistent with financial charges or available budget resources [3.5.1.3].

3.20. Economic analysis attempts to assess a project's impact on improving economic welfare. It assesses a project in the context of the national economy, rather than for the project participants or the EA implementing the project [3.5.1.1–3.5.1.3].

3.21. ADB's financial analysis process has six steps:

- preparing project cost estimates [3.4.3],
- forecasting incremental project net cash flows [3.4.7],
- determining the appropriate discount rate [3.5.2],
- calculating the financial net present value (FNPV) [3.5.3],

- calculating the financial internal rate of return (FIRR) [3.5.3], and
- undertaking risk and sensitivity analyses [3.5.4].

Financial Loan Covenants

3.22. Most DMCs are underserved by infrastructure services, particularly in poor and rural areas. In areas that do have service, systems are often badly maintained and service is unreliable. Common problems include: (i) below-cost tariffs and inappropriate tariff design; (ii) inefficient operations, with little incentive to improve efficiency; (iii) low billing and collection levels; and (iv) significant, but poorly-targeted subsidization. These problems can lead to financial losses, deterioration of facilities and limited funding for new investment.

We seek assurance that projects will be sustainable ...

3.23. To assist EAs to achieve their financial objectives—as well as governmental economic objectives that are being supported by ADB loans—ADB seeks assurance that the operational objectives of an EA agreed with the borrower would be met at least through the life of the project. These objectives are translated into loan covenants [3.6.1.1–3.6.4.4.2].

... by agreeing financial loan covenants that are designed to ...

3.24. ADB financial loan covenants are classified into:

... enhance EA performance, and

- operating covenants [3.6.2],
- capital structure covenants [3.6.3], and
- liquidity covenants [3.6.4].

3.25. Financial loan covenants are designed to: (i) support socioeconomic development; (ii) promote financial viability, financial performance and prudent financial management of the EA;

... ensure that loan proceeds are used effectively

(iii) develop local capability; (iv) assist the EA to achieve a creditworthy status to facilitate acceptance in capital markets; (v) protect the borrower's and ADB's financial interests; and (vi) provide a basis for monitoring by government regulatory agencies, and ADB, of the EA's financial performance [3.6.1.2].

4. Financial Management of Executing Agencies

Introduction

4.01. The primary objective of the financial management process is to optimize financial and economic benefits from an investment. Financial management systems include the policies and practices regarding financial planning, programming, accounting, reporting, auditing, funding, organization, and personnel of a project or of an EA [4.1].

Sound financial management systems help ensure that project benefits are optimized

4.02. EAs should plan, develop and maintain financial management systems that can provide timely and reliable information suitable for monitoring the project's and the EA's progress toward ADB-agreed objectives. The information should also provide early warnings of project implementation and EA management problems.

They should provide timely and accurate information ...

4.03. EAs should also have an effective control environment, including internal control systems that provide assurance that financial records are reliable and complete, including adherence to management policies, orderly and efficient conduct of the borrower's business, and proper recording and safeguarding of assets and resources [4.2.1].

... and operate within an effective control environment

4.04. ADB assesses the financial policies and the capacity of the financial systems practiced or proposed by the borrower/EA to support project

We assess the effectiveness of these systems

implementation and operation. The EA should be capable of providing correct and timely information on project implementation progress and, where appropriate, on its operation. ADB must also be assured that the expenditures incurred on a project are used for the purposes stated in the loan agreement [4.1–4.2.1.7].

ADB Financial Management Assessments

Assessment Objectives

Our objective is to assess the EA's financial management capacity to implement projects

4.05. The general objective of ADB assessments is to ensure that EAs are technically, managerially, and financially capable of efficiently and effectively implementing the proposed projects or programs. The specific appraisal objectives are to: (i) determine whether institutional capacity, in terms of financial management, justifies loan approval; (ii) identify the institution's financial management development needs—both project related and long term—that should be addressed either as a project component or by TA; and (iii) confirm that the financial management system is sustainable [4.1.3].

Assessment Scope and General Approach

While the assessment's exact scope will depend on our involvement with the EA ...

4.06. The scope of the financial management assessment will depend upon the extent and type of dealings ADB has with the EA concerned, the EA's experience in implementing projects, and the extent and nature of previous institutional strengthening [4.2.1.7].

... it will involve a review of the EA's financial management capacity and identification of any specific deficiencies

4.07. The financial management assessment will generally include: (i) analyzing the EA's structure and management framework with regard to financial management; (ii) assessing the agency's resources, including the number, quality, and

technical capabilities of its staff, the extent of financial and budgetary support it obtains, the nature of technology, equipment, and software in use; (iii) assessing the agency's operating results; and (iv) identifying specific performance shortfalls or variances [4.2.1.7].

4.08. Finally, ADB will examine performance shortfalls to identify specific institutional deficiencies and possible institutional-strengthening actions. Deficiencies will be classified into those relating to the management framework and those due to resource constraints [4.2.1.7].

ADB then considers possible actions to address those identified deficiencies

General ADB Financial Management Expectations

Financial Policies

4.09. ADB requires that projects be designed, developed and operated within the framework of the financial policies, strategies and systems prescribed by those government institutions that are responsible for national and sectoral economic and financial planning [4.2.4].

Project operations should be consistent with government financial policies ...

Project Objectives

4.10. Project objectives should be clearly defined. They should include sustainable economic goals, financial objectives, time-bound delivery of benefits, and financial viability. As a minimum, financial viability means that adequate funds will be available to finance day-to-day operations and maintenance [4.2.4.1.2].

... project objectives should be clearly defined ...

Project Implementation Plans

4.11. ADB also recommends that borrowers develop project implementation plans. Project plans help borrowers set realistic goals for each operating

... and project implementation plans should be developed

period. They also establish the basis for preparing and implementing project financial management requirements, internal controls, and financial reporting arrangements.

4.12. Project plans should include:

- time-bound implementation tasks for each project component (including TA and training);
- procurement actions with target dates for each step;
- disbursement schedules for each project component and expenditure category;
- funding schedules reflecting expected ADB financing, government counterpart funds and cofinancing arrangements;
- actions required to achieve project development objectives; and
- actions to establish project accounting and financial management systems (including auditing arrangements).

Disbursement Procedures and Fund-Flow Mechanisms

Disbursement procedures and fund-flow mechanisms should be appropriate to DMC and project circumstances

4.13. Loan disbursement is a key element in the project cycle. ADB expects that proposed disbursement procedures and fund-flow mechanisms will be suitable for the particular project. ADB procedures for withdrawal of loan proceeds are standardized to facilitate disbursements under most loans. Disbursement procedures comprise four major types:

- direct payment procedure where ADB, at the borrower's request, pays a designated beneficiary directly;

- commitment procedure where ADB, at the borrower's request, provides an irrevocable undertaking to reimburse a commercial bank for payments made or to be made to a supplier against a letter of credit financed from the loan account;
- reimbursement procedure where ADB pays from the loan account to the borrower's account or, in some cases, to the project account for eligible expenditures which have been incurred and paid for by the project out of its budget allocation or its own resources; and
- imprest fund procedure where ADB makes an advance disbursement from the loan account for deposit to an Imprest Account to be used exclusively for ADB's share of eligible expenditures.¹

Expectations of Revenue-Earning EAs

4.14. This section describes relevant ADB expectations of revenue-earning EAs and projects (see paragraphs 2.05–2.07).

We expect revenue-earning EAs and projects ...

Planning and Budgeting

4.15. Long-, medium- and short-term planning should be the primary elements in financial

... to have satisfactory planning and budgeting procedures ...

¹ The *Loan Disbursement Handbook* describes ADB loan disbursement procedures in detail (see www.adb.org). Furthermore, the Loan Financial Information Web Service (<http://lfiis.adb.org>) is designed to meet users' needs for accurate, on-demand financial information about loans to facilitate decision-making. The website provides detailed loan portfolio data and selected reports with facilities for downloading. Estimated debt service payments and disbursement manuals directly related to loan operations are also available to specified users.

management. Long- and medium-term plans are often referred to as corporate plans. Short-term financial plans are usually called budgets. ADB will seek assurance that satisfactory plans and budgets will be prepared in a regular, orderly and timely manner [4.2.8.3].

... and consistent accounting policies

Accounting Policies

4.16. ADB will consider the acceptability of accounting policies, including standards of financial reporting and general accounting practices. ADB expects these policies to be materially consistent with accepted national or international standards and practices [4.2.8.4].

Acceptable financial regulations should be in place ...

Financial Regulations

4.17. A sound accounting system is underpinned by financial regulations. These are usually designed to define the objectives of—and responsibilities within—the financial management system. ADB expects acceptable financial regulations to be in place [4.2.8.5, 4.2.8.9].

... and accounting information systems must be adequate

Accounting Information Systems

4.18. To ensure accountability for project implementation funds, each project (and, where applicable, each EA) should have an adequate accounting and internal control system for recording and reporting project-related financial transactions from the time that project expenditures commence—which could be before ADB Board approval of the loan. There are no exceptions to this requirement [4.2.8.6.3].

4.19. Specifically, accounting information systems should:

- be simple to operate;
- require staff to operate with minimum supervision, and have the necessary personnel trained to operate the system from project start-up;
- at a minimum, provide records of project receipts and expenditures generally from the date of first transactions;
- where available, have information technology systems that are modern, efficiently managed, and fully responsive to the needs of management of the EA and the proposed project;
- have adequate internal checks and controls; be able to balance financial data frequently and to report project financial results at intervals and within the time frame required by ADB;
- where needed, meet requirements for Statements of Expenditure (SOEs) and Imprest Fund records; and
- be capable of expansion, when necessary, to meet the increasing demands for financial data arising from expanding project activities or entity operations.

Accounting information systems should be simple to operate and be appropriate to EA and project needs

Internal Controls and Internal Audit

4.20. ADB's primary concern is to be assured that internal controls exist and are monitored regularly to ensure they are efficient and responsive to current operations [4.2.8.7–4.2.8.8.5].

Internal controls should be effective ...

... and management accounting systems should be adequate

Management Accounting

4.21. A management accounting system should collect and promptly report financial and related statistical information on all aspects of the operating performance of an agency's operations to the various management levels, supplying each level with the necessary details at the appropriate times.

4.22. ADB seeks assurance that the EA's management accounting system can produce the annual and periodic financial statements, including the statements for audit. It should also incorporate procedures for recording current budgeting and financial planning data, record keeping and reports, and cost accounting (including cost control and analysis) for recording costs [4.2.8.10].

Expectations of Nonrevenue-Earning EAs

Many nonrevenue-earning projects will have simple financial management arrangements

4.23. The financial management arrangements of nonrevenue-earning projects and EAs can vary substantially between DMCs. Many will use simple, cash-based accounting. This section describes relevant ADB expectations of nonrevenue-earning projects and EAs (see paragraphs 2.05–2.07).

Financial Management and Accounting Systems

4.24. For nonrevenue-earning EAs, the financial management system should support accounting procedures throughout project implementation [4.2.9.2].

Nevertheless, basic accounting records should be maintained...

4.25. In nonrevenue-earning projects, the system should be kept simple. An analytical cashbook, showing receipts and payments (classified by project activity and payee), could form a satisfactory basic accounting tool. It could be supplemented by additional documents (e.g., asset registers, contract registers, and inventory systems) as the needs for these arise during implementation [4.2.9.2.3].

4.26. A basic system should include internal controls, which separate responsibilities between those who approve budgets, authorize allotments, approve budgeted expenditures, make cash payments, keep the books of account, and reconcile cash and bank balances with the books of account. Where staff numbers are too small to adequately separate responsibilities, alternative arrangements should be implemented. For instance, actions might be jointly executed by two people (e.g., two signatures on checks) [4.2.9.2.5].

... appropriate internal controls should be established ...

Planning and Budgeting

4.27. ADB's expectations of planning and budgetary control for revenue-earning EAs (see paragraph 4.15) are the same for nonrevenue-earning EAs [4.2.9.5].

... and planning and budgeting systems should be adequate

Financial Accounting and Costing

4.28. ADB prefers that an EA maintains at least the records described in paragraphs 4.31–4.33, but in some accounting systems many such records—particularly control accounts—may not be maintained [4.2.9.6.1].

4.29. EA systems must support timely disclosure of: (i) cumulative and annual project costs by components agreed on between ADB and the EA for each project, (ii) operating costs analyzed in sufficient detail to provide control of incremental current expenditures, and (iii) the basis for all types of claims for disbursement of ADB loans [4.2.9.6.4].

EA systems should support timely disclosure of project transactions

Internal Control

4.30. If internal control mechanisms are unsatisfactory, and the effectiveness of the external audit is not established, then the project will generally not be allowed to proceed until the borrower/EA agrees to strengthen these mechanisms [4.2.9.7].

Projects will generally not proceed until control mechanisms are satisfactory

A simple system for a nonrevenue-earning project will be based on unsophisticated accounting records...

...which will ideally be supplemented by a general ledger that includes additional balances and information

A Simple System for a Nonrevenue-Earning Project

4.31. The following is a simple system for a nonrevenue-earning project. It should be modified as necessary to meet specific project and ADB requirements.

- Project Entity Bank Account Record, by categories of expenditures
- Project Entity Cash Payment Record, by categories of expenditures
- Record of Project Expenditures incurred but not paid by categories of expenditures
- Record of Project Expenditures by Third Parties by categories of expenditures
- A Summary of the above to produce Total Project Expenditures by categories of expenditures
- Record of Sources of Project Financing including ADB (and other lenders') loan disbursement claims [4.2.9.8.1]

4.32. It is also desirable that a simple general ledger be used to record payment totals and receipt totals (by week or by month). This ledger, in addition to recording summary amounts for the above accounts, should record assets, liabilities, contracts and currency transactions [4.2.9.8.2].

4.33. Corrections and adjustments to the data entered in the basic records can be made at any time before entries are summarized in general ledger entries. Changes to data already recorded in the General Ledger will need special entries in that ledger, preferably using journals [4.2.9.8.3].

5. Financial Reporting and Auditing

Introduction

5.01. ADB requires accurate and timely financial information from its borrowers to be assured that project expenditures were used for the purposes stated in the loan agreement and to satisfy ADB regarding project and EA economy and efficiency.

To ensure that ADB receives accurate and timely financial information...

5.02. To support this requirement, ADB reviews accounting and auditing arrangements during project preparation to ensure that these meet acceptable standards and practices. Moreover, ADB loan and project agreements include relevant financial management and audit covenants.

... we review accounting and auditing arrangements and agree relevant covenants

Accounting Standards and Policies

Introduction

5.03. ADB is concerned about the accurate interpretation of the financial position and performance of its borrowers and EAs. However, the preparation and reporting of accounting information vary widely among countries and contributes to a substantial lack of transparency and consistency in financial reporting [5.2.1].

Because financial reporting practices vary widely among DMCs ...

5.04. ADB, together with other MDFIs, encourages borrowers and EAs to adopt uniform standards of accounting and financial reporting. In this respect, ADB recommends that:

... ADB encourages the adoption of uniform standards of accounting and financial reporting

Financial statements must include a statement of accounting policies

... that is acceptable to ADB

This may be quite simple for a nonrevenue-earning EA

- Revenue-earning EAs comply with national accounting standards and move toward reporting in accordance with the International Accounting Standards (IAS), as capacity and resources allow. However, some time will be required to achieve a high level of uniformity.
- Nonrevenue-earning EAs in the public sector should follow and maintain sound financial policies, adequate accounting records, proper internal control systems, timely reporting to management, and sound auditing practices [5.2.1.3].

ADB Accounting Policy Requirements

5.05. Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements. Financial statements must include a Statement of Accounting Policies. An example is presented in Appendix 4 [5.2.3.5].

5.06. ADB will seek to agree the acceptable accounting standards and policies governing the preparation of financial statements not later than at loan negotiations [5.2.3.1.2].

Nonrevenue-Earning EAs

5.07. In the case of nonrevenue-earning EAs, Statements of Accounting Policies are likely to be simple. For instance, they may cover only cash-recognition policies [5.2.3.5].

Revenue-Earning EAs

5.08. In general, financial statements for private sector companies and organizations, and for revenue-earning public sector EAs, should be prepared in accordance with IAS-compliant accounting policies. Alternatively, ADB may accept audited annual financial statements of projects or EAs that are based on national or other defined standards, provided that the Notes to the Financial Statements include realignments and adjustments of the financial information in the audited annual financial statements to provide a report in accordance with IASs [5.2.3.1.2].

But, for most revenue-earning EAs, ADB expects IAS-compliant accounting policies ...

5.09. ADB therefore recommends that all public and private sector revenue-earning EAs should move to account and report for ADB-financed projects on the basis of IAS-compliant accounting policies current at the date of loan negotiations, or any other date in the project implementation period agreed between ADB and the borrower (see paragraph 5.04). Borrowers and EAs should adopt IAS-compliant accounting policies by an agreed date. Until this time, financial statements should be prepared in accordance with a set of accounting policies acceptable to ADB and noted in the minutes of loan negotiations [5.2.3.1.3].

... these may take time to be introduced

5.10. In some cases, national accounting standards and practices will not conform to accepted international standards. Where only minor items are involved (for instance, overhead allocation methods or inventory-valuation policies), the continued use of these standards and practices may be acceptable so long as the variances are quantified and disclosed in the Notes to the Financial Statement and in the Auditor's Report [5.2.3.2.2–5.2.3.2.3].

All significant variances should be quantified

For existing projects, the introduction of these requirements will be negotiated on a case-by-case basis

ADB seeks to receive acceptable interim and annual audited financial statements

Periodic progress reports are required on financial matters and compliance with agreed covenants

5.11. ADB recognizes that some time will be required for borrowers and EAs to adopt IAS-compliant accounting policies and will negotiate with existing borrowers on a project-by-project basis for the timing of their introduction [5.2.3.2.4].

Financial Reporting

Introduction

5.12. To ensure that adequate, timely, and reliable information is provided for project monitoring purposes, ADB seeks early agreement to receive acceptable interim and annual Audited Financial Statements for each financial year [5.3.1.1].

5.13. ADB typically requires the submission of periodic progress reports, including financial reports, covering:

- the progressive interim, annual, and final costs of a project;
- the financial performance and financial position of an EA (where appropriate);
- accountability for the funds, including ADB loans, provided for project implementation;
- the bases for disbursements of ADB loan proceeds;
- the extent of compliance with financial and related covenants; and
- the effectiveness of project-related financial management and accounting systems as specified by ADB and agreed to by the borrower [5.3.1.2].

5.14. Borrowers and EAs should notify relevant parties of ADB's requirements, including: (i) responsible government ministries; (ii) government auditors mandated by law to audit

EA accounts; and (iii) private auditors acting on behalf of government auditors [5.3.1.4].

Content and Timing of Financial Reporting

Universal ADB Requirements

5.15. The following basic principles apply to **all** interim and annual project financial statements issued by borrowers:

- English-language presentation [5.3.2.6 and 5.3.2.8];
- disclosure of full accountability for all funds of the borrower, other donors and lenders, and ADB;
- compliance with loan covenants and ADB requirements for project management;
- adequate disclosure of all material information; and
- a true and fair view, or a fair presentation in all material respects, of the financial performance and status of the project and of the EA (where applicable) [5.3.2.2].

All interim and annual financial statements must be presented in English ...

5.16. In addition, the following fundamental principles apply to **annual** financial statements: (i) a clear statement on the accounting policies and accounting standards adopted; and (ii) the results of an independent review of the financial accounts and financial management systems by an auditor acceptable to ADB [5.3.2.3].

... and annual financial statements must be audited

5.17. Interim and annual financial statements relating to each project should show sufficient information to identify separately the transactions relating to the reporting year and the cumulative transactions from the start-up date [5.3.2.4].

Annual and cumulative balances should be disclosed ...

... and separate financial statements should be provided for each subproject

Audited Financial Statements should be submitted to ADB not more than 6 months following the end of the fiscal year or project closing date

5.18. Interim and annual statements may combine financial transactions of a project with those of the EA, where the EA was established solely to develop the project [5.3.2.6].

5.19. Where an EA is responsible for implementing defined subprojects, separate financial statements should be provided for each defined component together with a consolidated financial statement for the complete project. Where an EA is responsible for developing more than one project, common or joint project financial transactions of the agency may be apportioned and allocated to each project on a basis defined in the Notes to the Financial Statements [5.3.2.7].

5.20. Borrowers are asked to provide interim and audited Annual Financial Statements in accordance with an ADB-agreed timetable. Interim financial reports are normally required at intervals of 3, 4 or 6 months of each financial year. Audited financial statements (for the EA, project accounts, and imprest fund as applicable) should be submitted to ADB not more than 6 months following the end of the fiscal year or project closing date (whichever is first) [5.3.2.9].

5.21. Where Audited Financial Statements are to be first submitted to a government legislature—with the risk of delaying provision of the Audited Financial Statements to ADB—a draft thereof (certified by the chief financial officer and the auditor) should be submitted to ADB within the required reporting timetable, with subsequent confirmation after they have been ratified by the legislature [5.3.2.10].

5.22. Interim and annual financial statements should normally be presented in the local currency, with the basis for translation of any foreign exchange transactions or commitments explicitly stated [5.3.2.11].

Financial statements should (normally) be presented in the local currency

Specific Requirements for Nonrevenue-Earning Projects

5.23. ADB recognizes that many project financial statements—particularly those prepared for nonrevenue-earning projects—are of a special purpose nature. Consequently, ADB requires that financial information submitted by nonrevenue-earning entities adhere to an appropriately designed format acceptable to ADB [5.3.2.1].

For nonrevenue-earning projects, audited annual statements are required for each year of project development and implementation

5.24. Audited annual financial statements of nonrevenue-earning projects are required for each financial year of project development and implementation [5.3.2.6].

Specific Requirements for Revenue-Earning Projects

5.25. For a revenue-earning project, ADB requires audited annual financial statements of the project and of the EA for the period of the loan. Along with the audit report which expresses the audit opinion following the audit of the annual financial statement, ADB also requires a management letter, by agency if there is more than one EA, from the auditors. The reports on the project may be incorporated within EA financial statements provided that the statements explicitly describe the project's financial status and performance for the financial year, the previous financial year and from start-up. Interim financial reporting should follow the format of the annual financial statements, but should cease on completion of ADB disbursements [5.3.2.8].

The financial statements of revenue-earning projects may be incorporated within the EA's financial statements

The financial reporting requirements for revenue and non-revenue projects...

... and EAs usually differ...

... the most significant difference is that many nonrevenue-earning projects and EAs use cash accounting

Accounting Statements and Financial Reports

5.26. The table on the opposite page summarizes the financial reporting requirements for projects and EAs. While the reporting requirements for revenue-earning projects and EAs are uniform, those for nonrevenue-earning projects and EAs are not [5.3.3.1].

5.27. The most significant difference among the financial reports of nonrevenue-earning projects and EAs depends on whether entities use the accrual or the cash accounting basis.

- Under the cash basis of accounting, nonfinancial assets (for instance, fixed assets, receivables, and inventories) will not be systematically recorded. Consequently, the information that is necessary to prepare Income Statements and Balance Sheets will not be available; instead, Statements of Cash Receipts and Payments will be prepared.
- Where accrual accounting is used, Statements of Income and Expenses will be prepared along with Balance Sheets. Accrual statements should always be supplemented with a Cash Flow Statement. While many ADB DMCs have signaled their intention to adopt the accrual basis of accounting, this will take many years. However, nonrevenue-earning entities in some countries that have historically used the Soviet Accounting System (e.g., Uzbekistan), may prepare accrual-based financial statements [5.3.3.2].

5.28. Statement of Accounting or Financial Policies. Irrespective of whether the cash or accrual accounting basis is used, a clear statement of the accounting or financial policies that underlie the accounting statements must be provided [5.3.3.4].

A clear statement of accounting policies must be provided

5.29. The Statement of Income (Cash Receipts) shows the year's complete financial information and cumulative data from project start-up. Where the cash accounting basis is followed, the opening and closing cash balances should be shown [5.3.3.5]

Accounting Statements and Financial Reports

Accounting Statement	Nonrevenue-Earning Projects and EAs		Revenue-Earning Projects and EAs	
	Interim (PMRs)	Annual Audited	Interim (PMRs)	Annual Audited
Statement of Accounting/ Financial Policies	...	✓	...	✓
Statement of Income (Cash Receipts)	✓	✓	...	...
Statement of Expenses (Cash Payments)	✓	✓	...	...
Cash Flow Statement	✓ note (a)	✓ note (a)	✓	✓
Imprest Account Statement	✓	✓	✓	✓
Statement of Expenditures	✓	✓	✓	✓
Income Statement	These statements are usually not prepared, as most nonrevenue-earning projects currently use the cash basis of accounting		✓	✓
Balance Sheet			✓	✓
Notes to the Financial Statements	✓ note (b)	✓ note (b)	✓ note (b)	✓ note (b)
Other Information	✓ note (c)	✓ note (c)	✓ note (c)	✓ note (c)

EA = executing agency; PMR = project management report.

- The content and format of Cash Flow Statements for nonrevenue-earning projects (and EAs) will not necessarily conform to IAS or to national accounting standards.
- The notes to the financial statements provide further breakdowns or explanations of the information provided in the main financial statements.
- The scope and nature of other information will be negotiated between ADB and the borrower.

5.30. The **Statement of Expenses (Cash Payments)** shows the year's financial information and cumulative totals from project start-up to the current date. Where the accrual basis of accounting is used, this statement will include noncash items, such as depreciation [5.3.3.6].

The Cash Flow Statement should disclose financing sources and payments in accordance with disbursement categories

5.31. The **Cash Flow Statement** should include:

- sources of project financing (for example, ADB and government contributions) by disbursement methods (for example, direct payment, imprest account);
- uses of funds summarized under project disbursement categories as per the loan agreement (for example: equipment, civil works, consultant services and training);
- others, which may be further subdivided following start of project implementation); and
- the opening and closing cash balances [5.3.3.7].

5.32. The **Imprest Account Statement** summarizes ADB's advances and replenishments, less amounts withdrawn by the project entity, showing the remaining cash balance in the Imprest Account [5.3.3.8].

The Imprest Account Statement summarizes advances and replenishments, less withdrawals and the remaining cash balance in the Imprest Account

5.33. Bank statements should be provided for each Imprest Account (where used). Each bank statement should summarize the current year's advances and replenishments, interest earned on balances, less withdrawals for project expenditures. The first account is used to receive money from ADB for the credit of the "Project Imprest Account" and the second may be used by the project for local

operating purposes (Second Generation Imprest Account, SGIA). The Project Imprest Account is to be used to replenish the SGIA (when used). It is necessary to attach Reconciliation Statements to reflect in-transit items between ADB and the Imprest Account and between Imprest Account and the SGIA. The third financial statement is a detailed statement of transactions of the Imprest Account's Operating Account(s). This is to be generated by the EA, where the Imprest Account is used to make direct payments in local and foreign currency [5.3.3.9].

5.34. The **Statement of Expenditures (SOE)** procedure is an ADB reimbursement procedure that does not require submission of supporting documentation. The SOE form should include certification, confirming existence of registration for mobilization and secured advances/deposits. ADB's *Loan Disbursement Handbook* describes the use of this method and associated reporting and auditing procedures [5.3.3.10].

Income Statements reflect financial performance. . .

5.35. **Income Statements and Balance Sheets** may not be necessary where cash accounting is used. Income Statements show the financial results of activities for a period. Balance Sheets show all financial items owned and owed at a certain point in time [5.3.3.11].

. . . and Balance Sheets show financial position

5.36. The Notes to the Financial Statements should be explanatory notes and/or supplementary financial statements that analyze or qualify important heads of account, or that present the information in conformity with generally accepted accounting practices of the country [5.3.3.12].

Interim Financial Statements and Project Management Reports

ADB requires regular submission of PMRs

5.37. During the course of each financial year, ADB requires project management reports (PMRs) as part of the system for monitoring a project's performance. The PMR is required on a periodic basis, and is designed to assist the EA to maintain regular control of project performance. The PMR financial statement is an interim financial statement that is a useful tool for reviewing progress and for planning, and is recommended for all projects. A sample PMR is attached as Appendix 5 [5.3.4.1].

Appendix 5 provides an example of a PMR

PMRs compare actual and budgeted amounts ...

5.38. The information in the PMR should be provided in respect of: (i) the most recent completed financial period (normally a quarter or half-year), (ii) the year-to-date totals, and (iii) cumulative totals-to-date from the beginning of the project [5.3.4.2].

... and identify and explain significant variances

5.39. The PMR should also show, for each line item, the planned or budgeted amounts for comparison with the actual reported information, with variances shown between actual and the plan. Explanations should be attached to the PMR with respect to significant variances for use in managing and monitoring the project [5.3.4.3].

Our expectations of audited annual financial statements depend on whether projects are revenue or nonrevenue earning

Audited Annual Financial Statements

5.40. Audited annual financial statements should be provided to ADB to fulfill the fiduciary requirements of the borrower, cofinanciers, donors and ADB. These financial statements may be classified into two broad categories:

- Annual financial statements for nonrevenue-earning projects. The statements may also include information on the performance and status of the EA

where the EA has no other financial performance commitments to ADB under a loan agreement; and

- Annual financial statements for revenue-earning projects and for project EAs, where the EA is an autonomous or semiautonomous revenue-earning entity with responsibility for project implementation [5.3.5.1].

Annual Statements for Nonrevenue-Earning Projects

5.41. EAs should only prepare annual financial statements for projects, particularly where the project is nonrevenue-earning and is implemented by organizations of national, provincial, state or regional and/or local governments. EA-related financial transactions may be included as line items in project income and expenses [5.3.6.1].

For nonrevenue-earning projects, ADB generally expects financial statements only for the project—not for the EA

5.42. The statements may take the following forms and may be produced in the local budgetary and accounting formats for the project and, where applicable, for the EA concerned:

- Statement of Income (or Cash Receipts),
- Statement of Expenses (or Cash Payments), and
- Notes to the Financial Statements [5.3.6.2].

Annual Statements for Revenue-Earning Projects and EAs

5.43. Borrowers are asked to provide ADB with annual financial statements in respect of each autonomous or semiautonomous EA that plays a substantive role in implementing and/or operating a project having revenue-earning characteristics. These financial statements should contain details sufficient to identify the financial performance and

... whereas, for revenue-earning projects, we generally expect EA financial statements that incorporate project information

status of the project or EA. Normally these should comprise:

- a Balance Sheet showing the financial position of the entity, including the project, at financial year-end,
- an Income (or Operating, or Income and Expenditure, or Profit and Loss) Statement,
- a Cash Flow Statement that should disclose the cash flows during each financial year, and
- notes to the Financial Statements [5.3.7.1].

In both cases, financial statements should include comparative figures and explanatory notes

5.44. Financial statements should include comparative figures for the preceding financial year together with supporting schedules and explanatory notes. Supplementary financial statements should be provided containing ADB-requested information regarding items requiring additional disclosure or explanation [5.3.7.2].

Supplementary Financial Statements

5.45. ADB will normally specify the form and content of supplementary financial statements to be attached to the standard annual financial statements, but borrowers should include all information that is considered informative and appropriate to illustrate the performance of project implementation and operation [5.3.8.1].

Model Financial Statements for Revenue-Earning EAs

5.46. Appendix 6 and Appendix 7 present model financial statements for a service and a manufacturing organization, respectively [5.3.11, 7.16–7.17].

Auditing Standards and Auditor Engagement

Introduction

5.47. An audit's overall objective is for the auditor to express an opinion as to whether the financial statements present a true and fair view of the project(s) and, where applicable, of the EA, or are similarly presented fairly in all material respects, in conformity with IAS or other ADB-accepted standards, and applied on a basis consistent with that of the preceding year [5.4.1.1].

Auditors examine financial statements ...

5.48. The auditor's opinion is necessary to establish the credibility, or otherwise, of the financial statements of an EA. The examination should be of such scope and depth to allow the auditor to give an opinion and make a report on the veracity, accuracy and fairness as regards the presentation of the financial statements of an EA or a defined part thereof (such as a project, a project unit, or a department or division). These financial statements may be annual, periodic, or ad hoc (i.e., relating to special reports) [5.4.1.2].

... and express an opinion on their veracity, accuracy and fairness

ADB Audit Requirements

5.49. ADB requires the borrower and the EA to have the required financial statements for each year audited by an independent auditor acceptable to ADB, and in accordance with standards on auditing that also are acceptable to ADB. An audit of such financial statements includes:

We require annual financial statements to be audited ...

- an assessment of the adequacy of accounting and internal control systems with respect to project expenditures and other financial

... in accordance with acceptable auditing standards

- transactions, and to ensure safe custody of project-financed assets;
- a determination as to whether the borrower and project implementing entities have maintained adequate documentation on all relevant transactions;
- confirmation that expenditures submitted to ADB are eligible for financing and identification of any ineligible expenditures; and
- compliance with loan covenants and ADB's requirements for project management [5.4.2].

ADB recognizes IAASB and INTOSAI auditing standards . . .

Auditing Standards

5.50. ADB recognizes the International Standards on Auditing (ISA) promulgated by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) and the auditing standards of the International Organization of Supreme Audit Institutions (INTOSAI). ISAs are widely adopted by the international accounting profession and many national professions. They form the benchmark for standards on auditing acceptable to ADB for audits in the public and private sector. Many auditors general and their equivalents use the INTOSAI auditing standards [5.4.2.2].

. . . and prefers that auditors conform to these standards

5.51. ADB prefers borrowers to engage auditors who will conform to ISA. However, it recognizes that—in some countries—auditors apply local, generally accepted auditing standards that may not conform to, or fully comply with, the ISA, but that have been prescribed by a country's law, or have been adopted by public accountants or associations of accountants in the country concerned [5.4.2.3].

5.52. Supplementary auditing and reporting procedures may be requested by ADB, if necessary, to confirm accountability and financial performance in cases where ADB considers that local auditing standards need to be supplemented. ADB would expect auditors to indicate in their report the extent of differences, and the impact of the audit, of use of local auditing standards compared with the application of ISAs [5.4.2.4].

ADB may require supplementary auditing procedures in some cases

Auditing Procedures

5.53. Auditors should understand the project and the entity being audited, including the contents of the RRP and legal agreements. Further guidance is available from the: (i) ADB Loan Disbursement Handbook; (ii) ADB Sample bidding documents; and (iii) ADB Procurement Handbook [5.4.3.2].

ADB expects auditors ...

... to understand the auditee and ADB policies and procedures ...

5.54. Auditors should ensure that any country-specific variations in accounting standards and practices that are adopted by the borrower, and that differ substantially from IAS, should be disclosed. Any significant effects on project financial performance or status, because of non-conformance with IAS, should be disclosed [5.4.3.7].

... to identify the impacts of variances in accounting practices ...

5.55. ADB expects audits to include: (i) an examination of assets and liabilities; (ii) an examination of commitments and contingent liabilities; (iii) confirmation of debtors, creditors and inventory; (iv) an examination of variations from IAS; (v) a review of the periodic PMR for each year; (vi) an audit of SOEs (where required) as a part of the overall project audit; and (vii) an audit of the Imprest Accounts [5.4.3].

... and to conduct work of acceptable scope

Auditor Selection and Appointment

Although borrowers are responsible for auditor selection, appointment and performance ...

... auditors must be acceptable to ADB

ADB expects auditors ...

...to be independent...

... to be reputable ...

... and to have relevant experience

5.56. ADB will ask borrowers to remove unacceptable restrictions, or otherwise arrange for an acceptable audit to be conducted. A borrower is responsible for the selection, appointment and performance of an auditor. ADB wishes to be informed by a borrower of an ongoing or proposed appointment of an auditor, who should meet required standards in terms of independence, experience and competence. More specifically, ADB will indicate the acceptability of an auditor in the form of a “no objection” [5.4.4.2].

5.57. To be acceptable to ADB, auditors must be:

- impartial and independent of the control of the entity to be audited and of the person appointing them. In particular, they should not—during the period covered by the audit—be employed by, serve as directors of, or have family, financial, or close business relationships with the entity, except as auditors, during the period of the audit;
- well established and reputable, use procedures and methods conforming with ISA or INTOSAI standards, and employ adequate staff with appropriate skills and competence required for their responsibilities;
- experienced in the types of assignments they are to undertake for the ADB project; and
- able to fulfill their terms of reference (TOR) within the specified timetable [5.4.4.2].

5.58. ADB requires that the borrower and EA select and appoint an acceptable auditor within sufficient time to carry out its responsibilities, including a review of the financial management systems at the beginning of project implementation, and periodically thereafter [5.4.4.3].

ADB requires that auditor appointments be made in a timely manner ...

5.59. ADB does not normally advise on the selection of auditors, but prefers to review a list of several auditors submitted from whom an appointment will be made by the borrower, and indicate any auditor who may not meet ADB's criteria. ADB will indicate its agreement to a proposal to engage an auditor when it is satisfied that an existing auditor, or the auditor under consideration for engagement, would be acceptable to ADB in terms of independence and competence to carry out the audit [5.4.4.4].

... and prefers to review a list of auditors and indicate those who may not meet our criteria

Issues in Auditor Selection

5.60. The scope and detail of an audit may depend upon laws or regulations that constrain a government auditor from providing the depth of examination required by ADB [5.4.5.1].

5.61. The following are unlikely to be acceptable auditors for ADB lending operations:

We expect auditors to act independently ...

- government auditors whose staff may be required by laws or regulations to participate in the processing of financial transactions,
- auditors who assist EAs to prepare the annual financial statements, or
- auditors who design and construct components of the EA's financial management system [5.4.5.1].

... but where this is just not possible, we expect auditors to distance themselves from decision making and management

Auditors must be able to commence work at project start-up

ADB will accept government auditors for revenue-earning projects on the basis of a capacity review

5.62. In certain instances, resource constraints may cause the borrower and EA to request auditors to compile part or all of the financial statements. When this occurs, to be eligible to carry out the audit, the auditor should have no part in any aspect of EA decision-making or management. The extent of the auditor's involvement in accounting should be discussed in the Management Letter [5.4.5.2].

5.63. Auditors must be able to commence work at project start-up. Therefore, borrowers should appoint auditors before the start of each financial year. Borrowers are expected to provide ADB with an assurance that the auditor has been notified of ADB's requirements, including the timing of the audit and issuance of the auditor's report. This will be no later than the project start date, or the date on which the ADB Board approves the loan, whichever is earlier [5.4.5.3].

5.64. Where a government auditor is to serve during execution and operation of a revenue-earning project until the loan period expires, the borrower is expected to assure ADB that the government auditor will begin and complete the audit operations within the required timetable [5.4.5.4].

5.65. Auditors for public sector projects and public sector EAs may be drawn from commercial or state audit practitioners. Government auditors will not be acceptable for private sector projects and for public sector EAs of revenue-earning entities, unless confirmed by ADB when a review of capacity, capability, and ongoing performance has been conducted [5.4.6.1].

5.66. The EA (or its controlling authority) is normally responsible for selecting and appointing auditors, except where a government auditor is

required by law to provide the service. Therefore, where no auditor is currently engaged, early steps should be taken to ensure that borrowers engage an acceptable auditor by the date of loan signing or project start-up [5.4.6.2].

5.67. Auditors' engagements should be kept under review to ensure consistent quality of performance, including the ability to adapt to changes in an entity's accounting and general operations, and to adopt improved audit techniques [5.4.6.7].

Borrowers should monitor auditor performance ...

5.68. Consequently, ADB encourages borrowers to restrict audit engagements to relatively short-term assignments [5.4.6.8].

... and auditor appointments should be for a suitable period

5.69. Some countries appoint auditors each year. However, engagements should be long enough to enable the auditor to become familiar with the auditee, but short enough to facilitate a change of auditor, if necessary. Engagements of 3–5 years are in the optimum range [5.4.6.9].

Terms of Reference for an Auditor

5.70. ADB requires that auditors' opinions be of such scope and detail as ADB may reasonably request, and requires that a TOR acceptable to ADB be prepared for each audit. For different types of audits, the scope of the audit will vary according to the nature of the EA and the type of operation being audited. For example, the TOR for a financial institution audit will require the auditor to pay particular attention to the loan portfolio, while a public utility audit will usually focus on fixed assets and accounts receivable [5.4.7.1].

The TOR prepared for each audit ...

... must be acceptable to ADB ...

... but should not restrict auditor independence or limit their ability to meet other obligations

5.71. ISAs suggest that auditors determine the scope of financial statement audits in accordance with the requirements of legislation, regulations and generally accepted auditing standards. The TOR should not restrict auditors' obligations in these respects, nor should they give reasons for auditors to claim that adherence to the TOR prevented adequate statutory, regulatory or professional performance [5.4.7.2, 5.4.7.8].

A management letter is always required

5.72. Nevertheless, the audit TOR provides an opportunity to draw attention to areas of concern that may not be covered or emphasized under a normal audit, such as compliance with loan covenants or a special review of procurement documents. The TOR should always include the requirement to give an opinion on any specific items. A management letter will always be required [5.4.7.3].

Model auditor TOR are appended

5.73. Model TORs for an EA audit and for a project audit are provided in Appendix 7 and Appendix 9, respectively. However, these model TORs should not be regarded as universally applicable [5.4.7.6].

Contract or Engagement Letter of Auditor

To clarify expectations, we recommend that contracts or audit engagement letters be prepared

5.74. ADB recommends that contracts or audit engagement letters be prepared. Where a formal contract is used, it is normally prepared by the EA. Auditors often prepare a simple engagement letter. The contract or letter sets out the auditor's responsibilities and should include:

- confirmation of acceptance of the appointment including reference to the TOR;
- the borrowers' responsibilities, particularly the preparation of financial information;

- the provision of access to whatever premises, records, documentation and any other information the auditor may request in connection with the audit;
- the form of audit reports;
- arrangements regarding the involvement of internal auditors and any other external auditors (such as the government auditor);
- the expected issuance date of the Audited Financial Statements; and
- the fees basis and billing arrangements [5.4.8].

Government Auditors

5.75. In some countries—where projects are executed by government-controlled or sponsored entities—statutory requirements may specify the use of the government auditor. Under such circumstances, ADB will require that (i) the auditor is independent and competent, (ii) the auditor has the capacity and professional capability to provide audit reports and opinions of the quality required by ADB, and (iii) is generally acceptable to ADB. Normally, the independence of a government auditor would not be questioned if the auditor's position is established under constitutional or legal provisions designed to assure independence [5.4.10.1].

5.76. In some cases, government auditors are involved in pre-expenditure and revenue-collection decision-making. This compromises their independence. In these cases, ADB may seek to agree with a borrower that the auditor, or ADB, will be provided with opinions and reports prepared by an independent commercial auditor in addition to the government auditor's report [5.4.10.3].

ADB requires government auditors to be independent, competent and to have suitable capacity ...

... consequently, ADB may sometimes request audits to be conducted by private auditors

5.77. Where ADB has concerns about the government auditor's independence or competence, ADB will seek the borrower's agreement for the government auditor to subcontract the audit to an independent and competent private auditor to conduct the audit on their behalf [5.4.10.4].

Submission of Financial Reports

5.78. EAs are required to submit Audited Project Accounts (APA) regularly during project implementation and—in some cases—until the loan has been fully repaid. In addition, EAs of revenue-earning entities are required to submit Audited Financial Statements (AFS). This enables ADB to monitor loan use and satisfy itself about the EA's financial viability [5.5].

ADB requires that APA and AFS be submitted...

5.79. The APA and AFS should be submitted to ADB—together with the auditor's opinion and report—immediately upon completion of the audit. These should be accompanied by any other material issued by the auditor that is relevant to the interpretation of the audit, such as a management letter. An audit opinion should also be made by the auditor and submitted to ADB on the use of the Imprest Fund and SOEs in projects where these have been used. Delays in submitting financial reports will directly affect the project's overall rating [5.5.2].

... immediately on audit completion

5.80. ADB identifies the following compliance categories:

- **Complied** is when the sole EA submitted acceptable APA/AFS in English by the due date; and where all EAs submitted acceptable APA/AFS in English by the due date.

- **Partly Complied** is where several EAs are involved and only one or a few submitted acceptable APA/AFS either by the due date or late. In determining whether APA/AFS comply with ADB requirements ...
- **Complied Late** is when APA/AFS meet the complied status but are submitted late.
- **Not Yet Due** is when APA/AFS are not yet due and are only applicable until the first APA/AFS for the project become due.
- **Not Required** is if submission of APA/AFS are not included in the loan covenants, and are only applicable to some exceptional program loans. ... we consider timeliness, language, and acceptability
- **Not Complied** is when:
 - APA/AFS are submitted in the local language,
 - APA/AFS are submitted but has material audit qualifications,
 - the sole EA submitted partial or incomplete APA/AFS, or
 - only unaudited project accounts and financial statements are submitted.

5.81. The following table provides guidance on how ADB classifies audit opinions for the purposes of determining compliance.

Type of Audit Opinion	Example	Classification
Unqualified Opinion	<i>"In our opinion, the financial statements give a true and fair view...." (ISA 700, para. 21)</i>	Acceptable
Qualified Opinion	<i>"In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of the financial position" (ISA 700, para. 46)</i>	Will depend on the nature of the audit qualification and will be considered on a case-by-case basis.
Adverse Opinion	<i>"In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements do not give a true and fair view of...." (ISA 700, para. 46).</i>	Unacceptable
Disclaimer of Opinion	<i>"Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements." (ISA 700, para. 44)</i>	Unacceptable

ADB Policy on Late or Unacceptable Financial Reports

When acceptable APA/AFS are **not received by due dates**, ADB will write immediately to the EA stating they are overdue and warning that, if they are not received within 6 months, Imprest Accounts will not be replenished and further reimbursement requests, commitment letters, and contract awards will not be processed.

When acceptable APA/AFS are **not received within 6 months** after the due dates, ADB will initiate stopping replenishment of Imprest Accounts, and processing of reimbursement requests, commitment letters and contract awards. ADB will then advise the EA of ADB's actions and state that if the situation does not improve within 6 months, loans may be suspended.

When acceptable APA/AFS are **not received within 12 months** after the due dates, ADB may suspend the loan.

Auditor Reports and Opinions

5.82. ADB requires the borrower and the project EAs to have the required financial statements for each year audited by an independent auditor acceptable to ADB, and in accordance with standards on auditing that also are acceptable to ADB. An audit of such financial statements includes:

- Assessing the adequacy of accounting and internal control systems with respect to project expenditures and other financial transactions, and to ensure safe custody of project financed assets.
- Determining whether the borrower and EAs have maintained adequate documentation on all relevant transactions.
- Confirming that expenditures submitted to ADB are eligible for financing and identification of any ineligible expenditures.
- Confirming compliance with loan covenants and ADB's project management requirements [5.6.1.1].

5.83. An audit report must include: (i) title of the auditor; (ii) date of the report; (iii) addressee (EA and/or borrower); (iv) identification of the financial information audited; (v) a reference to auditing standards or practices followed; (vi) an expression of opinion, including a qualification; disclaimer or declining of an opinion, on the financial information; (vii) the auditor's signature; (viii) auditor's address; and (ix) date of signing of the report [5.6.2.2].

5.84. Appendix 10 and Appendix 11 provide examples of typical auditor reports and unqualified

ADB expects auditor reports to consider...

... the adequacy of systems and record-keeping ...

... the eligibility of expenditures ...

... and whether ADB requirements have been met

The appendices illustrate our expectations of auditor reports

opinions for: (i) a nonrevenue-earning project, and (ii) a revenue-earning project. The auditor should appropriately restate each example when qualifications or other modifications are necessary [5.6.2.3].

5.85. Audited Financial Statements provided to ADB in accordance with a loan agreement should be accompanied by the report of the auditor that contains their opinion on the financial statements [5.6.2.4].

Audit reports should indicate audit coverage...

5.86. The auditor should indicate whether any attached supplementary financial statements and Notes to the Financial Statements have been subjected to the same auditing procedures as in the case of the basic financial statements [5.6.2.6].

... additional matters should be addressed in management letters or detailed reports

5.87. Additional matters may be addressed in a detailed auditor's report, where these are not addressed in the Management Letter. As examples: (i) implementation of the auditor's recommendations made in prior years audit reports; (ii) efficacy of, and improvements required in budgetary control; (iii) reliability of field and financial controls; and (iv) any payroll, procurement, or inventory problems [5.6.2.7].

The audit report should consider reporting formats and bases ...

5.88. The auditor's opinion for a project should refer to the reporting format agreed between the borrower and ADB, noting the basis of accounting followed (e.g., cash basis) [5.6.2.8].

5.89. The auditor's opinion for a revenue-earning entity, including a commercial type entity in the private sector, should refer to the accounting standards adopted and any significant departures from IASs, with a reference to a quantified impact of such departures on the Balance Sheet and the

Income Statement prepared by the EA in the Notes to the Financial Statements. An example of the above would be where government regulations legislate the basis for bad debt provision rather than relying on an actual assessment [5.6.2.9].

5.90. Borrowers and EAs enter into financial performance covenants with ADB. The auditor is required to confirm, or otherwise, compliance with each financial covenant contained in the legal documents for the project. The auditor should also indicate, where present, the extent of any noncompliance, by reference to the specified (required) and actual performance measurements for each financial covenant for the financial year concerned [5.6.4].

... and indicate the extent of noncompliance with financial covenants

5.91. Borrowers and EAs enter into agreement with ADB in the loan documents to provide all appropriate financial management, accounting and financial reporting requirements necessary to support effective management of the project. The auditor should also indicate the extent of any noncompliance with the loan agreement, by reference to the specified (required by the loan documents) and actual performance of the borrower in respect of these ADB requirements for the financial year concerned [5.6.5].

Auditors should also indicate any other noncompliance with ADB requirements

Use of Technical Experts

5.92. For certain types of expenditures to be financed from ADB loans, the auditor may need to rely on an independent technical expert who normally would be engaged by the EA. An example would be civil works executed by the regular labor force of an entity (e.g., “force account” carried out by the Ministry of Works); or fixed-price reimbursements for measured units of work to be supervised by independent experts such as an

Where auditors rely on the work of technical experts ...

... appropriate certification should be provided

engineering or architectural firm. In addition to the normal responsibility of such experts to check that the work is performed in accordance with the plans and specifications, an appropriate certification by the expert of the value of the work executed must be acceptable to ADB [5.6.8.1].

The auditor's report should state any dissatisfaction with the work of technical experts ...

5.93. The acceptability of the certification would depend on the independence and competence of the firm and its staff engaged in the verification. Such a certification, where used, should normally be attached to the related documentation supporting the expenditure. Any dissatisfaction with the work of the expert that concerns the auditor should be stated in the auditor's report [5.6.8.2].

... and identify extent of reliance that was placed on technical experts

5.94. The content of the certificate might cover matters such as whether the goods and services were procured, received, paid for and used in the project in conformity with the loan agreement. In the above instances, the auditor should include a note under the scope paragraph of the opinion, stating the extent and amount involved with respect to their reliance on the technical expert (who should be identified and expertise noted in the Notes to the Financial Statements prepared by the EA) [5.6.8.3].

Audit opinions must consider SOEs and Imprest Accounts, where these are used

Statements of Expenditure and Imprest Accounts

5.95. Where the legal agreement of a project requires the separate audit of the SOEs and the Imprest Accounts, respectively, additional paragraphs should be included in the audit opinion of the project:

- referring to the SOE financial statement, certifying to the eligibility of those expenditures against which SOE disbursements were made; and

- referring to the Imprest Account financial statements attached [5.6.9.1].

Audit Management Letters

5.96. ADB requires auditors to provide a management letter with reference to the EA. This is a report on the internal controls and operating procedures of the entity, covering all aspects included during the normal course of the audit. Because an auditor is unlikely to cover all activities of a client during an annual audit, the management letter may address only those specific matters that came to the attention of the auditor during the review [5.6.10.1].

ADB requires a management letter on internal controls and operating procedures

5.97. The borrower and the auditor may agree at the commencement of the audit on particular subjects (including those at the request of ADB) to be included in the TOR and addressed in the management letter. These may include the review of compliance with financial covenants, and actual versus planned performance indicators. However, it should be the prerogative of the auditor to address any matter not agreed upon, but which, in the auditor's opinion, should be drawn to the borrower's attention. In addition, the auditor should comment on all significant variations between the PMR and the annual Audited Financial Statements [5.6.10.2].

Although the TOR should identify the management letter's focus and scope ...

... this should not constrain the auditor from commenting on other matters

5.98. ADB wishes to review all management letters. The EA should provide copies of the management letter to ADB at the same time as the audited annual financial statements are issued [5.6.10.4].

management letters must be provided to ADB with the audited financial statements

ADB Assistance to Improve Accounting and Auditing

The incremental costs of annual audits are eligible for ADB financing

Financing of Audit Expenditures

5.99. The costs of annual audits may be included in project costs and are eligible for ADB loan financing for those borrowers for whom the audit costs are incremental (i.e., without the project they would not be incurred). For other borrowers, where only part of the audit costs are incremental—particularly auditing to ADB standards, reporting on compliance with loan covenants or for those borrowers that may require foreign exchange for the purpose—these audit costs may be financed to ensure that ADB will receive an auditor’s opinion and report that accord with ADB requirements.

ADB will consider supporting improvements in accounting and auditing systems ...

Capacity Building in Project Accounting

5.100. Wide disparities exist in accounting and auditing standards and capacity among borrowers. To help borrowers avoid difficulties in meeting ADB’s requirements, specific accounting and reporting requirements to ensure proper project financial management are discussed with the borrower and EAs and reflected in the loan covenants of the loan agreement. If accounting and auditing systems are found unacceptable, corrective measures may be taken using either ADB TA funds (if available) or with support from other assistance agencies.

... we also arrange training for project accountants who are unfamiliar with our requirements

5.101. Hands-on training for preparing project accounts is arranged for project accountants if they are unfamiliar with ADB’s accounting and auditing requirements. The cost may be included in the loan amount.

6. Financial Institutions

Introduction

6.01. Financial institutions (FIs) include commercial banks and other financial institutions. ADB previously referred to FIs as development finance institutions (DFIs). The World Bank and the African Development Bank refer to FIs as financial intermediaries. They are also known by sectoral titles, such as agricultural development banks (AgDBs), industrial development banks (IDBs) and housing development banks (HDBs), or as development financial intermediaries, microfinance institutions (MFIs) and microfinance intermediaries [6.1.2].

Financial institutions, such as commercial banks, act as intermediaries to provide loans and equity to organizations

General Approaches and Expectations

6.02. ADB expects FIs to generate an interest rate spread (the difference between lending and borrowing rates) that covers all operating costs, including provisions for bad and doubtful debts, and in appropriate circumstances provides a profit. ADB can support FI operations in both the public and the private sectors [6.1.3].

ADB expects FIs to generate an adequate interest rate spread

6.03. In general, ADB-supported FI loans aim to remove or substantially reduce the use of directed credits, as these lead to resource allocation outside market mechanisms [6.2.4.1].

6.04. However, ADB may support directed-credit programs to promote sustainable financing—for sectors such as microfinance institutions or the rural

In certain situations, ADB may support directed-credit programs ...

sector—provided they are accompanied by reforms that address underlying institutional problems and any market imperfections that inhibit the market-based flow of funds to those sectors [6.2.4.3–6.2.4.4].

... or programs involving subsidies

6.05. ADB only supports programs involving subsidies if they (i) are transparent, targeted, and capped; (ii) are funded explicitly through the government budget or other sources subject to effective control and regular review; (iii) are fiscally sustainable; (iv) do not give an unfair advantage to some FIs over other qualified and directly competing institutions; and (v) are economically justified, or can be shown to be the least-cost way of achieving poverty reduction objectives [6.2.5.1].

ADB Approach to FI Reviews and Monitoring

Before providing support to FI operations ...

6.06. ADB appraises proposed FI loans to ensure that their objectives include (i) supporting reform programs in the financial sector or related real sectors; (ii) financing real sector investment needs; (iii) promoting private sector development; (iv) helping to stabilize, broaden, and increase the efficiency of financial markets and their allocation of resources and services; (v) promoting the development of the participating FIs; and (vi) supporting poverty reduction objectives [6.3.2.4].

... ADB considers the extent to which FI operational performance is effective, efficient and sustainable

6.07. ADB reviews an FI's operational performance to assess its ability to (i) deliver subloans to achieve defined country or sector economic objectives; (ii) efficiently recover subloans; and (iii) cover all operating costs and make a reasonable profit on the invested capital. FIs have numerous forms of performance indicators that can provide an understanding of past and ongoing performance [6.2.1.2].

6.08. At least once each year during implementation, ADB will conduct a formal review of the condition and performance of participating FIs—including a review of their Audited Financial Statements—to determine their continued compliance with eligibility criteria [6.3.4.5.4].

... and monitors performance during implementation

Assessing FI Performance

Introduction

6.09. Suitable indicators for measuring FI performance include, among other things, (i) adequacy of capital; (ii) quantity and quality of earnings; (iii) quality of assets; (iv) sufficiency of liquidity; (v) extent of subsidy dependence; (vi) effectiveness of FI loan administration (appraisal, supervision, and collection performance); and (vii) adequacy and timeliness of audited financial statements [6.3.4.5.3].

6.10. The most important criteria for determining the appropriateness of an FI to act as a financial intermediary are its solvency, profitability and liquidity. In this respect, the Basel Committee² on Banking Supervision of the Bank of International Settlements provides guidance in assessing an FI [6.4.1.3].

The most important criteria for determining FI performance are solvency, profitability and liquidity

Assessing Microfinance Institutions

6.11. The World Council of Credit Unions recommends a set of financial ratios covering **Protection**, **Effective financial structure**, **Asset quality**, **Rates of return and costs**, and **Liquidity and Signs of growth (PEARLS)** to monitor the financial stability of credit unions, including MFIs. The PEARLS

² Further information on the Basel Committee can be found at <http://www.bis.org>.

methodology is specifically designed for evaluating credit unions [6.4.2.1].³

ADB's main concern is that FIs manage their risk exposure

Assessing FI Risks

6.12. ADB's main concern is that FIs manage their exposure to potential risks. Capital markets are dynamic—their activities can generate rapid and dangerous movements that need to be anticipated and managed. The ability of traditional performance measurement criteria to indicate declining or poor FI performance is limited [6.4.4.1.1].

ADB will seek to identify potential risks to which an FI is exposed ...

6.13. Furthermore, in many cases, the FIs that ADB deals with are attached to the public sector and have multiple objectives (e.g., sectoral development objectives in addition to profitability objectives). The risk factors associated with these FIs are likely to be more significant than for single-objective commercial banks. Consequently, ADB will seek to (i) identify the principal potential risks that an FI is exposed to and (ii) agree an appropriate set of indicators that will provide FI management and ADB with an early warning of problems [6.4.4.1.3].

... and agree an appropriate set of indicators to monitor these risks

The major FI-related risks include market, exchange, maturity, and contagion risk

6.14. The major FI-related risks include

- market risk—the potential that a borrower or counterparty will fail to perform on an obligation [6.4.4.2.1];
- exchange risk—the potential changes in assets and liabilities caused by foreign exchange movements [6.4.4.3.1];
- maturity risk—the mismatching of investments and borrowing operations [6.4.4.4.1]; and

³ Further information on the PEARLS methodology can be found at www.woccu.org.

- contagion risk—contagion can arise in regions, in countries, in regions within countries, or within a class or category of financial institutions [6.4.4.5.1].

6.15. Financial sector supervisors and regulators are best able to identify, anticipate, and avoid contagion risk. They should monitor the financial sectors and economic developments with the objective of providing early warnings, not only to financial institutions, but also to ministries with economic management responsibilities [6.4.4.5.3].

Specialized FI Internal Controls

6.16. Internal controls for FIs (i) should comprise a set of rules and procedures designed to provide qualitative standards that complement quantitative risk analyses; (ii) are becoming increasingly employed by banks and securities institutions; (iii) should be used to internally manage operational risk, agency risk, and legal risk; and (iv) should be exercised by an independent control unit reporting to the board of directors that has no operating linkages with risk-creating trading activities [6.4.6.1].

6.17. ADB expects FIs to establish and maintain an appropriate risk management environment by, for instance

- requiring transparency of reports and documentation of the risk control process,
- monitoring the content and the efficiency of the vertical and horizontal information flows,
- monitoring and reporting on accountability,

ADB will seek assurance that appropriate internal controls are in place

- ensuring remuneration policy rewards efficient risk management through high returns and minimum risk,
- monitoring observance of trading limits and market procedures,
- establishing rules for dealing with changes in volatilities,
- testing the soundness of models,
- examining the quality and uniformity of data input, and
- validating and back-testing procedures [6.4.6.2].

FI Reporting and Auditing Issues

Introduction

Financial reporting and auditing requirements for FIs are also specialized

6.18. Financial reporting by, and audits of, FIs require individual specifications for each institution so that financial reporting and auditing requirements will be appropriate to the type, nature, and form of the institution [6.6.1.1].

6.19. For example, an industrial FI and an MFI have few common characteristics and the reporting requirements and the auditing specifications will differ sharply [6.6.1.2].

Financial Reporting

... additional financial statements will generally be required

6.20. In addition to the standard statements (Balance Sheet, Income Statement and Cash Flow Statement), an FI will generally be required to provide the additional statements listed below. This listing is not all-inclusive and may be amended to address the objectives and operations of the particular FI:

- The income statement and balance sheet adjusted for subsidies;

- Portfolio Report for current and past 2 years;
- Portfolio Report showing aging of receivables (arrears);
- Portfolio Report showing aging of portfolio at risk;
- Portfolio Report showing market and sectoral exposure;
- Capital Adequacy Analysis;
- Assets Structure by Income;
- Related party transactions; and
- Table of Contingencies, Guarantees, Commitments showing corresponding securities and collateral [6.6.2.2].

FI Auditing

6.21. ADB expects that the TOR for an FI audit will be tailored to the particular FI. For instance, the TOR for a commercial bank audit will differ from those for an MFI audit. Moreover, auditors should have appropriate experience in auditing the particular FI [6.6.3.1].

ADB expects that auditors of FIs will have appropriate experience

6.22. In addition to the standard requirements for auditor selection and appointment (see part 5), including providing a report and an opinion on the annual financial statements, the auditor should be required to include in the report confirmation, or otherwise, that the additional financial statements and performance indicators can be relied on [6.6.3.2].

Appendix 1 Contents of the Guidelines

This appendix presents the Guidelines' contents for information and reference purposes (see paragraph 1.02, page 1).

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Appendix 2 Project Investment Plan

Paragraph 3.05 (page 8) refers to this appendix.

Std. Code		Total
COMPONENTS ***		
Base Cost		
03	Civil Works	0.00
06	Survey, Investigation, Design, Mapping	0.00
09	Research and Development (Extension and Demonstration)	0.00
12	Institutional Development and Strengthening	0.00
15	Equipment, Vehicles and Furniture (Purchase and Maintenance)	0.00
18	Materials	0.00
21	Consulting Services	0.00
24	Training and Fellowships	0.00
27	Operations and Maintenance	0.00
30	Financing of Nongovernment Organizations (NGOs)	0.00
	– Implementation Assistance	0.00
	– Land	0.00
	– Capital Goods	0.00
	– Incremental Administrative Costs	0.00
	– Initial Working Capital	0.00
	– Taxes and Duties	0.00
	Base Costs as at...(date)...	0.00
Contingencies ***		
87	Physical	0.00
84	Price	0.00
81	Other (Identify)	0.00
	SUB-TOTAL	0.00
Financing Charges During Development***		
66	Interest	0.00
69	Other	0.00
	TOTAL PROJECT COST AND FINANCING REQUIRED	0.00

*** Footnotes to be used as necessary, particularly for contingencies' explanation and rates used for calculating financing changes.

Appendix 3 Project Financing Plan

Paragraph 3.15 (page 10) refers to this appendix.

	Total	%
Funds Required		
Proposed Project		
Capital expenditures	0.00	
Operating expenditures	0.00	
Interest during construction	0.00	
TOTAL PROJECT REQUIREMENTS	0.00	100
Sources of Funds		
Proposed ADB loan	0.00	
Other loans	0.00	
Equity or capital contributions		
Government	0.00	
Other sources	0.00	
Subsidies for operations	0.00	
Internal cash generation	0.00	
TOTAL SOURCES	0.00	100

Appendix 4 Example of Accounting Policies

Paragraph 5.05 (page 22) refers to this appendix. The following table provides guidance on General Accounting Policies. Particular accounting policies should set out the policies applicable to revenues, expenses, assets and liabilities. A model set of IAS-based accounting policies and financial statements is available at www.iasplus.com. An IAS disclosure checklist is also available from this website.

Issue	Details	Example
Reporting Entity	The accounting policies should clearly define the reporting entity.	<i>These are the consolidated financial statements of ABC Limited and its subsidiaries: DEF Limited, GHI Limited and JKL Limited.</i>
Reporting Period	The reporting period should be stated.	<i>These financial statements apply to the financial year ended 31 December 20X2.</i>
Legislative Basis	The legal basis under which the financial statements have been prepared should be clearly stated.	<i>These financial statements have been prepared in accordance with Article 123 of the Companies Act 20X1.</i>
Accounting Policy Basis	The accounting policy basis should be stated.	<i>These accounting policies are based upon the International Accounting Standards (IASs) issued by the International Accountants Standards Board (IASB) as at 30 September 20X2. Where no IAS has been issued on specific topics, the accounting policy is based on other authoritative sources.</i>
Measurement Base	The measurement base used to prepare the financial statements should be described.	<i>These financial statements have been prepared using the accrual basis of accounting. The measurement base applied is historical cost adjusted for revaluation of assets.</i>
Changes in Accounting Policies	Changes in accounting policies should be noted.	<i>There have been no material changes in accounting policies during the financial year.</i>
Going Concern	There should be a clear statement as to whether or not the entity is a going concern.	<i>The financial statements have been prepared on a going concern basis.</i>

Issue	Details	Example
Indirect Taxes and Duties	The treatment of indirect taxes and duties should be clearly stated.	<i>Revenue and expense items are recognized net of Value Added Tax (VAT). The net amount receivable in respect of VAT is included as part of accounts receivable. Assets are recorded net of VAT if the tax is recoverable.</i>
Comparatives	Where there have been changes of format or presentation from one accounting period to the next, comparatives should be restated, and that fact disclosed in the Notes to the Financial Statements together with any explanation necessary for the reader to understand the changes which have occurred.	Where there is any change of format or presentation from one accounting period to the next, comparatives are to be restated, and that fact disclosed in the notes to the financial statements together with any explanation necessary for the reader to understand the changes that have occurred.
Basis of Combination (Consolidation)	Where consolidated financial statements have been prepared, the combination basis should be stated.	Controlled entities are consolidated using the purchase method of combination. Corresponding assets, liabilities, revenues and expenses are added together line by line. Transactions and balances between these sub-entities are eliminated on combination.
Related Parties	The policy applied to the disclosure of related-party transactions should be stated.	There were no related-party transactions during the financial year.
Foreign Currency	The basis for recording foreign currency transactions and translating these transactions and balances should be stated.	Foreign currency transactions are measured and recorded in United States dollars (US\$) using the exchange rate in effect at the date of the transaction. However, where short-term transactions are covered by a forward exchange contract, the forward rates specified in those contracts have been used to translate the transactions into US\$. At the end of each reporting period any foreign currency monetary balances (money being held and assets and liabilities to be received or paid in money) have been translated into US\$ using the spot exchange rate in effect on that date. Exchange differences, arising when there is a change in the exchange rate between the transaction date and the date of settlement, have been recognized as either revenues or expenses.

Appendix 5 Sample Project Monitoring Report

This appendix presents sample PMR formats (see paragraph 5.37 on page 29).

Government of Pacifica: Education Sector Improvement Project

Cash Receipts and Payments

Asian Development Bank (ADB) Loan No. 1234-ATL

For the Quarter ended 31 March 2003

(Pp '000s)^a

	Quarter	Cumulative	Forecast: Next 6 months
Cash Receipts			
Government Funds	24,000	260,000	75,000
ADB Funds	<u>129,795</u>	<u>623,245</u>	<u>175,000</u>
Total Financing	153,795	883,245	250,000
Less: Expenditures by Component			
Institutional Strengthening	94,695	569,045	185,000
Increasing Access	60,000	220,000	24,251
Teacher Development	2,500	17,450	5,500
Project Development	1,600	6,500	2,952
Other (including Loan Fee)	..	12,250	12,000
Total Expenditures	<u>158,795</u>	<u>825,245</u>	<u>229,703</u>
Receipts Less Expenditures	-5000	58,000	20,297
Add: Foreign Exchange Difference	<u>-1000</u>	<u>-14000</u>	<u>..</u>
Net Change in Cash	<u>-6000</u>	<u>44,000</u>	<u>20,297</u>
Opening Cash balances			
Local Currency Bank Account	2,000	..	4,000
Foreign Currency Bank Account	<u>48,000</u>	<u>..</u>	<u>40,000</u>
Total Opening Cash	50,000	..	44,000
Add: New Change in Cash	<u>-6000</u>	<u>44,000</u>	<u>20,297</u>
Net Cash Available	<u>44,000</u>	<u>44,000</u>	<u>64,297</u>
Closing Cash Balances			
Local Currency Bank Account	4,000	4,000	14,297
Foreign Currency Bank Account	<u>40,000</u>	<u>40,000</u>	<u>50,000</u>
Total Closing Cash Balances	<u>44,000</u>	<u>44,000</u>	<u>64,297</u>

Pp = Pacific Pesos.

Notes: a The following rates were used for conversion:

- Opening balance of Foreign Currency Bank Account in Quarter: US\$1 = PPs14:7.
- ADB fund received and any foreign currency expenditures made are converted at the rate of exchange on the date of the transaction. The weighted average of these rates since project inception is approximately 14.5.
- Closing balance of Foreign Currency Bank Account: US\$1 = PPs14.9.

Appendix 6 Model Financial Statements: Service Organization

Paragraph 5.46 (page 31) refers to this appendix. This model set of summary financial statements is appropriate for use by a service-type organization. When using these financial statements it is essential that: (i) an appropriate Statement of Accounting Policies be developed and agreed between ADB and the borrower; (ii) appropriate Notes to the Financial Statements supplement the financial statements; and (iii) where appropriate, the Financial Statements should be tailored so that they adequately reflect the organization's performance and position.

The format used for this particular model set of summary financial statements is appropriate for forecasting (projecting) financial statements (for instance, during project preparation).

Example Service Organization Forecast Income Statements [Format for financial projections] for the years ended 31 December (\$'000)

	Notes	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast	20X7 Forecast
Operating Revenues								
Revenues from services	1	35,052	36,748	39,288	41,202	41,202	41,202	41,202
Investment income		1,157	1,073	1,126	1,243	1,243	1,243	1,243
Other operating revenue		317	332	279	269	269	269	269
		36,526	38,153	40,693	42,714	42,714	42,714	42,714
Operating Expenses								
Wages, salaries and employee benefits		12,960	13,363	13,975	14,504	14,504	14,504	14,504
Supplies and consumables used		4,022	4,285	4,582	4,687	4,687	4,687	4,687
Repairs and maintenance		1,000	1,000	1,000	1,000	1,000	1,000	1,000
Depreciation and amortization expenses		791	872	918	926	926	926	926
Other operating expenses		18,677	20,395	20,601	21,280	21,280	21,280	21,280
		37,450	39,915	41,076	42,397	42,397	42,397	42,397
Surplus/(Deficit) from Operating Activities		-924	-1,762	-383	317	317	317	317
Project-related interest costs		2,373	2,527	2,588	2,512	2,512	2,512	2,512
Other interest costs		..	..	..	..	..	..	..
Gains on sale of fixed assets		..	..	..	..	..	..	..
Total non-operating expenses		2,373	2,527	2,588	2,512	2,512	2,512	2,512
Surplus/(Deficit) from Ordinary Activities		1,449	765	2,205	2,829	2,829	2,829	2,829
Minority interest share of surplus/(deficit)		..	..	..	..	..	..	..
Net surplus/(deficit) before extraordinary items		1,449	765	2,205	2,829	2,829	2,829	2,829
Extraordinary items		..	..	..	..	..	..	..
Income tax expense		..	..	..	..	..	..	..
Net Surplus/(Deficit) for the Year after Tax		1,449	765	2,205	2,829	2,829	2,829	2,829

Example Service Organization Forecast Balance Sheets
[Format for financial projections] as at 31 December
(\$'000)

Notes	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast	20X7 Forecast
Current Assets							
Cash and cash equivalents	210	93	97	100	100	100	100
Marketable securities	10,440	11,279	9,929	9,473	9,473	9,473	9,473
Receivables	5,520	5,490	5,559	5,593	5,593	5,593	5,593
Inventories	274	329	348	379	379	379	379
Work in progress	3,995	4,768	5,519	6,032	6,032	6,032	6,032
Investments	338	341	954	2,210	2,210	2,210	2,210
	20,777	22,300	22,406	23,787	23,787	23,787	23,787
<i>Less: Current Liabilities</i>							
Payables and provisions	4,716	4,588	4,428	4,401	4,401	4,401	4,401
Short-term borrowings	2,236	2,413	2,413	2,413	2,413	2,413	2,413
Current portion of borrowings	7,208	7,648	7,533	7,528	7,528	7,528	7,528
Employee benefits	832	857	857	856	856	856	856
	14,992	15,506	15,231	15,198	15,198	15,198	15,198
WORKING CAPITAL	5,785	6,794	7,175	8,589	8,589	8,589	8,589
<i>Plus: Non-current Assets</i>							
Investments	14,392	15,204	16,102	16,930	16,930	16,930	16,930
Property, plant and equipment	25,252	25,861	25,787	25,851	25,851	25,851	25,851
Intangible assets	2	302	830	1,322	1,322	1,322	1,322
	39,646	41,367	42,719	44,103	44,103	44,103	44,103
<i>Less: Non-current Liabilities</i>							
Payables	524	510	492	489	489	489	489
Borrowings	28,833	30,591	30,131	30,113	30,113	30,113	30,113
Employee benefits	7,491	7,710	7,716	7,706	7,706	7,706	7,706
	36,848	38,811	38,339	38,308	38,308	38,308	38,308
Net Assets	8,583	9,350	11,555	14,384	14,384	14,384	14,384
EQUITY							
Issued and paid-up capital	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Reserves	7,201	7,190	7,190	7,190	7,190	7,190	7,190
Accumulated surpluses/(deficits)	382	1,160	3,365	6,194	6,194	6,194	6,194
Total Equity	8,583	9,350	11,555	14,384	14,384	14,384	14,384

Example Service Organization Forecast Cash Flow Statements
[Format for financial projections] for the years ended 31 December
(\$'000)

Notes	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast	20X7 Forecast
OPERATING CASH FLOWS							
Receipts							
Cash receipts from customers	34,793	36,603	39,177	41,118	41,118	41,118	41,118
Other receipts	341	265	289	279	279	279	279
Payments							
Employees	-12,615	-13,043	-13,428	-13,917	-13,917	-13,917	-13,917
Suppliers	-19,750	-20,920	-20,848	-21,167	-21,167	-21,167	-21,167
Other payments	-369	-490	-1,088	-1,684	-1,684	-1,684	-1,684
Net Cash Flows from Operating Activities 2	2,400	2,415	4,102	4,629	4,629	4,629	4,629
INVESTING CASH FLOWS							
Receipts							
Interest received	1,070	835	834	901	901	901	901
Sales of fixed assets	250	125	68	59	59	59	59
Sales of investments	1,983	57	1,071	244	244	244	244
Payments							
Interest paid	-2,507	-2,516	-2,561	-2,502	-2,502	-2,502	-2,502
Purchases of fixed assets	-1,469	-2,459	-2,808	-3,181	-355	-355	-355
Purchases of investments	-130	-55	-102	-98	-98	-98	-98
Net Cash Flows from Investing Activities	-803	-4,013	-3,498	-4,577	-1,751	-1,751	-1,751
FINANCING CASH FLOWS							
Receipts							
Capital contributions from owners	..	..	..	..	..	..	..
Proceeds from new borrowings	275	1,477	353	56	56	56	56
Payments							
Capital withdrawals	..	..	..	..	..	..	..
Repayment of borrowings	-1,900	..	-953	-105	-105	-105	-105
Dividends paid	..	..	..	..	-2,829	-2,829	-2,829
Net Cash Flows from Financing Activities	-1,625	1,477	-600	-49	-2,878	-2,878	-2,878
CASH AND CASH EQUIVALENTS							
Balances as at 1 January	230	210	93	97	100	100	100
Currency changes on opening balances	8	4	..	..	..	..	..
Net increases/(decreases) for period	-28	-121	4	3	..	..	..
Balances as at 31 December	210	93	97	100	100	100	100

Example Service Organization
Notes to the Financial Statements [Format for financial projections]
for the years ended 31 December
(\$'000)

	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast
Note 1: Revenues by Service Type						
Service Type A	376	353	379	387	387	387
Service Type B	34,035	35,748	38,274	40,195	40,195	40,195
Service Type C	641	647	635	620	620	620
	35,052	36,748	39,288	41,202	41,202	41,202
Note 2: Reconciliation of Income Statement to Operating Cash Flows						
Net Surplus/(Deficit) per Income Statement	1,449	765	2,205	2,829	..	..
<i>Items included in net surpluses but not in net cash flows from operations:</i>						
Unrealized net foreign exchange gains	-66	-87	..	..	..	..
Interest received	-1,070	-835	-834	-901	..	..
Interest paid	2,507	2,516	2,561	2,502	..	..
<i>Asset movements</i>						
Depreciation	791	872	918	926	..	..
Gains/(losses) on sales of assets	-7	3	..	..	..	..
<i>Other non-cash items</i>						
Movements in employee benefit liabilities	-936	110	864	1,134	..	..
<i>Movements in working capital</i>	-286	-929	-1,612	-1,861		
Net Cash Flows from Operations	2,400	2,415	4,102	4,629	..	..

Appendix 7 Model Financial Statements: Manufacturing Organization

Paragraph 5.46 (page 31) refers to this appendix. This model set of summary financial statements is appropriate for use by a manufacturing-type organization. When using these financial statements, it is essential that: (i) an appropriate Statement of Accounting Policies be developed and agreed between ADB and the borrower; (ii) appropriate Notes to the Financial Statements supplement the financial statements; and (iii) where appropriate, the Financial Statements should be tailored so that they adequately reflect the performance and position of the organization. The format used for this particular model set of summary financial statements is appropriate for year-end reporting.

Example Manufacturing Organization Income Statement [Format for year-end reporting] for the year ended 31 December 20X2

	Notes	For the Year Ended 31 December 20X2				Cumulative Since Project Start-Date			
		Actual \$'000	Forecast \$'000	Variance \$'000	%	Actual \$'000	Forecast \$'000	Variance \$'000	%
SALES	1	893,121	1,431,093	-537,972	-37.6	1,976,522	2,173,098	-196,576	-9.0
Less Cost of Goods Sold	2	813,673	1,296,081	482,408	37.2	1,760,823	1,932,016	171,193	8.9
GROSS PROFIT		79,448	135,012	-55,564	-41.2	215,699	241,082	-25,383	-10.5
Operating Costs									
Administrative Salaries		27,326	37,742	10,416	27.6	39,950	41,506	1,556	3.7
Depreciation		3,917	7,335	3,418	46.6	8,554	7,953	-601	-7.6
Amortization		12,357	12,357	..	0.0	12,357	12,357	..	0.0
Administration Costs		56,037	88,259	32,222	36.5	92,672	97,306	4,634	4.8
Marketing Expenses		3,109	4,985	1,876	37.6	6,904	7,596	692	9.1
		102,746	150,678	47,932	31.8	160,437	166,718	6,281	3.8
OPERATING PROFIT		-23,298	-15,666	-7,632	48.7	55,262	74,364	-19,102	-25.7
Other income		1,000	1,080	-80	-7.4	1,166	1,260	-94	-7.5
Foreign exchange gains/(losses)		..	-1,570	1,570	-100.0	-1,564	-1,845	281	-15.2
Net Income before									
Interest and Taxes		-22,298	-16,156	-6,142	38.0	54,864	73,779	-18,915	-25.6
Project-related interest expenses		-42,672	-63,657	20,985	-33.0	-52,343	-39,604	-12,739	32.2
Other interest expenses		..	..	..	0.0	..	..	..	0.0
Income tax expense		..	..	..	0.0	..	-8,189	8,189	-100.0
Net Income after Interest and Taxes		-64,970	-79,813	14,843	-18.6	2,521	25,986	-23,465	-90.3
Gross Margin (% of Sales)		8.9	9.4	-0.5	..	10.9	11.1	-0.2	..
Operating Margin (% of Sales)		-2.6	-1.1	-1.5	..	2.8	3.4	-0.6	..

Example Manufacturing Organization
Balance Sheet
[Format for year-end reporting]
as at 31 December 20X2

	Notes	For the Year Ended 31 December 20X2				Cumulative Since Project Start-Date			
		Actual \$'000	Forecast \$'000	Variance \$'000	%	Actual \$'000	Forecast \$'000	Variance \$'000	%
Current Assets									
Cash and bank		25,308	10,373			34,085	-62,165		
Bills receivable		56,114	59,943			82,791	91,025		
Accounts receivable	3	18,705	19,981			27,597	30,342		
Inventories	4	365,150	402,058			427,488	455,796		
Prepayments and other current assets		120,193	120,193			120,193	120,193		
		585,470	612,548			692,154	635,191		
Less: Current Liabilities									
Accounts payable		93,174	103,203			140,826	156,768		
Short-term debt		207,610	207,610			207,610	207,610		
Notes and bills payable		5,000	5,000			5,000	5,000		
Advances from customers		13,084	13,084			13,084	13,084		
Accrued wages and salaries		184,427	184,427			184,427	184,427		
Taxes payable		72,607	72,648			72,890	81,167		
Accruals and other current Liabilities		47,749	47,749			47,749	47,749		
Current portion of term debt		3,000	13,578			28,824	71,070		
		626,651	647,299			700,410	766,875		
WORKING CAPITAL		-41,181	-34,751			-8,256	-131,684		
Plus: Non-current Assets									
Fixed assets		800,263	1,222,024			1,136,482	1,056,928		
Capital work in progress (Assets under construction)		445,108	169,390			520,880	913,740		
Intangibles and deferrals		49,426	37,069			24,712	12,355		
Other non-current assets		30,572	15,572			..	..
		1,325,369	1,444,055			1,682,074	1,983,023		
Less: Non-current Liabilities									
Term loans		443,700	621,349			554,132	670,517		
Payables		7,646	7,646			7,646	7,646		
Other non-current liabilities		49,250	49,250			49,250	49,250		
		500,596	678,245			611,028	727,413		
NET ASSETS		783,592	731,059			1,062,790	1,123,926		
EQUITY									
Issued and paid-up capital		315,147	342,427			671,637	706,787		
Accumulated surpluses/(deficits)		468,445	388,632			391,153	417,139		
		783,592	731,059			1,062,790	1,123,926		
Current Ratio		0.93	0.95			0.99	0.83		
Quick Ratio		0.16	0.14			0.21	0.08		
Long-term Debt: Equity		0.64	0.93			0.57	0.65		

Example Manufacturing Organization
Statement of Cash Flows
[Format for year-end reporting]
for the year ended 31 December 20X2

Notes	For the Year Ended 31 December 20X2				Cumulative Since Project Start-Date				
	Actual \$'000	Forecast \$'000	Variance \$'000	%	Actual \$'000	Forecast \$'000	Variance \$'000	%	
OPERATING CASH FLOWS									
Receipts									
Cash receipts from customers	915,146	1,448,537	-533,391	-36.8	1,972,084	2,173,621	-201,537	-9.3	
Tax rebates	23,260	27,280	-4,020	-14.7	30,990	35,150	-4,160	-11.8	
Other receipts	1,000	1,080	-80	-7.4	1,166	1,260	-94	-7.5	
Payments									
Employees and suppliers	-896,292	-1,387,934	491,642	-35.4	-1,811,168	-2,019,189	208,021	-10.3	
Taxes paid	-5,942	-7,508	1,566	-20.9	-10,212	-11,414	1,202	-10.5	
Other payments			..	0.0			..	0.0	
Net Cash Flows from Operations	5	37,172	81,455	-44,283	-54.4	182,860	179,428	3,432	1.9
INVESTING CASH FLOWS									
Receipts									
Interest received	..	..	..	0.0	..	..	..	0.0
Sales of fixed assets	..	..	..	0.0	..	..	..	0.0
Sales of investments	..	..	..	0.0	..	..	..	0.0
Payments									
Interest paid	-28,482	-42,370	13,888	-32.8	-41,700	-39,604	-2,096	5.3	
Capital expenditures	..	-219,390	219,390	-100.0	-351,490	-392,860	41,370	-10.5	
Purchases of investments			..	0.0			..	0.0	
Net Cash Flows from Investing Activities		-28,482	-261,760	233,278	-89.1	-393,190	-432,464	39,274	-9.1
FINANCING CASH FLOWS									
Receipts									
Capital contributions from owners	..	..	..	0.0	..	..	..	0.0
Proceeds from new borrowings	..	168,370	-168,370	-100.0	247,620	185,610	62,010	33.4	
Payments									
Repayment of borrowings	-3,000	-3,000	..	0.0	-13,578	-28,824	15,246	-52.9	
Dividends paid	..	..	..	0.0	..	..	..	0.0
Net Cash Flows from Financing Activities		-3,000	165,370	-168,370	-101.8	234,042	156,786	77,256	49.3
CASH AND CASH EQUIVALENTS									
Balances as at 1 January	19,618	25,308				10,373	34,085		
Currency changes on opening balances	..	..				..	..
Net increases/(decreases) for period	5,690	-14,935	-20,625	-138.1	23,712	-96,250	-119,962	-124.6	
Balances as at 31 December	25,308	10,373				34,085	-62,165		

Example Manufacturing Organization
Notes to the Financial Statements
[Format for year-end reporting]
for the year ended 31 December 20X2

	For the Year Ended 31 December 20X2				Cumulative Since Project Start-Date			
	Actual \$'000	Forecast \$'000	Variance \$'000	%	Actual \$'000	Forecast \$'000	Variance \$'000	%
Note 1: Gross Margin by Product								
<i>Sales by Product:</i>								
Product A	240,318	284,659	-44,341	-15.6	394,096	433,618	-39,522	-9.1
Product B	230,868	258,132	-27,264	-10.6	357,413	393,240	-35,827	-9.1
Product C	262,416	586,880	-324,464	-55.3	812,700	894,080	-81,380	-9.1
Product D	149,919	287,022	-137,103	-47.8	397,913	437,760	-39,847	-9.1
Product E	9,600	14,400	-4,800	-33.3	14,400	14,400	..	0.0
Total	893,121	1,431,093	-537,972	-37.6	1,976,522	2,173,098	-196,576	-9.0
<i>Cost of Sales by Product:</i>								
Product A	203,418	311,059	107,641	34.6	352,165	405,723	53,558	13.2
Product B	203,418	336,981	133,563	39.6	316,948	367,083	50,135	13.7
Product C	260,375	414,746	154,371	37.2	739,546	734,166	-5,380	-0.7
Product D	138,324	220,334	82,010	37.2	334,556	405,723	71,167	17.5
Product E	8,138	12,961	4,823	37.2	17,608	19,321	1,713	8.9
Total	813,673	1,296,081	482,408	37.2	1,760,823	1,932,016	171,193	8.9
<i>Gross Profit by Product (\$'000):</i>								
Product A	36,900	-26,400	63,300	-239.8	41,931	27,895	14,036	50.3
Product B	27,450	-78,849	106,299	-134.8	40,465	26,157	14,308	54.7
Product C	2,041	172,134	-170,093	-98.8	73,154	159,914	-86,760	-54.3
Product D	11,595	66,688	-55,093	-82.6	63,357	32,037	31,320	97.8
Product E	1,462	1,439	23	1.6	-3,208	-4,921	1,713	-34.8
Total	79,448	135,012	-55,564	-41.2	215,699	241,082	-25,383	-10.5
<i>Gross Margin by Product (%):</i>								
Product A	15.4	-9.3	24.6	..	10.6	6.4	4.2	..
Product B	11.9	-30.5	42.4	..	11.3	6.7	4.7	..
Product C	0.8	29.3	-28.6	..	9.0	17.9	-8.9	..
Product D	7.7	23.2	-15.5	..	15.9	7.3	8.6	..
Product E	15.2	10.0	5.2	..	-22.3	-34.2	11.9	..
Total	8.9	9.4	28.2	..	10.9	11.1	20.5	..
Note 2: Cost of Goods Sold								
Raw Materials	424,751	690,624	265,873	38.5	945,534	1,039,383	93,849	9.0
Utilities	238,734	416,461	177,727	42.7	592,612	679,561	86,949	12.8
Direct Labor	79,639	121,775	42,136	34.6	118,937	112,413	-6,524	-5.8
Direct Depreciation	35,257	66,012	30,755	46.6	76,988	71,601	-5,387	-7.5
Other Variable Costs	22,750	38,117	15,367	40.3	52,182	57,366	5,184	9.0
	801,131	1,332,989	531,858	39.9	1,786,253	1,960,324	174,071	8.9
Plus opening finished goods	93,437	80,895	-12,542	-15.5	117,803	143,233	25,430	17.8
Less closing finished goods	-80,895	-117,803	-36,908	31.3	-143,233	-171,541	-28,308	16.5
Cost of Goods Sold	813,673	1,296,081	482,408	37.2	1,760,823	1,932,016	171,193	8.9

Example Manufacturing Organization
Notes to the Financial Statements
[Format for year-end reporting]
for the year ended 31 December 20X2

	For the Year Ended 31 December 20X2				Cumulative Since Project Start-Date			
	Actual	Forecast	Variance		Actual	Forecast	Variance	
	\$'000	\$'000	\$'000	%	\$'000	\$'000	\$'000	%
Note 3: Receivables								
<i>By Organization Type:</i>								
Related parties	576	700			750	750		
State-owned organizations	10,256	12,500			17,200	19,000		
Other organizations	9,744	9,000			12,500	14,000		
Gross Receivables	20,576	22,200			30,450	33,750		
<i>By Age</i>								
Less than 30 days old	10,000	11,000			15,000	19,000		
30–60 days old	5,000	5,500			7,000	9,000		
60–90 days old	2,500	2,500			5,000	4,000		
90–180 days old	2,000	2,000			2,000	1,000		
More than 180 days old	1,076	1,200			1,450	750		
Gross Receivables	20,576	22,200			30,450	33,750		
Less: Provision for Doubtful Debts	-1,871	-2,219			-2,853	-3,408		
Net Receivables per balance	18,705	19,981			27,597	30,342		
Note 4: Inventories								
<i>By Age</i>								
Less than 2 months old	100,000	120,000			125,000	160,000		
2–4 months old	80,000	90,000			95,000	150,000		
4–6 months old	100,000	95,000			95,000	90,000		
6–9 months old	60,000	60,000			70,000	40,000		
9–12 months old	20,000	30,000			35,000	20,000		
More than 12 months old	15,150	17,058			17,488	5,796		
Gross Inventories	375,150	412,058			437,488	465,796		
Less: Provision for Obsolete Inventories	-10,000	-10,000			-10,000	-10,000		
Net Inventories per balance sheet	365,150	402,058			427,488	455,796		
Note 5: Reconciliation of Income Statement to Operating Cash Flows								
Net Surplus/(Deficit) per Income Statement	..	..			..	..
Items included in net surpluses but not in net cash flows from operations:								
Unrealized net foreign exchange gains	..	..			..	..
Interest revenues	..	..			..	..
Interest expenses	..	..			..	..
Asset movements								
Depreciation	..	..			..	..
Gains/(losses) on sales of assets	..	..			..	..
<i>Other non-cash items</i>								
Movements in employee benefit liabilities	..	..			..	..
<i>Movements in working capital</i>								
Decrease/(increase) in receivables	..	..			..	..
Decrease/(increase) in inventories	..	..			..	..
Decrease/(increase) in work in progress	..	..			..	..
Increase/(decrease) in payables	..	..			..	..
Net Cash Flows from Operations	..	..			..	..

Appendix 8 Model Auditor Terms of Reference: Executing Agency Audit

Paragraph 5.73 (page 37) refers to this appendix.

ENTITY NAME: XYZ AUDIT OF ANNUAL FINANCIAL STATEMENTS AUDITOR TERMS OF REFERENCE

GUIDANCE: This template is appropriate for the audit of executing agencies (EAs) or implementing agencies (IAs). It should be completed—by the borrower, EA or project preparatory technical assistance (PPTA) consultants—and provided to ADB for comments before fact finding. This template can be applied to the audit of either a revenue-earning or nonrevenue-earning EA.

Introduction

GUIDANCE: Briefly describe the audit assignment. Specify whether the engagement is for one or more financial years. A longer period (e.g., 3–5 years) will enable the auditor to become familiar with the entity. The actual contract should allow for termination for inadequate performance, but not for issuing a qualified, adverse or disclaimer opinion.

1. The management of XYZ requires an auditor to carry out the following audit services for the [X] years ended 31 December 20xx:
 - An audit of XYZ Annual Financial Statements (AFS).
2. This letter describes the assignment scope and terms and invites you to submit a proposal for delivery of these services.

General Background

GUIDANCE: Briefly describe the project in the context of its contribution to achievement of the EA's economic goals. The auditor must understand the “purpose for which the funds are intended” in the context of the broad project objectives as well as in terms of the specific project budget.

3. ...

GUIDANCE: Briefly summarize relevant accounting and financial management practices. Various diagnostic reports are available that describe accounting and financial management practices (e.g., ADB Diagnostic Studies of Accounting and Auditing, World Bank Country Financial Accountability Assessments). Emphasis should be placed on issues raised and risks identified in these reports.

4. ...

Employing Authority or Entity

GUIDANCE: The details of the proposed contractor of the auditor's services should be provided. If the contractor is acting on behalf of, or is part of, a larger authority or entity, this should be disclosed, to assist prospective auditors to determine their independence.

5. The audit services will be contracted by:

Delivery of Opinions and Reports

GUIDANCE: The required opinions and documents should be clearly specified, together with delivery time frames.

6. The auditor will provide the following opinions and reports to management (with copies to ADB), in accordance with the following time frames:

- Audit Opinion on Annual Financial Statements of [XYZ]
- Management Letter relating to [XYZ]

7. All reports must be provided in the English language.

Objectives

8. The primary objective of the AFS audit is to enable the auditor to express an independent opinion on whether the AFS present fairly, in all material respects the financial position of XYZ as of 31 December 20xx, and of the results of its operations and its cash flows for the year then ended in accordance with agreed accounting standards (see Terms and Definitions).

9. Secondary objectives include confirming compliance, or otherwise, with: (i) each financial covenant contained in the legal documents for the project (see Terms and Definitions); and (ii) all other financial assurances contained in the legal documents for the project (see Terms and Definitions).

Description of XYZ

GUIDANCE: A detailed description—both legal and generally informative—should be provided to enable the auditor to understand fully the nature, location and objective of the entity under audit. Geographic characteristics should be described, together with: (i) organization charts; (ii) names of senior managers; (iii) name and qualification of the person(s) responsible for financial management, accounting and internal audit; (iv) name and address of any existing external auditor; (v) computing or other data processing facilities in use; (vi) a copy of the latest published financial statements; and (vii) internal facilities (if any) available to an external auditor (e.g., office accommodation, calculators, and computer facilities). A general summary of the financial management assessment of the EA should be included, together with a reference that the full financial management assessment will be made available to the auditor. Detailed information should be appended.

10. ...

Description of Materials and Timing of Delivery

GUIDANCE: The AFS and supporting documentation that will be supplied to the auditor, and on which they are to give an opinion and a report, should be specified. The estimated time for providing these documents to the auditor should be stated (e.g., one month after financial year-end). This schedule helps the auditee and the auditor plan for the accounts-preparation and the audit process.

11. The AFS (see Terms and Definitions) and supporting documentation will be provided to the auditor on the following estimated dates:

Audit Scope

GUIDANCE: The scope of the audit should be sufficiently clear to properly define what is expected of the auditor but not in any way restrict the audit procedures or the techniques the auditor may wish to use to form an opinion. This section will not generally have to be customized to a particular audit situation.

12. *Auditing Standards and Program.* The audit will be carried out in accordance with the agreed auditing standards (see Terms and Definitions), including professional or general standards, standards of fieldwork and reporting standards.

13. The audit program will consider the risk of material misstatements resulting from fraud or error. It should include procedures that are designed to provide reasonable assurance that material misstatements (if any) are detected.

14. *Internal Control Systems.* The auditor will assess the adequacy of financial management systems, including internal controls.

15. The auditor should communicate with independent board members (where present). Among other things, this dialogue should cover the adequacy of bad-debt provisions, contingent liabilities, related-party transactions, internal control systems, management and board reporting, and management systems, integrity and capability.

16. *Accounting Policies and Changes.* The auditor should comment on the entity's accounting policies, and confirm the extent to which the agreed accounting standards (see Terms and Definitions) have been applied. In particular, the auditor should note the impact on the AFS arising from any material deviations from agreed accounting standards. The auditor should also comment on any material accounting policy changes, either during a financial year, or from one year to another.

17. *Compliance with Financial Covenants.* The auditor will confirm compliance with each financial covenant contained in the legal documents for the project (see Terms and Definitions). Where present, the auditor should indicate the extent of any noncompliance by comparing required and actual performance measurements for each financial covenant for the financial year concerned.

18. *Compliance with Financial Assurances.* The auditor will confirm compliance with all financial assurances contained in the legal documents for the project (see Terms and Definitions). Where present, the auditor should indicate the extent of any noncompliance by comparing required and actual performance of the borrower in respect of these ADB requirements for the financial year concerned.

Management Letter

19. On conclusion of the audit, the auditor will prepare a management letter, detailing:

- any material weaknesses in the accounting and internal control systems that were identified during the audit,
- recommendations to rectify identified weaknesses,
- the status of significant matters raised in previous management letters and any corrective actions taken by the organization,
- practical recommendations on the steps that the organization could take to become materially compliant with the agreed accounting standards (see Terms and Definitions), together with a time frame for making these changes,
- any other matters that the auditor considers should be brought to the attention of the organization's management, and
- any significant matters that the auditor considers should be brought to ADB's attention.

Statement of Access

20. The auditor will have full and complete access, at all reasonable times, to all records and documents including books of account, legal agreements, bank records, invoices and any other information associated with the project and deemed necessary by the auditor.

21. The auditor will be provided with full cooperation by all employees of [XYZ] and the project-implementing units, whose activities involve, or may be reflected in, the annual financial statements. The auditor will be assured rights of access to banks and depositories, consultants, contractors and other persons or firms hired by the employer.

Independence

22. The auditor will be impartial and independent from any aspects of management or financial interest in the entity under audit. In particular, the auditor should be independent of the control of the entity. The auditor should not, during the period covered by the audit, be employed by, or serve as director for, or have any financial or close business relationship with the entity. The auditor should not have any close personal relationships with any senior participant in the management of the entity. The auditor must disclose any issues or relationships that might compromise their independence.

Auditor and Audit Staff Competence

23. The auditor must be authorized to practice in the country and be capable of applying the agreed auditing standards (see Terms and Definitions). The auditor should have adequate staff, with appropriate professional qualifications and suitable experience, including experience in auditing the accounts of entities comparable in nature, size and complexity to the entity whose audit they are to undertake.

24. To this end, the auditor is required to provide curriculum vitae (CV) of the auditors who will provide the opinions and reports, together with the CVs of managers, supervisors and key personnel likely to be involved in the audit work. These CVs should include details of audits carried out by these staff, including ongoing assignments.

Submission of Proposal and Work Plan

25. You are invited to submit a proposal and a work plan to provide the audit services described in this letter. Proposals should address, among other things:

- the extent (if any) that you would not conform to the agreed auditing standards (see Terms and Definitions) and indicate any alternative standards to which the auditor may (be required to) conform;
- whether the audit would be conducted as a completed audit (i.e., will you carry out the audit after financial year-end, when the books of account are, or are being, closed);
- whether an audit carried out after the close of a financial year would be supplemented by one or more interim audits during

a financial year. The principal purpose is to test ongoing systems and internal controls, and to relieve pressure on the staff of the entity and on the auditor at year-end;

- the manner in which the auditor proposes to address any statutory requirements relating to audit (e.g., certifications relating to shareholders' equity required under the companies' act) or to which they may be implicitly bound by contractual obligations of the employer (e.g., ADB auditing requirements, Statements of Expenditure, Imprest Accounts);
- procedural requirements for certain verification procedures (e.g., checking of stocks, inventories, assets, etc.);
- specific actions required on the part of the employer (e.g., access to computer systems and records, disclosures);
- discussions before signing the opinion and report on any matters arising from the audit, and with whom these discussions would be held; and
- the timetable for provision of opinions and reports.

Terms and Definitions

26. This section defines the terms used in this document.

1. Annual Financial Statements

GUIDANCE: The EA will prepare Annual Financial Statements (AFS). Most revenue-earning EAs (e.g., Utilities) will prepare accrual-based financial statements. EA reporting requirements will usually be specified in the Report and Recommendation of the President and in the loan agreement. The component parts of the AFS should be specified in this section.

27. The AFS comprises:

[Option A: Generally IAS-compliant Accrual-based Financial Statements]:

- Statement of Accounting Policies,
- Statement of Financial Performance (or income statement),
- Statement of Financial Position (or balance sheet),
- Statement of Movements in Equity,
- Statement of Cash Flows,
- Notes to the Financial Statements, and
- Other Information (specify).

[Option B: Other Financial Reports]:

- Statement of Accounting/Financial Policies,
- Statement of Income/Cash Receipts,
- Statement of Expenses/Cash Payments,
- Statement of Cash Flows/Cash Receipts and Payments,
- Notes to the Financial Statements, and
- Other Information (specify).

2. Agreed Accounting Standards

GUIDANCE: The accounting standards that govern AFS preparation will normally be agreed and documented in the RRP and/or loan agreement. Choose the appropriate option.

28. “Agreed accounting standards” regarding the preparation of the AFS, means:

- [Option A: International Accounting Standards] the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) (commonly known as international accounting standards).
- [Option B: National Accounting Standards] the accounting standards issued by [national authority].
- [Option C: Modified National Accounting Standards] the accounting standards issued by [national authority], with the following modifications and/or additional disclosures:
- [Option D: Cash-based International Public Sector Accounting Standards] the cash-based International Public Sector Accounting Standards (IPSAS) promulgated by the International Federation of Accountants (IFAC).
- [Option E: Accrual-based International Public Sector Accounting Standards] the accrual-based International Public Sector Accounting Standards (IPSAS) promulgated by the International Federation of Accountants (IFAC).
- [Option F: Specific Government Accounting Standards] describe these standards.

3. Agreed Auditing Standards

GUIDANCE: The agreed auditing standards will normally be documented in the RRP and/or loan agreement. Choose the appropriate option.

29. “Agreed auditing standards” means:
- [Option A: International Standards on Auditing] the International Standards on Auditing (ISA) promulgated by the International Auditing and Assurance Standards Board (IAASB).
 - [Option B: INTOSAI Auditing Standards] the auditing standards promulgated by the International Organization of Supreme Audit Institutions (INTOSAI).
 - [Option C: National Auditing Standards] the auditing standards promulgated by [national authority].

4. Financial Covenants Applicable to [XYZ]

GUIDANCE: The financial covenants that are applicable to the EA will be included in the loan agreement (e.g., Self-financing Ratio). This section should list, describe and fully reference all applicable financial covenants.

30. The following financial covenants, regarding [XYZ], have been agreed:

5. Financial Assurances Applicable to [XYZ]

GUIDANCE: The financial assurances that are applicable to the EA—such as a commitment to employ suitably-qualified accounting personnel—will be included in project legal documents. This section should list, describe and fully reference all applicable financial assurances.

31. The following financial assurances, regarding [XYZ], have been given:

Appendix 9 Model Auditor Terms of Reference: Annual Project Accounts Audit

Paragraph 5.73 (page 37) refers to this appendix.

[ENTITY NAME: XYZ] AUDIT OF ANNUAL PROJECT ACCOUNTS AUDITOR TERMS OF REFERENCE

GUIDANCE: This template is appropriate for an APA audit. It should be completed—by the borrower, executing agency (EA) or project preparatory technical assistance (PPTA) consultants—and provided to ADB for comments before fact finding. This template can be applied to the audit of either a revenue-earning or nonrevenue-earning project.

A. Introduction

GUIDANCE: Briefly describe the audit assignment. Specify whether the engagement is for one or more financial years. A longer period (e.g., 3–5 years) will enable the auditor to become familiar with the entity. The actual contract should allow for termination for inadequate performance, but not for issuing a qualified, adverse or disclaimer opinion.

32. The management of XYZ requires an auditor to carry out the following audit services for the [X] years ended 31 December 20xx:

- An audit of the Annual Project Accounts (APA) for each of the loan projects listed below (see Terms and Definitions).

33. This letter describes the assignment scope and terms and invites you to submit a proposal for delivery of these services.

General Background

GUIDANCE: Briefly describe the supervising agency and the EA. Describe the project in the context of its contribution to achievement of the EA's economic goals. The auditor must understand the “purpose for which the funds are intended” in the context of the broad project objectives as well as in terms of the specific project budget.

34. ...

GUIDANCE: Briefly summarize relevant accounting and financial management practices. Various diagnostic reports are available that describe accounting and financial management practices (e.g., ADB Diagnostic Studies of Accounting and Auditing, World Bank Country Financial Accountability Assessments). Emphasis should be placed on issues raised and risks identified in these reports.

35. ...

Employing Authority or Entity

GUIDANCE: The details of the proposed contractor of the auditor's services should be provided. If the contractor is acting on behalf of, or is part of, a larger authority or entity, this should be disclosed, to assist prospective auditors to determine their independence.

36. The audit services will be contracted by:

Delivery of Opinions and Reports

GUIDANCE: The required opinions and documents should be clearly specified, together with delivery time frames.

37. The auditor will provide the following opinions and reports to management (with copies to ADB), in accordance with the following time frames:

- Audit Opinion on the Annual Project Accounts of:
 - Loan xxx
 - Loan xxx
- Management Letter on the following projects:
 - Loan xxx
 - Loan xxx

38. All reports must be provided in the English language.

Objectives

GUIDANCE: Specify the audit's objectives.

39. The objective of the APA audit (see Terms and Definitions) is to enable the auditor to express an opinion on the financial position of each of the loan projects listed below (see Terms and Definitions), for the years ending 31 December 20xx, and on the funds received and expenditures for the years then ended.

GUIDANCE: This paragraph should be applied where it is referred to in the loan agreement.

40. Separate opinions on the eligibility of claims made in Statements of Expenditure (SOEs) and on the Imprest Account Statement are also required.

Description of Materials and Timing of Delivery

GUIDANCE: The form of the APA and supporting documentation that will be supplied to the auditor, and on which they are to give an opinion and a report, should be specified. In practice, the form and content of APA will vary among countries and projects. For instance, the APA may comprise a Statement of Receipts and Payments only on project transactions. Other schedules may include cumulative work-in-progress, assets and inventories, and a summarized bank reconciliation. The estimated time for providing these documents to the auditor should be stated (e.g., one month after financial year-end). This schedule helps the auditee and the auditor plan for the accounts-preparation and the audit process.

41. The Annual Project Accounts (APA) (see Terms and Definitions) and supporting documentation will be provided to the auditor on the following estimated dates:

Audit Scope

GUIDANCE: The scope of the audit should be sufficiently clear to properly define what is expected of the auditor, but should not restrict the audit procedures or the techniques the auditor may wish to use to form an opinion. This section will not generally have to be customized to a particular audit situation. The list of issues outlined in this section is not exhaustive,

nor should all matters be addressed in every project. The scope and detail of an audit are likely to be unique for each project.

42. **Auditing Standards and Program.** The audit will be carried out in accordance with the agreed auditing standards (see Terms and Definitions), including professional or general standards, standards of fieldwork and reporting standards.

43. The audit program will consider the risk of material misstatements resulting from fraud or error. It should include procedures that are designed to provide reasonable assurance that material misstatements (if any) are detected.

44. **Accounting Policies and Changes.** The auditor should comment on the project's accounting policies, and confirm the extent to which the agreed project accounting policies (see Terms and Definitions) have been applied. In particular, the auditor should note the impact on the APA arising from any material deviations from the agreed accounting standards. The auditor should also comment on any accounting policy changes, either during a financial year, or from one year to another.

45. **Imprest Account (or Special Account).** The Imprest Account reflects: (i) deposits and replenishment received from financiers; (ii) payments substantiated by withdrawal applications; and (iii) the remaining balance at financial year-end. The auditor will examine whether the Imprest Account has been maintained in accordance with the provisions of the relevant financing agreements.

46. The auditor must form an opinion on whether the Imprest Account was used in compliance with required procedures (e.g., those of ADB), and the fairness of the presentation of Imprest Account activity and the year-end balance. The auditor should examine the eligibility and correctness of financial transactions during the period under review, account balances at the end of the period, the operation and use of the Imprest Account in accordance with the financing agreement, and the adequacy of internal controls for this particular disbursement mechanism.

47. **Statements of Expenditures (SOEs).** The auditor will audit all SOEs used as the basis for the submission of credit withdrawal applications

to ADB. These expenditures should be compared for project eligibility with the relevant financing agreements (and with reference to the RRP and other project documents for guidance when considered necessary). Where ineligible expenditures are identified as having been included in withdrawal applications and reimbursed against, these should be separately noted by the auditor. The annual audit report should include a separate paragraph commenting on the accuracy and propriety of expenditures withdrawn under SOE procedures, and the extent to which ADB can rely on those SOEs as a basis for credit disbursement. Annexed to the APA should be a schedule listing individual SOE withdrawal applications by specific reference number and amount.

48. **Compliance with Financial Covenants.** The auditor will confirm compliance with each financial covenant contained in the project legal documents (see Terms and Definitions). Where present, the auditor should indicate the extent of any noncompliance by comparing required and actual performance measurements for each financial covenant for the financial year concerned.

49. **Compliance with Financial Assurances.** The auditor will confirm compliance with all financial assurances contained in the project legal documents (see Terms and Definitions). Where present, the auditor should indicate the extent of any noncompliance by comparing required and actual performance of the borrower in respect of these ADB requirements for the financial year concerned.

50. **Use of Funds for the Purpose Intended.** The auditor will confirm, or otherwise, that:

- All external funds have been used in accordance with the relevant financing agreements covering each project, with due attention to economy and efficiency, and only for the purpose for which the financing was provided;
- Counterpart funds have been provided and used in accordance with the relevant financing arrangements and only for the purpose for which the financing was provided; and
- Goods and services financed have been procured in accordance with the relevant financing agreements.

51. **Record Keeping.** The auditor will pay particular attention to whether all necessary supporting documents, records, and accounts have been kept in respect of all project activities, with clear linkages between the accounting records and the APA. This will include: (i) computation and recalculation, including checking the mathematical accuracy of estimates, accounts or records; (ii) reconciliation, including reconciling related accounts to each other, subsidiary records to primary records and internal records to external documents; (iii) physical observation, including inspecting or counting tangible assets, such as materials, inventory, land buildings, property or equipment; (iv) confirmation, including directly confirming balances or transactions with external third parties, such as cash balances, accounts receivable or accounts payable; (v) sampling, including vouching or examining supporting documentation to determine if balances are properly stated; and (vi) tracing, including tracing journal postings, subsidiary ledger balances, and other details to corresponding general ledger accounts or trial balances.

52. **Internal Control Systems.** The auditor will assess the adequacy of the project financial management systems, including internal controls, including whether: (i) proper authorizations are obtained and documented before transactions are entered into; (ii) accuracy and consistency are achieved in recording, classifying, summarizing and reporting transactions; (iii) reconciliations with internal and external evidence are performed on a timely basis by the appropriate level of management; (iv) balances can be confirmed with external parties; (v) adequate documentation and an audit trail is retained to support transactions; (vi) transactions are allowable under the agreements governing the project; (vii) errors and omissions are detected and corrected by project personnel in the normal course of their duties, and management is informed of recurring problems or weaknesses; (viii) management does not override the normal procedures and the internal control structure; and (ix) assets are properly accounted for, safeguarded and can be physically inspected.

Management Letter

53. On conclusion of the audit, the auditor will prepare a Management Letter for each of the audited projects, detailing:

- Any material weaknesses in the accounting and internal control systems that were identified during the audit;

- Recommendations to rectify identified weaknesses;
- The status of significant matters raised in previous management letters;
- Practical recommendations on the steps that could be taken to become materially compliant with the agreed project accounting policies (see Terms and Definitions), together with a time frame for making these changes;
- The degree of compliance with each of the financial covenants in the loan agreement and recommendations for improvement;
- Matters that have come to the auditor's attention during the course of the audit which have a significant impact on project implementation;
- Any other matters that the auditor considers should be brought to the attention of the project's management; and
- Significant matters that the auditor considers should be brought to ADB's attention.

Statement of Access

54. The auditor will have full and complete access, at all reasonable times, to all records and documents including books of account, legal agreements, bank records, invoices and any other information associated with the project and deemed necessary by the auditor.

55. The auditor will be provided with full cooperation by all employees of [XYZ] and the project-implementing units, whose activities involve, or may be reflected in, the annual financial statements. The auditor will be assured rights of access to banks and depositories, consultants, contractors and other persons or firms hired by the employer.

Independence

56. The auditor will be impartial and independent from any aspects of management or financial interest in the entity under audit. In particular, the auditor should be independent of the control of the entity. The auditor should not, during the period covered by the audit, be employed by, or serve as director for, or have any financial or close business relationship with the entity. The auditor should not have any close personal relationships with any senior participant in the management of the entity. The auditor must disclose any issues or relationships that might compromise their independence.

Auditor and Audit Staff Competence

57. The auditor must be authorized to practice in the country and be capable of applying the agreed auditing standards (see Terms and Definitions). The auditor should have adequate staff, with appropriate professional qualifications and suitable experience, including experience in auditing the accounts of entities comparable in nature, size and complexity to the entity whose audit they are to undertake.

58. To this end, the auditor is required to provide curriculum vitae (CV) of the auditors who will provide the opinions and reports, together with the CVs of managers, supervisors and key personnel likely to be involved in the audit work. These CVs should include details of audits carried out by these staff, including ongoing assignments.

Submission of Proposal and Work Plan

59. You are invited to submit a proposal and a work plan to provide the audit services described in this letter. Proposals should address, among other things:

- the extent (if any) that you would not conform to the agreed auditing standards (see Terms and Definitions) and indicate any alternative standards to which you may (be required to) conform;
- whether the audit would be conducted as a completed audit (i.e., will the auditors carry out their audit after financial year-end, when the books of account are, or are being, closed);
- whether an audit carried out after financial year-end would be supplemented by one or more interim audits during a financial year. The principal purpose is to test ongoing systems and internal controls, and to relieve pressure on the staff of the entity and on the auditor at year-end;
- the manner in which the auditor proposes to address any statutory requirements relating to audit (e.g., certifications relating to shareholders' equity required under the companies' act) or to which they may be implicitly bound by contractual obligations of the employer (e.g., ADB auditing requirements, Statements of Expenditure, Imprest Accounts);
- procedural requirements for certain verification procedures (e.g., checking of stocks, inventories, assets, etc.);

- specific actions required on the part of the employer (e.g., access to computer systems and records, disclosures);
- discussions before signing the opinion and report on any matters arising from the audit, and with whom these discussions would be held; and
- the timetable for provision of opinions and reports.

Terms and Definitions

60. This section defines the terms used in this document.

Annual Project Accounts

GUIDANCE: The Annual Project Accounts (APA) may comprise a Statement of Receipts and Payments (Cash flow statement). This template is specifically intended for audits of these types of APA. Other schedules of value or cumulative work-in-progress, assets and inventories and a summarized reconciled bank statement are to be attached. Project reporting requirements will usually be specified in the RRP and in the loan agreement. The component parts of the APA should be specified in this section.

61. The Annual Project Accounts (APA) comprises:
[Option A: Generally IAS-compliant Accrual-based Financial Statements]:

- Statement of Accounting Policies,
- Statement of Financial Performance (or income statement),
- Statement of Financial Position (or balance sheet),
- Statement of Movements in Equity,
- Statement of Cash Flows,
- Notes to the Financial Statements, and
- Other Information (specify).

[Option B: Other Financial Reports]:

- Statement of Accounting/Financial Policies,
- Statement of Income/Cash Receipts,
- Statement of Expenses/Cash Payments,
- Statement of Cash Flows/Cash Receipts and Payments,
- Statement of Uses of Funds by Project Activity,
- Notes to the Financial Statements, and
- Other Information (specify).

GUIDANCE: The APA should include: (a) a summary of funds received showing ADB funds, any cofinancing and counterpart funds separately; (b) a summary of expenditures shown under the main project components and by main categories of expenditures (as referenced in loan and appraisal documentation) for the year ending 31 December 20xx and cumulative expenditures on the project to date; and (c) statement of fund balance as of 31 December 20xx.

Loan Projects

GUIDANCE: List the loan projects that will be audited. Provide brief details and attach relevant documents.

62. Annual Project Accounts (APA) and supporting documentation will be provided for the following loan projects financed by the Asian Development Bank (ADB) [and IDA, EBRD, etc]:

- Loan xxxx,
- Loan xxxx, and
- Loan xxxx.

Agreed Project Accounting Policies

GUIDANCE: The project accounting policies that govern APA preparation will normally be agreed and documented in the RRP and/or loan agreement. Choose the appropriate option.

63. “Agreed project accounting policies” with regard to preparation of Annual Project Accounts, means

- [Option A: Cash-based International Public Sector Accounting Standards] the cash-based International Public Sector Accounting Standard (IPSAS) promulgated by the International Federation of Accountants (IFAC).
- [Option B: Accrual-based International Public Sector Accounting Standards] the accrual-based International Public Sector Accounting Standards (IPSAS) promulgated by the International Federation of Accountants (IFAC).
- [Option C: International Accounting Standards] the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) (also known as international accounting standards).

- [Option D: National Accounting Standards] the accounting standards issued by [national authority].
- [Option E: Modified National Accounting Standards] the accounting standards issued by [national authority], with the following modifications and/or additional disclosures:
- [Option F: Specific Government Accounting Standards] describe these standards.

Agreed Auditing Standards

GUIDANCE: The agreed auditing standards will normally be documented in the RRP and/or loan agreement. Choose the appropriate option.

64. “Agreed auditing standards” means

- [Option A: International Standards on Auditing] the International Standards on Auditing (ISA) promulgated by the International Auditing and Assurance Standards Board (IAASB).
- [Option B: INTOSAI Auditing Standards] the auditing standards promulgated by the International Organization of Supreme Audit Institutions (INTOSAI).
- [Option C: National Auditing Standards] the auditing standards promulgated by [national authority].

Financial Covenants Applicable to Projects

GUIDANCE: The financial covenants that are applicable to projects will be included in loan agreements. This section should list, describe and fully reference all applicable financial covenants.

65. The following financial covenants have been agreed for the following projects:

Financial Assurances Applicable to Projects

GUIDANCE: The financial assurances that are applicable to the EA—such as a commitment to employ suitably-qualified accounting personnel—will be included in project legal documents. This section should list, describe and fully reference all applicable financial assurances.

66. The following financial assurances, regarding the following projects, have been given:

Appendix 10 Model Auditor Opinion for a Nonrevenue-Earning Project

Paragraph 5.84 (page 41) refers to this appendix.

To: Borrower (or designated agency)

We have audited the accompanying financial statements (pages ____ to ____) of the _____ Project financed under the Asian Development Bank Loan No. ____ as of 31 December, 20 ____, and for the year then ended.

These financial statements are the responsibility of the management of [the EA]. Our responsibility is to express an opinion on the accompanying statements based on our audit.

We conducted our examination in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audit also includes assessing the accounting principles and significant estimates made by management, as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

_____ [The EA's] policy is to prepare the accompanying statements in the format agreed between the Asian Development Bank and the Government of _____ as noted in the Minutes of Negotiations for the Loan [on a cash receipts and disbursements basis in which cash is recognized when received and expenses are recognized when paid, rather than when incurred]/[on an accruals basis in which expenses are recognized when incurred and revenue is reported when income is due].

In our opinion, (A) the aforementioned financial statements and appended notes that were also the subject of the audit, fairly present in all material respects the financial position of the _____ project as at _____ 20 __ and the results of its operations for the year ended _____ 20 __, in conformity with _____ accounting standards, applied on a basis consistent in all material respects with that of the previous year; (B) the [Borrower] [EA] has utilized all proceeds of the loan withdrawn from the Asian Development Bank only for purposes of the Project as agreed between the Asian Development Bank and [the

Borrower] in accordance with the loan agreement; and no proceeds of the loan have been utilized for other purposes; and (C) the [Borrower] [EA] was in compliance as at the date of the balance sheet of the year of audit with all financial covenants of the loan agreement.

In addition:

- (i) (a) With respect to Statements of Expenditures, adequate supporting documentation has been maintained to support claims to the Asian Development Bank for reimbursements of expenditures incurred; and (b) which expenditures are eligible for financing under Loan Agreement No. _____.
- (ii) (a) The Imprest Accounts (page ___) give a true and fair view of the receipts collected and payments made during the year ending _____; and (b) these receipts and payments support Imprest Account liquidations/replenishments during the year.

[(i) and (ii) above are to be provided where the loan agreement requires separate Imprest Account and statement of expenditures audits and audit opinions.]

Appendix 11 Model Auditor Opinion for a Revenue-Earning Agency

Paragraph 5.84 (page 41) refers to this appendix.

To: Borrower (or designated agency)

“We have examined the Balance Sheet of _____ as of _____ 20__ , and the Income Statement, Cash Flow Statement and related statements and Notes (see pages ___ to ___ of our Report) of the _____ Project financed under the Asian Development Bank Loan No. _____ as of 31 December, 20__ , and for the year then ended.

We conducted our examination in accordance with International Standards on Auditing [auditing standards of the country of ____]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatement. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audit also includes assessing the accounting principles and significant estimates made by the Management, as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, (A) the aforementioned financial statements and appended notes that were also the subject of the audit, fairly present separately (i) the financial position of the _____ Project and (ii) the overall operations of the _____ [name of EA] as at _____ 20__ and the separate results of the project operations and the EA’s operations for the year ended _____ 20__ , in conformity with International Accounting Standards [accounting standards of the country of _____], applied on a basis consistent in all material respects with that of the previous year; (B) the [Borrower] [EA] has utilized all proceeds of the loan withdrawn from the Asian Development Bank (ADB) only for purposes of the Project as agreed between the Asian Development Bank and [the Borrower] in accordance with the loan agreement; and no proceeds of the loan have been utilized for other purposes; and (C) the [Borrower] [EA] was in compliance as at the date of the Balance Sheet of the year of audit with all financial covenants of the loan agreement.

In addition:

- (i) (a) With respect to statements of expenditures, adequate supporting documentation has been maintained to support claims to the Asian Development Bank for reimbursements of expenditures incurred; and (b) which expenditures are eligible for financing under loan agreement No. _____. (Required where an SOE audit is required under the loan agreement.)
- (ii) The Imprest Accounts (page ____) gives a true and fair view of the receipts collected and payments made during the year ending _____.

[(i) and (ii) above to be provided where a separate Imprest Account audit is required under the Loan Agreement.]

Appendix 12 Useful Reference Materials

Users of this Handbook may find the following reference materials useful. They are available from Asian Development Bank (ADB) in hard copy or can be freely downloaded from www.adb.org.

Selected ADB Guidelines

Guidelines for the Economic Analysis of Projects (1997)

Guidelines for the Economic Analysis of Telecommunications Projects (1997)

Guidelines for the Economic Analysis of Water Supply Projects (1998)

Guidelines for the Financial Governance and Management of Investment Projects financed by ADB (2002)

Guidelines on the Use of Consultants by Asian Development Bank and Its Borrowers (2002)

Selected ADB Handbooks

Handbook for Integrating Poverty Impact Assessment in the Economic Analysis of Projects (2001)

Handbook for Integrating Risk Analysis in the Economic Analysis of Projects (2002)

Handbook for the Economic Analysis of Health Sector Projects (2000)

Handbook for the Economic Analysis of Water Supply Projects (1999)

Handbook for Users of Consulting Services: Procedures and Practices – Volume I, Fifth Edition (2002)

Loan Disbursement Handbook (2001)

Other Recommended Reading

Anticorruption Policy: Description and Answers to Frequently Asked Questions (2000)

Economic Analysis of Subregional Projects (1999)

Economic Evaluation of Environmental Impacts: A Workbook (1996)

Framework for the Economic and Financial Appraisal of Urban Development Sector Projects (1994)