

1. Introduction to the Guidelines

1.1. Introduction

1.1.1. The vision of the Asian Development Bank (ADB) is a poverty-free Asia and Pacific region. ADB strives to be an effective partner for its Developing Member Countries (DMCs) in Asia and the Pacific in responding to the challenges of achieving sustained and equitable development, improving the quality of life, and eradicating poverty. ADB recognizes that sustained pro-poor growth, social development, and good governance are essential for poverty reduction. This vision reflects the belief that unleashing the potential of the poor will substantially contribute to overall growth and enhance the quality of life for all.

1.1.2. The *Financial Management and Analysis of Projects* (the Guidelines) serve two purposes. First they provide guidance to ADB staff and borrowers on the financial due diligence activities to be completed as part of the project appraisal process, namely financial analysis and financial management assessment. Second, they describe and explain ADB's policies, procedures, and approach to the financial management of the projects that it finances. They replace ADB's *Guidelines for the Preparation and Presentation of Financial Analysis* that were first published in 1989. In addition to providing guidance on ADB's financial due diligence activities, the Guidelines contain business processes and good practice examples of financial management and financial analysis practices adopted by ADB and other multilateral development banks (MDBs).

1.1.3. This is the second release of the Guidelines. It incorporates results of a pilot testing exercise conducted during 2002 and 2003, a full technical review (completed in 2003), and further amendments to reflect ongoing activities associated with the Harmonization Agenda.¹ A matrix summarizing the second release amendments is provided under the "Revisions" tab.

¹ In February 2003, a Harmonization Forum was jointly sponsored by five Multilateral Development Banks (MDBs) (African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, and World Bank) and the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD-DAC). All MDB presidents attended the meeting. The closing statement, the Rome Declaration on Harmonization, summarized progress and committed all participating institutions to specific activities to enhance harmonization. Subsequent to the Forum, the Islamic Development Bank joined the harmonization effort. In addition, an MDB Technical Working Group on Financial Management Harmonization was formed to foster increasing harmonization among the MDBs.

1.1.4. The Guidelines are summarized in the *Handbook for Borrowers on the Financial Governance and Management of Investment Projects financed by the ADB*. The *Handbook* sets out the policies and procedures of ADB with respect to the financial management of projects and executing agencies (EAs). It has been prepared for the benefit of borrowers, EAs, auditors, consultants, and others whose work requires them to be familiar with ADB procedures. The Guidelines are further supported by the *Financial Due Diligence Methodology Note* which summarizes standard due diligence activities to be completed during project processing and appraisal.

1.1.5. ADB activities are guided by policies (approved by the ADB Board) and operationalized through the Operations Manual (OM). Implementation is guided through the preparation of various guidelines. Furthermore, project implementation is undertaken following the Project Administration Instructions (PAIs).

1.1.6. These Guidelines address the financial management of investment projects with the exception of those that involve equity participations and venture capital that ADB may assist in the private sector.

1.1.7. The Knowledge Management section of the Guidelines (most of which is only available from the web-based Guidelines) includes international standards and practices recognized by ADB that are recommended by international bodies such as the Basle Committee on Banking Supervision (BCBS) of the Bank of International Settlements (BIS) and the International Accounting Standards Board (IASB).

1.1.8. These Guidelines have been developed as a web-based document, with a search facility. There is provision to update these guidelines on a regular basis. The full web-based guidelines can be accessed at www.adb.org/documents/guidelines/financial. This hardcopy version of the Guidelines is an abridged version of the web-based guidelines. It has been developed to improve access to the Guidelines, in particular by ADB borrowers and development partners.

1.2. Rationale

1.2.1. These Guidelines represent one of several initiatives that ADB is taking to support improved operational financial management and financial governance arrangements. The following key factors are driving these initiatives:

- ADBs fiduciary responsibilities are derived from the 1966 ADB Charter, requiring ADB to be guided by sound banking principles. Article 14 of the Charter sets out ADBs operating principles and includes particularly:

In making or guaranteeing a loan, the Bank shall pay due regard to the prospects that the borrower and its guarantor, if any, will be in a position to meet their obligations under the loan agreement. (Article 14 (vi))

The Bank shall take the necessary measures to ensure that the proceeds of any loan made, guaranteed or participated in by the Bank are used only for the purposes of which the loan was granted and with due attention to considerations of economy and efficiency. (Article 14 (ix))

In accordance with this, ADB has adopted specific requirements for financial reporting and management by its borrowing countries, including the borrowers' executing agencies where applicable.

- The international community, as a whole, is supporting the development of guidelines, standards, and codes in relation to good financial management and governance arrangements. These guidelines, standards, and codes—to varying extents—all involve accounting and auditing arrangements. They include Principles of Corporate Governance (OECD), Code of Good Practices on Fiscal Transparency (IMF), Code of Good Practices on Transparency of Monetary and Financial Policies (IMF), Implementation of the Objectives and Principles for Securities Regulation Assessment Surveys (IOSCO), International Accounting Standards (IASB), International Standards on Auditing (IFAC), and Draft Banking Supervision Guidelines (BCBS).
- OM C4 (Governance) identifies four elements of good governance: (i) accountability, (ii) participation, (iii) predictability, and (iv) transparency. In particular, OM C4 states that ADB will focus on: improving public financial management, and promoting transparency. In relation to transparency, ADB will focus on the disclosure of information ... and ... encourage loan project executing and implementing agencies to produce, or improve the quality of, annual reports and to disseminate these more widely to the public at large.
- In accordance with Section 588 of the United States Foreign Assistance Act (FAA) 2001, the US Secretary of the Treasury must certify to the US Congress that ADB is fulfilling the requirements of the FAA. Ten percent of the US congressional appropriation to ADB may be withheld in the absence of such certification. The certification relates to ADB's efforts regarding procurement reforms and financial

management reforms, including: (i) annual project audits by qualified independent auditors, (ii) fraud and corruption investigations, (iii) assessments of recipient countries' financial management capabilities, and (iv) support to improve transparency and financial management in recipient countries.

- The Harmonization Agenda has, at its core, the objective of improving aid effectiveness by reducing the transaction costs to the recipient country. Improved financial management systems, at the country level, and agreement from development partners to rely on these systems to the greatest extent possible are critical to the harmonization efforts. The Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD-DAC) has developed a number of good practice notes, including the Good Practice Paper on Financial Reporting and Auditing (December 2002) and the MDB Technical Working Group on Financial Management Harmonization have developed the *Framework for Collaboration Among Participating MDBs on Financial Reporting and Auditing* (February 2003).

1.3. Objectives

1.3.1. With the intention of (i) ascertaining the financial viability and sustainability and (ii) appropriate management and use of funds in ADB-funded projects, these Guidelines are intended to provide a framework for ADBs financial due diligence requirements throughout the ADB project cycle. Thus, the Guidelines' scope includes:

- financial analysis of projects,
- project and entity financial management assessment, and
- auditing requirements for projects.

1.3.2. The Guidelines' due diligence framework is intended to provide broad guidance for all ADB projects irrespective of specific funding source modalities. (Further guidance on due diligence in ADB private sector projects can also be accessed in the Private Sector Operations—Staff Instructions). The Guidelines provide specialized and appropriate financial analysis and financial management techniques to be utilized for all ADB projects and for every stage of the project cycle—CSP and concept stage, feasibility and Project Preparatory Technical Assistance (PPTA) stage, loan negotiations and agreements stage, supervision and monitoring stage as well as post-evaluation, where appropriate. This includes where necessary, the prescription by ADB staff of the design and installation of suitable financial systems by borrowers to assure ADB's management on project financial viability and sustainability. The latter must be confirmed by timely, accurate financial reporting by borrowers and by timely and rigorous project supervision by financial analysts.

1.3.3. It was also considered that ADB's project portfolio contains a wide array of projects that require specialized financial management and measurement techniques, ranging from public sector revenue-earning operations to nonrevenue-earning ones such as in the health and education sectors; from public and private sector financial institutions (FIs) to public utilities and transportation, plus the many specialized elements of agriculture. These financial management techniques include sectoral and project-specific financial analysis, financial performance measurement, design, and operation of institutional financial management systems, including accounting, financial reporting and auditing, supported by the loan management and disbursement techniques.

1.3.4. ADB's staff, borrowers, consultants, and development partners should have access at any time to guidelines on all these aspects of project, entity, and financial management. The aim, in this regard, is to ensure that each project and entity is financially well managed and that borrowers and ADB staff have immediate access to identical information and guidance on using these techniques.

1.3.5. The Guidelines have, therefore, been designed to provide a complete set of reference and training materials to fulfill these requirements and to set up a knowledge management base to enhance and sustain these necessary professional skills in ADB.

1.3.6. The Guidelines' overall objective is to enhance the quality of ADB's portfolio by:

- establishing the norms for financial analysis and financial management of revenue-earning and nonrevenue-earning projects for use during the project cycle;
- defining the financial management requirements for projects and project entities of borrowers, EAs, and other organizations charged with efficient use of funds provided by ADB;
- explaining to borrowers the project and institutional financial performance requirements of ADB to achieve successful implementation and the sustainability of ongoing operations;
- providing financial knowledge management for the guidance and training of ADB staff and borrowers; and
- providing ready access to ADB's project financial management requirements to all interested parties.

1.3.7. The Guidelines' specific purpose is to provide ADB management, staff, and borrowers with an understandable, comprehensive and transparent directory of standards of financial analysis, and financial management for the implementation and operation of projects, including:

- a cross-referenced methodology note which lays out a standardized approach to financial due diligence (financial analysis and financial management assessment);
- a summarized quick reference guide and detailed checklist on project financial management for ADB staff;
- a concise reference booklet for the use of borrowers on ADB's requirements for the financial management of projects and project entities; and
- a financial knowledge management base for ADB staff engaged in the project cycle.

1.3.8. The Guidelines aim, in this regard, to provide fundamental parameters, designs and measurement techniques on which to construct the necessary institutional and financial analyses of investment projects and, where appropriate, of EAs. They are designed to achieve consistency in the presentation of findings and recommendations by ADB staff and borrowers in studies, reports, and documents for which these forms of analysis are required.

1.3.9. The advice, directions, and recommendations in these Guidelines should not be regarded as a substitute for the professional judgment of ADB staff. The Guidelines should be considered as reference guide to assist staff in conducting an appropriate degree of financial due diligence during project processing and should guide staff in determining the appropriate level of financial management safeguards required for a given project and/or EA.

1.4. Structure

1.4.1. In addition to this introduction, the Guidelines comprise six principal parts as follows.

1.4.2. Part 2 – **User Instructions** – describes ADB's financing methods and how to apply these Guidelines to different types of projects.

1.4.3. Part 3 – **Preparing and Appraising Investment Projects** – advises on the key features that a borrower and a financial analyst need to know to participate in the preparation, appraisal, implementation, and supervision of an investment project. It includes appraisal checklists and describes the preparation of project cost tables and other forms of financial tables. In addition, a draft form of each principal type of legal covenant (necessary to support financial requirements in legal documents) is provided.

1.4.4. Part 4 – **Financial Management of Executing Agencies** – advises on institutional and systems requirements and relevant financial management

considerations. Furthermore, individual sections address key topics such as governance, anticorruption, forms of implementing agencies, financial systems necessary to support investments and to provide sound bases for financial analysis, and the principal techniques of performance measurement.

1.4.5. Part 5 – **Reporting and Auditing** – focuses on ADB’s requirements for financial reporting and auditing of projects, EAs and IAs. It also includes examples of auditors’ opinions, a questionnaire to check the adequacy of financial statements, and draft terms of reference for an auditor.

1.4.6. Part 6 – **Financial Institutions (FIs)** – describes the particular applicability of these guidelines to FIs. Given ADB’s increased involvement with small-medium enterprise lending and microfinance, this part considers the specific application of the Guidelines to financial institutions. In particular, the part provides guidance on: (i) reviewing FI financial management, (ii) appraising FIs, (iii) measuring FI performance, and (iv) FI reporting and auditing.

1.4.7. Part 7 – **Knowledge Management** – The 1989 Guidelines provided limited resource materials. The Knowledge Management section of the revised web-based Guidelines includes a wide variety of guidance materials. These include lists and descriptions of accounting and auditing standards, and useful Internet sites. The section also contains best-practice guidance and sector-specific case studies. Space and presentation constraints limit the Knowledge Management section of the abridged hardcopy Guidelines to essential reference materials.

1.4.8. Please note that, for purposes of these Guidelines, unless otherwise indicated, “Asian Development Bank” means the Asian Development Bank, the Asian Development Fund, and the Technical Assistance Special Fund. Also, unless stated otherwise, the requirements for executing agencies also apply to implementing agencies.

1.5. Project File

1.5.1. These Guidelines mention a Project File. This permanent division file should be maintained by the responsible Regional Division. While Regional Division Managers are responsible for ensuring its continued relevance and security, they will normally delegate these duties to the responsible financial analyst.

1.5.2. A Project File must contain all relevant financial information gathered during fact-finding, appraisal, and project supervision (either originals or copies). This

information should include details of original and amended financial policy decisions affecting the project and the EA; the assumptions and basic calculations underlying financial analysis, for financial performance indicators, and for the design of financial covenants. The file must also include copies of all computer files that may be used to develop project-specific programs and analyses.

1.6. Guideline Updates

1.6.1. The Guidelines are available as a downloadable hardcopy document, via the Internet (www.adb.org/documents/guidelines/financial), and on CD-ROM. The web-based version of the Guidelines and the downloadable abridged hardcopy of the Guidelines are updated occasionally. A list of changes to the Guidelines can be accessed online at <http://intra.asiandevbank.org/fmguide/>. After reviewing these changes, users may decide to download an up-to-date hardcopy of the Guidelines.

1.7. Roles of Financial Analysis Specialists and Financial Management Specialists

1.7.1. The function of the Principal Financial Management Specialist (PFMS) and the additional Financial Management Specialist (FMS) in RSDD is to provide overall guidance, develop best practices and guidelines, carry out diagnostic studies of DMCs and provide other assistance to projects departments as needed. To provide operational support, they also review selected project documents to ensure quality of projects at entry as well as consistency with ADB's policies and guidelines. The PFMS also networks on financial governance and management issues through the departmental FMSs.

1.7.2. The primary responsibility of the FMSs that is based in the regional departments is to provide assistance on financial management matters to the whole department, and to undertake reviews of audited annual project accounts.

1.7.3. The Financial Analysis Specialists (FASs) are based in project divisions. Their focus is at the project level, particularly the financial analysis of investment projects (see Part 3 of the Guidelines).