

5. Reporting and Auditing

5.1. Financial Reporting and Auditing Overview

5.1.1. This part of the Guidelines addresses the financial reporting by, and auditing of, projects, project EAs, and project implementing agencies (IAs). It also advises on the selection and terms of reference of public and private sector auditors, particularly in relation to the qualifications and competence of government auditors. Arrangements for monitoring and reviewing financial reports and auditors' reports are explained in detail. A checklist is provided for reviewing auditors' reports.

5.1.2. Together with Part 3 (Preparing and Appraising Investment Projects) and Part 4 (Financial Management of Executing Agencies), this part aims to: (i) provide financial analysts with detailed guidelines to enable them to advise governments, EAs, and IAs on ADB's financial reporting and auditing requirements; and (ii) facilitate the identification of inadequate financial reporting and auditing performance by EAs, IAs and auditors.

5.1.3. It is based on the Operations Manual (OM), Project Administration Instructions (PAIs), and related guidance documents. Part six of these guidelines provides specific guidance on particular financial reporting and auditing issues for FIs. In addition to this introduction and overview, this part has five sections:

5.2	Accounting Standards and Policies	This section describes accounting standards and their applicability to financial reports on ADB-financed projects.
5.3	Financial Reporting	This section outlines ADB financial reporting requirements for ADB-financed projects.
5.4	Auditing Standards and Auditor Engagement	This section describes auditing standards and their use in the audit of the financial reports of ADB-financed projects.
5.5	Reviewing Financial Reports	Project Administration Instruction 5.09 sets out ADB requirements for monitoring financial reporting. This section discusses the process of reviewing financial reports and outlines actions that should be taken where financial reports are overdue or are inadequate.

- 5.4 Reviewing Audit Reports This section provides guidance on reviewing auditor reports. It includes an audit report questionnaire.

5.2. Accounting Standards and Policies

5.2.1. Introduction

5.2.1.1. The preparation and reporting of accounting information varies widely among countries and contributes to a substantial lack of transparency and consistency in financial reporting. This means that precise interpretation of public and private sector financial statements can be a daunting process. At best, they may be misleading; at worst, they may be fraudulent. A serious ADB concern is the accurate interpretation of the financial position and performance of its borrowers and EAs. It is even more important for investors and those charged with the safeguarding of trading operations in stock exchanges, brokerage houses, and banks to have confidence in reported financial performance and position.

5.2.1.2. In recent years, there has been significant progress in the availability and usage of internationally consistent accounting standards. First, the IAS issued by the IASB were developed to the point where they presented a viable, and arguably preferable, alternative to nationally developed accounting standards. Second, most developed and developing countries are in the process of either harmonizing their accounting standards with IAS or adopting IAS directly. Financial analysts should be conversant with the status of these developments.

5.2.1.3. ADB, together with other IFIs, including the other MDBs, is actively encouraging borrowers and EAs to adopt uniform standards of accounting and financial reporting. In this respect, ADB recommends that revenue-earning EAs report in accordance with IAS-compliant accounting policies.¹⁰ However, some time will be required to achieve a high level of uniformity. In the case of nonrevenue-earning EAs in the public sector, ADB expects sound financial policies, adequate accounting records, proper internal control systems, timely reporting to management, and sound auditing practices.

5.2.1.4. This section discusses ADB's approach to the application and use of accounting standards and policies by borrowers.

¹⁰ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3)

5.2.2. International Accounting Standards

5.2.2.1. Differences in financial reporting practices and accounting standards can be significant between countries. The factors that influence the development of accounting practices and the differences between countries in terms of these practices include the nature of a country's legal system, the prevalent providers of finance, the influence of taxation, and the strength of the accountancy profession.

5.2.2.2. The IASB, which superseded the International Accounting Standards Committee (IASC) on 1 April 2001, promulgates IASs. The term "International Accounting Standards (IAS)" is used here to define all accounting standards adopted by the IASB—this includes both the international accounting standards issued by the predecessor to the IASB, the Board of the International Accounting Standards Committee (IASC) between 1973 and 2001 and designated "International Accounting Standards" (IAS) as well as the standards issued by the IASB post 2001 and designated as "International Financial Reporting Standards" (IFRS). The IASB's objectives are to: (i) develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions; (ii) promote the use and rigorous application of those standards; and (iii) bring about convergence of national accounting standards and IASs to high quality solutions. IASs are appropriate for private sector reporting and for reporting by government business enterprises, including public utilities (e.g., electricity, gas, water and sanitation, and telecommunications). The Knowledge Management section of these guidelines provides a list of IASs. Further information is provided at www.iasb.org and at www.iasplus.com.

5.2.2.3. Surveys of national accounting standards show that most countries are aligning their accounting standards with IASs. Some countries have adopted IASs completely. In particular, the Group of 7 nations has pledged to align their accounting standards with IAS and the European Union has decreed that all member countries should adopt IASs for listed company reporting by 2005. The status of country adoption of IASs can be examined at the IASB's website (www.iasb.org).

5.2.2.4. In 1998, the IMF was charged with monitoring the country adoption and usage of IASs. Consequently, countries will be under pressure to adopt some form of accounting standards in close harmony with IAS, if not the complete IAS package of standards. The G7 expects the IFIs, including ADB, to contribute to advancing the use of IAS in their member countries. These contributions may be by requiring use of IASs in financial reporting to ADB, and by providing assistance in appropriate cases to modify systems and build capacity.

5.2.3. ADB Accounting Policy Requirements

5.2.3.1. Requirement to Meet International Standards

5.2.3.1.1. Financial analysts need to fully understand IASs. They also need to be reasonably familiar with the accounting standards in use in the countries in which they operate. In this respect, financial analysts should review DSAA, where they have been prepared (see section 4.2.5). More particularly, financial analysts should become familiar with the accounting policies used by the EAs and IAs that manage ADB-financed projects. This will enable analysts to recommend approaches that will: (i) provide ADB with adequate information to understand the efficiency of the management of borrowers' investments, and (ii) contribute to narrowing differences between IASs and national accounting standards.

5.2.3.1.2. ADB will seek to agree with the borrower, EA and PIU on the acceptable accounting standards and policies governing the preparation of financial statements not later than at loan negotiations. Financial statements for private sector companies and organizations, and for revenue-earning public sector EAs, should be prepared in accordance with accounting policies that are consistent with IASs.¹¹ Alternatively, ADB may accept audited annual financial statements of projects, EAs and IAs 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. In relation to nonrevenue-earning projects in the public sector, ADB expects sound financial policies, proper accounting records, proper internal control systems, timely reporting to management, and sound auditing practices.

5.2.3.1.3. ADB therefore recommends that all public and private sector revenue-earning EAs and IAs should move to account and report for projects financed by ADB on the basis of accounting policies consistent with IASs current at the date of loan negotiations, or any other date(s) in the project implementation period agreed between ADB and the borrower. Borrowers, EAs or IAs should adopt IAS-compliant accounting policies by an agreed date.¹² 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.

¹¹ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3)

¹² Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3)

5.2.3.2. Timetable to Introduce Acceptable Accounting Policies

5.2.3.2.1. ADB expects that public and private sector revenue-earning project financial reports will be prepared on the basis of IAS-compliant accounting policies.¹³

5.2.3.2.2. In some cases, national accounting standards and practices will not conform to accepted international standards.

5.2.3.2.3. 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.

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

5.2.3.2.5. In these instances, financial analysts should coordinate with the Supreme Audit Institution (SAI) of the borrowing country, the EA and the PIU, to determine required modifications of accounting policies and the required date for their introduction. The introduction date of the revised policies and practices may be included as a loan covenant, or as a requirement prior to the commencement of project implementation activities.

5.2.3.2.6. ADB will develop a timetable for each borrower and EA in the private sector and for each public sector revenue-earning EA for the complete adoption of accounting policies that are consistent with IASs, or to local standards that are similar to IASs.¹⁴ In this respect, financial analysts should review the action plans developed as part of the DSAA, where they have been prepared (see section 4.2.5).

5.2.3.3. Statements on Accounting Standards and Policies

5.2.3.3.1. Financial analysts should pay close attention to the text or wording of statements made by EAs in the financial statements on the accounting standards and policies used to prepare the reports. Attention should also be given to auditors' comments on the accounting standards and policies used.

¹³ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3)

¹⁴ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3)

5.2.3.3.2. It is common for financial statement preparers (i.e., EAs) and external auditors to use vague phrases, such as “approved standards”, “official local standards”, and “international standards”. Analysts should insist on the accurate description of both accounting standards and policies used to compile the financial statements and the definition of the auditing standards applied by the auditor.

5.2.3.4. ADB Reports on Accounting Standards and Policies

5.2.3.4.1. ADB reports relating to project identification, preparation, appraisal (RRP), and supervision should describe the current status of application and use of IASs in the country concerned, and by the EA and/or PIU.¹⁵ The reports should include recommendations, or commentaries on, timetables and associated steps by ADB to encourage borrowers, EAs and IAs to adopt IAS-compliant accounting policies.

5.2.3.5. Example of Accounting Policies

5.2.3.5.1. 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. In the case of nonrevenue-earning EAs, Statements of Accounting Policies are likely to be simplistic (for instance, they may cover only cash-recognition policies).

5.2.3.5.2. The following table provides guidance on General Accounting Policies. Particular Accounting Policies should set out the policies applicable to revenues, expenses, assets and liabilities. It is highly recommended that financial analysts review the model set of IAS-based accounting policies and financial statements available at www.iasplus.com. An IAS disclosure checklist is also available from this website.

Issue	Details	Example
Reporting Entity	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	Reporting period should be stated.	<i>These financial statements apply to the financial year ended 31 December 20X2.</i>

¹⁵ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3)

Issue	Details	Example
Legislative Basis	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	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	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 revaluations 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>
Indirect Taxes and Duties	Treatment of indirect taxes and duties should be clearly stated.	<i>Revenue and expense items are recognized net of 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.	<i>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.</i>

Issue	Details	Example
Basis of Combination (Consolidation)	Where consolidated financial statements have been prepared, the combination basis should be stated.	<i>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.</i>
Related Parties	The policy applied to the disclosure of related-party transactions should be stated.	<i>There were no related party transactions during the financial year.</i>
Foreign Currency	The basis for recording foreign currency transactions and translating these transactions and balances should be stated.	<i>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 (being money 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.</i>

5.3. Financial Reporting

5.3.1. Introduction

5.3.1.1. This section describes the required form and timing of reports on the financial position and performance of projects and, where applicable, of EAs and IAs. ADB seeks to agree with borrowers, EAs and/or IAs at loan negotiations to receive, for each project, interim and annual audited financial statements acceptable to ADB in respect of each fiscal year (OM J7 and GP 43).

5.3.1.2. In cases where an ADB TA grant is provided in parallel with, and linked to, an ADB loan to a borrower for the same project operation, the provisions for financial reporting and auditing set out in this part of the Guidelines will apply. Depending on the obligations agreed upon by ADB and the borrower and its EAs and IAs on the progress of a project, ADB typically requires the submission of periodic progress reports, including financial reports, covering: (i) the progressive interim, annual, and final costs of a project; (ii) where appropriate, the financial performance and financial position of an EA or PIU; (iii) accountability for the funds, including ADB loans, provided for project implementation; (iv) the bases for disbursements of proceeds of ADB loans; (v) the extent of compliance with financial and related covenants, and (vi) the effectiveness of project-related financial management and accounting systems as specified by ADB and agreed to by the borrower.

5.3.1.3. Early in the project processing cycle, preferably at project identification, the financial analyst should inform borrowers, EAs, and IAs of the project accounting and auditing requirements. Commitments are to be sought, as confirmed in a subsequent Aide Memoire and in the loan agreement as to the nature, form and manner of compliance, and the timing of the appointment of the auditor. Where necessary, commitments are to be detailed in the minutes of loan negotiations. The appointment of auditor should be made either before the date of ADB loan approval or the start-up date of the project.

5.3.1.4. Borrowers and EAs should be reminded of the need to inform other concerned entities or persons on ADB's reporting requirements including: (i) a government ministry responsible for the performance of an EA, and for assigning or appointing the auditor; (ii) a government auditor mandated by law to audit the accounts of the EAs or IAs; (iii) private or commercial auditors acting on behalf of, or in substitution for, a government auditor; and (iv) a principal or holding company having financial responsibility for the EAs or IAs. Early notification of ADB requirements to the above responsible authorities is essential to enable the Project Officer to assess the likely prospects for compliance prior to, and during, appraisal. This will also allow the Project Officer to comment on the expected performance and quality of financial reporting and auditing in the RRP and, if necessary, in the project identification and preparation BTORs.

5.3.1.5. Reports on project identification, preparation, appraisal (RRP), and supervision should include a reference to the accounting standards and policies adopted by the borrower's EA and PIU, and their acceptability to ADB. Any modifications that will be, or have been, made to financial reporting requirements should be communicated to ADB.

5.3.2. Content and Timing of Financial Reporting

5.3.2.1. 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.

5.3.2.2. The following fundamental principles should apply to all interim and annual financial statements on projects issued by a borrower: (i) disclosure of full accountability for all funds of the borrower, other donors and lenders, and ADB; (ii) compliance with loan covenants and ADB requirements for project management; (iii) adequate disclosure of all material information; and (iv) a true and fair view, or a fair presentation in all material respects, of the financial performance and status of the project (and where applicable, of the EA/PIU).

5.3.2.3. In addition, the following fundamental principles apply to annual financial statements only: (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.

5.3.2.4. Interim and annual financial statements relating to each project should be presented in the English language and show sufficient information to identify separately the transactions relating to the reporting year and the cumulative transactions from the date of start-up (PAI 5.10 refers). This applies particularly to those expense and revenue categories contained in the loan agreement and/or RRP and revisions thereto. The reporting year includes a part-year from the start-up date to the end of that fiscal year, and a part-year from the start of the fiscal year in which a project is closed, to the date of closure (PAI 5.10 refers). “Date of start-up” means the date of the first financial transaction that is the subject of the Project Cost Table and/or the project operating costs and revenue forecasts referred to in the RRP. Therefore the date of start-up could include the date when costs that were approved for retroactive financing were incurred (e.g., design costs or mobilization expenses) (PAI 5.10 refers).

5.3.2.5. In a case where there are no financial transactions in the first fiscal year (or part thereof), if an Imprest Account has been established with ADB funds, this transaction must be reported in the annual financial statements, even where there have been no withdrawals therefrom (PAI 5.10 refers). In the event that a PIU or EA was established and local counterpart funds were expended (e.g., on salaries and wages) but no project implementation occurred, the first year’s annual financial statements should be provided to ADB showing the operating costs of the PIU/EA (PAI 5.10 refers).

5.3.2.6. Audited annual financial statements of nonrevenue-earning EAs are required in the English language for each fiscal year of project development and implementation, including the year of final commissioning of the project. Interim and annual statements may combine financial transactions of a project with those of the EA, where the agency is established solely for purposes of developing the project.

5.3.2.7. Where an EA is responsible for implementing defined subprojects (with or without engaging PIUs for subproject implementation) 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. For projects where multiple EAs are required to submit separate APA/CFS, compliance details will be recorded separately in PPRs indicating separate status of compliance and ratings which will be the basis for calculating the overall APA/CFS rating/compliance of the project (PAI 5.10 refers).

5.3.2.8. For a revenue-earning project, ADB requires English language presentations of audited annual financial statements of the project and of the borrower or project EA for the period of the loan. Along with the audit report which expresses the audit opinion following the audit of the annual financial statements, ADB also requires a Management Letter, by agency if 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 financial status and performance of the project for the fiscal year, the previous fiscal 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.

5.3.2.9. Borrowers are required to provide interim and audited annual financial statements in accordance with a timetable agreed with ADB. Interim financial statements are normally required at intervals of 3, 4 or 6 months of each fiscal 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). This reporting period could be extended to 9 months, for the following exceptions:

- In cases of weak institutional capacity, submission of audited financial statements/audited project accounts can be started at 9 months and later be reduced to 6 months over the course of project implementation

- In cases of decentralization, the deadline could be extended upto 9 months if logistical considerations are such that they would impact the physical flow of information

As state owned enterprises (SOEs) are expected to behave as a corporate entity, and to operate on commercial principles, no exceptions beyond 6 months should be considered for submission of AFS, APA, imprest funds, and SOEs as applicable.

It should be noted that the timely submission of APA and AFS depends to a large extent on the timely preparation of financial accounts. One approach that should be considered would be to require preparation of project accounts and financial statements (which is the responsibility of the EA/IA) and submission to the external auditor within 2 to 3 months of the fiscal year end. Project supervision and administration activities should, among other things, monitor the timely preparation of accounts.

5.3.2.10. Where audited financial statements are to be first submitted to a government legislature (with the risk thereby of substantially delaying the transmission 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.

5.3.2.11. 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.

5.3.3. Accounting Statements and Financial Reports

5.3.3.1. The following table summarizes the financial reporting requirements for projects and EAs/PIUs. While the reporting requirements for revenue-earning projects and EAs/PIUs are uniform, those for Nonrevenue-earning projects and EAs/PIUs are not.

5.3.3.2. The most significant difference among the financial reports of nonrevenue-earning projects and EAs/PIUs depends on whether entities use the accrual or the cash basis of accounting. Under the cash basis of accounting, nonfinancial assets (for instance, fixed assets, receivables, 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.

5.3.3.3. The purpose and format of each accounting statement, which is listed in the following table, is described in the following subsections.

Accounting Statements and Financial Reports

Accounting Statements	Nonrevenue-Earning Projects and Executing Agencies (PIUs)		Revenue-Earning Projects and Executing Agencies (PIUs)	
	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 (i)	✓ note (i)	✓	✓
Imprest Account Statement	✓	✓	✓	✓
Statement of Expenditures (SOE)	✓	✓	✓	✓
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 (ii)	✓ note (ii)	✓ note (i)	✓ note (i)
Other Information	✓ note (iii)	✓ note (iii)	✓ note (iii)	✓ note (iii)

(i) The content and format of Cash Flow Statements for nonrevenue-earning projects (and EAs) will not necessarily conform to international accounting standards or to national accounting standards.

(ii) The notes to the financial statements provide further breakdowns or explanations of the information provided in the main financial statements.

(iii) The scope and nature of other information provided will be negotiated between ADB and the borrower.

Statement of Accounting or Financial Policies

5.3.3.4. As discussed in section 5.2.3, and irrespective of whether the cash or accrual basis of accounting is used, a clear statement of the accounting or financial policies that underlie the accounting statements must be provided.

Statement of Income (or Cash Receipts)

5.3.3.5. Shows the year's complete financial information, and cumulative data from project start-up to date. Where the cash basis of accounting is followed, the opening and closing cash balances should be shown. ADB financing should be subdivided as follows when ADB disburses via SOE procedures: (i) by expenses category in the loan agreement, RRP or revisions thereto, (ii) disbursements via SOE, and (iii) other methods.

Statement of Expenses (or Cash Payments)

5.3.3.6. 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.

Cash Flow Statement

5.3.3.7. The Cash Flow (or project funds) Statement should include:

- Sources of project financing (for example, ADB, Government contribution, etc.), and by methods of disbursement by ADB (for example, direct payment, imprest account, etc.)
- Uses of funds summarized under project disbursement categories as per the loan agreement (for example: equipment, civil works, consultant services and training, and "Other" which may be further subdivided following start of project implementation)
- The opening and closing cash balances; and
- In accordance with IAS 7, separate disclosure is required of funds that are not available for use, such as confirmed future commitments.

Imprest Account Statement

5.3.3.8. This statement summarizes ADB's advances and replenishments, less amounts withdrawn by the project entity, showing the remaining cash balance in the Imprest Account.

5.3.3.9. Bank statements should be provided by each local bank that is selected to operate each imprest account, where these are in use for the project. 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"). The Project Imprest Account is to be used to replenish the SGIA, when this is in use. It will be necessary to attach "Reconciliation Statements" to reflect in-transit items between ADB and the Imprest Account and between Imprest Account and the SGIA. (Replenishment made by ADB not yet received; and reimbursements to the SGIA from the Imprest Account not yet received by it). 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.

Statement of Expenditures

5.3.3.10. 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. The ADB *Loan Disbursement Handbook* describes the use of this method and associated reporting and auditing procedures.

Income Statement and Balance Sheet

5.3.3.11. These statements may not be necessary where cash accounting is used. These statements are described in section 4.3.4 (*Preparing Financial Tables*).

Notes to Financial Statements

5.3.3.12. The EA should provide Notes to the financial statements. These 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.

5.3.3.13. For example, if Statements are prepared on a "cash basis", information may be required from the EA to convert key items to an "obligation" or "accrual" basis and ADB, therefore, may seek details relating to obligations (unpaid commitments and accounts receivable) in supplementary statements. Similarly, details may also be required to distinguish between transactions relating to capital (development) investments and operating expenditures.

Other Information

5.3.3.14. ADB wishes to receive financial reports on a project that illustrate both performance in the fiscal year under review and accumulated transactions from project commencement particularly with regard to sources of funds and expenditures for assets and inventories.

5.3.3.15. Reporting practices in some government entities require only disclosure of annual financial transactions against annual budget authorizations. Therefore, to monitor performance from start-up throughout the project's implementation period, the reported results of project transactions and financial performance data for previous fiscal years should be included as memorandum entries in a current fiscal year's Statement of Income (or Cash Receipts) and Statement of Expenses (or Cash Payments).

5.3.3.16. Alternatively, the reported results of prior years may be included in the annual financial statements as of the last day of the reporting fiscal year, that summarizes and classifies all receipts and expenditures relating to the project from its commencement. In addition, the accumulated sources or provision of funds for the project in the ratio agreed upon between the borrower and ADB should be disclosed in the Notes to the financial statements.

5.3.4. Interim Financial Statements and the Project Management Report

5.3.4.1. During the course of each financial year, ADB requires Project Financial 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/PIU 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.

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

5.3.4.3. The PMR should also show, for each line item, the planned/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.

5.3.4.4. A sample PMR format for a nonrevenue-earning project in the public sector, that uses the cash accounting basis, is provided in the Knowledge Management section. The sample should be used as a guide; it may need to be amended to reflect country-specific circumstances.

5.3.5. Audited Project Financial Statements

5.3.5.1. Audited annual project financial statements should be provided to ADB to fulfill the fiduciary requirements of the borrower, cofinancier/donor(s), and ADB. These financial statements may be classified into two broad categories:

- Annual financial statements in respect of a nonrevenue-earning project only that may also include information on the performance and status of the EA where this agency has no other financial performance commitments to ADB under a loan agreement; and
- Annual financial statements in respect of a revenue-earning project and of the project EA where the latter is an autonomous or semi-autonomous revenue-earning entity with responsibility for implementing the project, usually to provide an addition to its revenue-earning capacity.

5.3.6. Annual Financial Statements for a Nonrevenue-Earning Project

5.3.6.1. Annual financial statements should be prepared by an EA in respect of a project only particularly where the project is nonrevenue-earning and is implemented by organizations of national, provincial, state, or regional and/or local governments. Financial transactions relating to the EA may be included as line items in project income and expenses.

5.3.6.2. 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.

5.3.7. Annual Financial Statements for Revenue-Earning Projects and EAs

5.3.7.1. Borrowers are asked to provide ADB with annual financial statements in respect of each autonomous or semi-autonomous 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 status of the project/EA. Normally these should comprise:

- A Balance Sheet showing the financial position of the entity, including the project, as at the close of each fiscal year.
- 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 fiscal year.
- Notes to the Financial Statements.

5.3.7.2. Financial statements should include comparative figures for the preceding fiscal year; with appropriate supporting schedules and explanatory notes (e.g., methods of revaluation of assets; unusual conditions that affected performance). Supplementary financial statements should be provided containing information requested by ADB with respect to items requiring additional disclosure or explanation.

5.3.7.3. At appraisal, the proposed EA would be expected to provide these statements with an auditor's opinion and report for the most recent years of its performance as an established agency, usually 5 fiscal years preceding the date of appraisal.

5.3.7.4. During project implementation, an extended form of the PMR is requested for each autonomous or semi-autonomous EA that plays a substantive role in implementing and/or operating a project having commercial or revenue-earning characteristics. Unaudited interim Cash Flow Statements and Balance Sheets, may be required for specified periods of each fiscal year—for example, each quarter or semester—in addition to audited annual financial statements.

5.3.7.5. An Income Statement should report the results of operations for the period covered under major categories of financial information. These may embrace, but are not limited to the following: (i) operating revenue by categories of sales or service charges; (ii) operating expenses by category (e.g., labor, supplies, and administration; cost of sales, or transmission and distribution, etc.); (iii) depreciation; (iv) income from sources other than operations; (v) taxes on income; (vi) interest and financing costs charged to operations; and (vii) net income.

5.3.7.6. The Cash Flow Statement should show, during the period covered by the Income Statement, the origins of all cash flows and their use in financing the project, any expansion of the entity, debt service, working capital, and, where appropriate, payment of dividends on equity or other forms of surplus funds distribution. ADB prefers that this Cash Flow Statement be designed and presented in a manner which illustrates the cash flow of the entity during the period, with separately identified information on noncash and working capital transactions.

5.3.7.7. The Balance Sheet should be drawn up at the close of a reporting period and should display fixed, current and other assets, with liabilities, particularly long and short-term debt, paid-up equity, and accumulated earnings and surpluses. To best illustrate the nature and business of the entity, the Balance Sheet should be compiled in a manner that highlights such important characteristics as the capital structure, the liquidity position, or the reserves.

5.3.8. Supplementary Financial Statements

5.3.8.1. 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. The following are examples of information that may be requested by ADB:

- A detailed summary of the fixed assets of an entity distinguishing between assets in service and construction work in progress, and accounting for changes during the year, the basis for their valuation (and revaluation, where applied), and related accumulated depreciation, including an explanation of the methods and rates of depreciation (frequently required for public utilities).
- A summary of long-term debts, including lenders, terms, amounts outstanding showing subborrowers repayment history, amounts still to be disbursed showing currencies of repayment, and noting the extent to which any of the entity's assets have been pledged (frequently required for financial institutions).
- A summary of accounts receivable and accounts payable in terms of their age, showing differences in accounts outstanding for government and nongovernment parties (frequently required where agencies of governments do not meet their commitments to public utilities).
- A summary showing major categories of inventory and the basis of their valuation.
- For financial institutions, a summary of subborrowers' accounts showing the short-term and long-term positions, with an explicit statement on provisions for losses (bad and doubtful debts), their methods of computation, and the adequacy of securities.

- Information on costs of sales, labor costs, and other important items in the Income Statement.
- Comparators and performance indicators showing the methods of calculation and tracking record from start-up of the project or such other date as shall be agreed with ADB.
- An analysis of any asset and debt revaluation, method used, and the effect on the entity's financial position.
- A statement of budget allocations and actual expenses to date.

5.3.9. Designing Financial Reports for Revenue-Earning Projects

5.3.9.1. The characteristics of the project and of the EA should normally determine the detail and timing of periodic financial reports. Normally, a revenue-earning EA should be asked to provide the following financial statements and information:

- balance sheets showing the EA's financial condition at the opening and close of a financial reporting period (usually a part or the whole of a fiscal year);
- combined income statements for the project and the EA for the current and previous reporting period or fiscal year;
- statements of cash flows for the EA for the current and previous reporting period or fiscal year, showing flows specific to the project; and
- Notes to the Financial Statements plus supplementary information and disclosures necessary to support or explain information presented in the reports.

5.3.9.2. In all cases referred to above, where the financial statements include information relating to the operation of the EA, the financial and statistical data relating to a project should be clearly segregated and reported within each statement. In particular, if the project has been under implementation for more than 2 years, the Notes to the Financial Statements should provide a listing of annual expenses against annual budgets.

5.3.9.3. Where subborrowers or secondary EAs are responsible for implementation of project components, they should be required by the borrower or the principal EA to provide similar financial statements necessary to document project activities, and where appropriate, their own financial performance and status.

5.3.9.4. EAs for revenue-earning projects are required to provide updated forecasts after loan signing and the start of project implementation, for a specified period. These updated forecasts provide early warnings of project problems so that timely corrective

actions can be taken. The specified period is at the discretion of the financial analyst but will normally be from 3 to 5 years following project completion. Likewise, an EA for a revenue-earning project will normally be required to submit audited annual financial statements for a specified period for monitoring purposes. This requirement will be specified in the loan agreement. The exact period is at the discretion of the financial analyst and will normally match with the specified period for which updated forecasts are required to be provided.

5.3.9.5. Arrangements should be made by the management of the regional division concerned to retain the relevant records within the Division, or to have ready access made available by Records Section, for the requisite period.

5.3.10. Designing Financial Reports for Nonrevenue-Earning Projects

5.3.10.1. While annual financial statements are likely to be required to demonstrate the financial position and performance of all revenue-earning EAs, including project implementation and operational performance, the requirements for nonrevenue-earning EAs are usually determined on a case-by-case basis.

5.3.10.2. Many of these projects are in the public sector, and are implemented and operated by government departments or agencies. In each case, it should be decided whether financial reporting is limited to project activities only, or the project-related activities of the EA that manages the project, or the whole agency. For example, a health care center project to be implemented by a regional or district health authority is unlikely to require an audit of the related Ministry of Health or of a complete Regional Health and Hospitals Division.

5.3.10.3. However, in case of a project that includes the reorganization or improvement of the financial management of a Ministry or a municipality, ADB may require financial reporting and auditing of these institutions. This requirement would assist in the monitoring of performance of project implementation, even though the project's principal components may be Nonrevenue earning. Examples are provided in the box below.

Examples of Financial Reporting and Auditing Requirements

For a Government Ministry

A Hospital Management Division of a Ministry of Health is required to administer an annual budget of \$2.5 million equivalent. It has no effective budget compilation procedure, because it has no budgetary control records, nor does it maintain any records of individual hospitals' expenditures and incomes. A health project component is introduced to rectify these budgetary and accounting failures, and to ensure that mismanagement of funds could not occur in the future. By requiring the preparation of financial reports on this Hospital Management Division's activities, and audits thereof, ADB can monitor the extent to which mismanagement is being replaced by a sound system.

For a Local Government Municipality

A housing sites and services project may be used as a means of improving the financial management of municipal housing by providing financial assistance to improve the accounting and rent collection control systems within the municipality. The municipality also regularly subsidizes its housing stock. In order to ensure that this stock does not place an unreasonable burden on the remainder of municipal services, ADB requires that audited financial statements of the municipality, which will show the overall finances of the municipality, the housing subsidies, and the housing accounting and income control, are to be provided.

5.3.10.4. Project objectives, particularly financial objectives, will also determine the scope of financial reporting requirements. Projects developed in some sectors by a municipality or regional authority may have components that may not be revenue-earning and may or may not affect the EA's financial performance or status. For example, a sites and service housing scheme could be executed by a municipality using grant funds, with resulting increases in property tax revenues from the higher property values accruing to the municipality.

5.3.10.5. If, in such a case, a project objective is the improvement of municipal finance and operations, the reporting requirements should address the municipality as a whole, or specified key activities or departments. But if the objective is slum upgrading only, the project could be treated as nonrevenue-earning, and the reporting requirements could be limited accordingly.

5.3.10.6. Broadly, ADB requires financial reporting and auditing of nonrevenue-earning projects: (i) for project transactions only when an EA executes the project, but does not operate the facilities; (ii) for the relevant activities of the EA, including project transactions, when an agency executes the project and operates the resultant facilities,

particularly if ADB financing is used to meet incremental current expenditures of ongoing operations; and (iii) for the relevant activities of the EA, including project transactions, when it finances improvements in the financial management of that agency.

5.3.10.7. Financial reports for a nonrevenue-earning project preferably should contain, to the extent possible, data constructed and presented in a similar manner and form as for revenue-earning projects. This latter form of reporting is designed to yield maximum information for management and ADB. However, as a minimum, these reports may comprise Statements of Income and Expenses, or Statements of Cash Receipts and Cash Payments only. Staff should request borrowers to incorporate simple adjustments (e.g., to convert the latter financial reports to an accruals basis, to disclose the treatment of past and current obligations), if such adjustments are necessary for good management and reporting. The income or receipts shown in these minimum form statements should disclose the sources of funds, including local funds, ADB loan disbursement proceeds, and cofinanciers fund disbursements, where appropriate.

5.3.10.8. In a nonrevenue-earning project that includes the financing of incremental current expenditures, e.g., salaries, wages, the financial reports should include separate statements of these expenditures, and any related recurrent income of the EA. These statements should include annual budgetary provisions and allotments, supplementary budget provisions and allotments, and actual expenditures under each budget head and subhead. The budget heads and subheads of expenditures for which ADB financing is furnished and the actual expenditures and amounts of ADB disbursements claimed should be indicated. In this respect, it is important during project preparation to ensure that adequate budgetary descriptions and line items are, or will be, made available to fulfill this analysis.

5.3.10.9. Details of the financial position, at the start and end of each fiscal year, of a nonrevenue-earning project or EA should be requested from the borrower. These details may be best provided in a form of balance sheet, at the opening and closing of each fiscal year, to show the accumulated totals of transactions over the project period and to account for assets, inventories, equity (or grants) and loans provided as part of the project.

5.3.10.10. Balance sheet preparation need not be an elaborate process. Its preparation can take the form of an accumulation of data from income statements for completed years, with adjustments to show closing balances of inventories and cash, where appropriate. However, some government departments may not be experienced in preparing and maintaining data for balance sheets. In such cases, during project preparation, the analyst should ask the government to arrange for the training of staff

prior to loan negotiations and project start-up. Otherwise, engagement of competent personnel, including a fulltime financial management expert and a project accountant to prepare the financial reports in the required form and on a timely basis, should be provided.

5.3.11. Examples of Model Financial Statements

5.3.11.1. The Knowledge Management section of these Guidelines provides examples of model financial statements for revenue-earning and nonrevenue-earning projects. Furthermore, a set of model financial statements, which are cross-referenced to IAS requirements, together with a disclosure checklist is provided at www.iasplus.com.¹⁶

5.4. Auditing Standards and Auditor Engagement

5.4.1. Introduction

5.4.1.1. 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 standards acceptable to ADB, and applied on a basis consistent with that of the preceding year.¹⁷

5.4.1.2. 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).

5.4.1.3. The auditor's examination should include an evaluation of the systems and operating procedures for accounting, custody of assets, control of environment and internal financial control, financial reporting, and related systems. An analysis of explanations submitted to the auditor, and all information necessary to support the auditor's opinion and to construct the report of the auditor, should be provided.

¹⁶ Financial analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

¹⁷ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

5.4.1.4. Financial analysts, however, cannot assume that the auditor's opinion is an assurance as to the future viability of an entity or as to the efficiency or effectiveness with which management has conducted the affairs of the entity.

5.4.1.5. During project identification and preparation, analysts should become familiar with the existing laws, regulations, and rules of the country and the EA that govern financial reporting, and auditing requirements. It is essential to identify incompatibilities between ADB and local legal requirements for auditing and to resolve these before appraisal.

5.4.2. ADB Requirements

5.4.2.1. ADB requires the borrower and the project 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: (i) an assessment of 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, (ii) a determination as to whether the borrower and project implementing entities have maintained adequate documentation on all relevant transactions, (iii) confirmation that expenditures submitted to ADB are eligible for financing and identification of any ineligible expenditures, and (iv) compliance with loan covenants and ADB's requirements for project management.

5.4.2.2. ADB recognizes ISAs, promulgated by IFAC and the auditing standards of the 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 INTOSAI auditing standards.

5.4.2.3. ADB prefers that auditors conform to ISAs, but recognizes that in some countries auditors are expected to apply generally accepted auditing standards which may not conform to these Guidelines but that have been prescribed by a country's law, or that have been adopted by public accountants or associations of public accountants in the country concerned.¹⁸

5.4.2.4. Supplementary auditing and reporting procedures may be requested by ADB, if necessary, to confirm accountability and financial performance in cases where

¹⁸ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

ADB considers local standards need to be supplemented. In addition, ADB would expect auditors to indicate in their report the extent of differences, and the impact on the audit, of use of local auditing standards compared to the application of ISAs.

5.4.3. Auditing Procedures

5.4.3.1. The audit is intended to provide an ex post review of the EA's financial statements, financial systems, records, transactions, and operations, performed by professional accountants. It is intended to provide assurances of accountability, give credibility to the financial statements and other management reports, identify weaknesses in internal controls and financial systems, and make recommendations for improvements.

5.4.3.2. The auditor should obtain an understanding of the project and the entity being audited, including the contents of the RRP, legal agreements, and these Guidelines. In addition the following guidance is available from the: (i) ADB *Loan Disbursements Handbook*, (ii) ADB sample bidding documents for competitive bidding under international competitive bidding procedures, and (iii) ADB *Procurement Handbook*.

5.4.3.3. The extent of an auditor's review of the accounting records depends on the systems of accounts and of internal checks and controls used by the entity being examined. As an example, an auditor will need to examine, and where necessary, test: (i) the organizational procedures for making financial decisions, budgeting, and authorizing expenditures; (ii) the design, management, and operation of the accounting system; (iii) the effectiveness of related systems and procedures such as inventory control and data processing; (iv) the efficiency of the systems of internal control and of internal audit; (v) all financial transactions, and verify year end balances, including an appropriate degree of physical verification; (vi) compliance with IASs and any other applicable accounting standards, including the adequacy of disclosures; (vii) subsequent events and their possible effect on the financial statements; (viii) overall comparators of actual costs and achievements against budgets and planned indicators, obtaining, and reporting adequate explanations for significant variations; (ix) test compliance with loan covenants and ADB's requirements for project management; and (x) the adequacy and competence of accounting staff. In the light of their findings, auditors should normally test the financial transactions of the organization against such documentary or other evidence as maybe necessary to enable them to be satisfied as to the authenticity and correctness of the transactions, their complete and proper entry in the books of account, and their effect on financial performance and status.

5.4.3.4. The timeliness and accuracy of the recording of assets and liabilities and of the methods of their valuation should be reviewed by the auditors, particularly for projects executed by government departments, for which asset recording typically is not a routine requirement. In addition they should be satisfied as to the methods of regularly-determining their existence, ownership, and appropriate valuation, including, where necessary, physical inspection by the auditor. Examples of items to be addressed include: (i) land, buildings, machinery, and equipment, including methods of provision for depreciation, if such provision is applicable to the accounting procedures for the project or EA under audit; (ii) inventories, including appropriate accounting for obsolescence, spoilage, or losses; (iii) receivables, including provisions for bad and doubtful debts; (iv) cash and bank balances; (v) investments; (vi) amounts due to third parties (long and short-term loans and suppliers' accounts payable); and (vii) insurance coverage, particularly of project components.

5.4.3.5. Where appropriate, an auditor should examine such items as capital commitments and treatment of contingent liabilities, the effects of currency devaluation or revaluation on foreign currency transactions, and events occurring after the date of preparation of the balance sheet.

5.4.3.6. Circumstances beyond the control of an auditor and the EA may sometimes make it impossible to carry out all preferred auditing procedures, at least in full; in such cases, auditors should satisfy themselves by alternative procedures that are practicable and reasonable in the circumstances. However, there are two important auditing procedures which should be carried out: (i) direct correspondence with debtors and creditors on a substantial test basis by an auditor, to confirm sums due to, and payable by, the EA under audit; and (ii) observation by the auditor of physical inventory taken by the client. Specific disclosure should be made of the reasons for noncompliance in cases where these procedures are not carried out, and whether satisfactory alternative procedures were employed.

5.4.3.7. Any country-specific variations in accounting standards and practices that are adopted by the borrower, and are known by the auditor to differ substantially from IAS, should be disclosed. Any significant effects on the financial performance or status of the project, as a result of not conforming to IASs, should be disclosed.¹⁹ Examples of such variations and their effects on reported financial results that should be disclosed are any overstatements of assets and understatements of liabilities that may be sanctioned by local laws; accounting on a cash basis or on a basis other than historical costs; recognition and equalization of income over several accounting periods; omission of certain gains or losses in determination of net income; the use of "reserve" accounting when full details of

¹⁹ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

movements in, and realized profits on, reserves may not be revealed; and the treatment of foreign exchange profits or losses in a manner that does not disclose their impact.

5.4.3.8. The auditor should review the periodic PMR for each year and compare them with the financial statements of the fiscal year. ADB requires the auditor to report any differences, particularly any ineligible expenditure against which ADB may have disbursed, recommending actions necessary to avoid recurrences.

5.4.3.9. The audit of SOEs (where required) should be included as a part of the overall audit of the project. However, ADB requires that particular attention be paid to the internal control systems and the verification of documents relating to SOE expenditures, not only to ascertain proper financial accountability, but also that expenditures are eligible for inclusion in the project. ADB requires a special reference in the auditor's opinion with respect to the SOE portion of the audit.

5.4.3.10. ADB also requires an audit of the Imprest Account, which may be separate, or included as a part of the overall audit of the project. This audit is limited to the transactions of the Imprest Accounts, as the audit of the expenditures reimbursed or paid directly from the Imprest Accounts are to be audited as a part of the project audit, with appropriate review of the in-transit items. Where the audits of the imprest accounts are self-standing, a special purpose audit opinion is required. Where the audit forms a part of that of the project, a separate reference to the imprest account audit should be included in the auditor's opinion.

5.4.4. Auditor Selection and Appointment

5.4.4.1. Legal and professional requirements will normally determine the scope and depth of an audit examination, but these may also be supplemented by client instructions in the form of a TOR. These instructions would usually extend an audit's scope and detail, but they may restrict an auditor's activities rendering them unacceptable. Care should be taken when framing a request for additional work from an auditor.

5.4.4.2. Borrowers should be asked to remove unacceptable restrictions, or otherwise arrange for an acceptable audit to be carried out. 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 the required standards in terms of independence, experience, and competence. More specifically, ADB should indicate the acceptability of an auditor in the form of a "no objection" provided that actual or proposed auditors satisfy the following criteria:

- They must be impartial and independent of the management of the entity to be audited, and of the person appointing them. In particular, the auditors should not otherwise be employed by, serve as directors for, or have any financial or close business relationship with the entity during the period covered by the audit.
- They must be well-established and reputable using procedures and methods that conform to ISAs or INTOSAI auditing standards, and employ adequate staff with the skills and competence required for their responsibilities.
- They must be able to demonstrate experience in auditing the accounts of projects or entities comparable in nature, size, and complexity to the assignments they are to undertake (specialized auditing experience, obtainable only from external sources, may be necessary for some projects).
- The audit work should be assigned to personnel who have the professional and technical training and proficiency required in the circumstances.

5.4.4.3. ADB requires that the borrower and the project implementing entity select and appoint an auditor acceptable to ADB 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.

5.4.4.4. 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 indicating 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.

5.4.4.5. Many prospective borrowers and EAs have ongoing audit arrangements. In other cases, borrowers initiate audit engagements at the start of a project. Whenever an auditor is to be appointed by a borrower, or the auditor is a statutory appointee, ADB may seek information to be satisfied regarding independence and experience of the proposed auditor. To ascertain acceptability, ADB routinely seeks information to be satisfied on the independence and competence of the proposed auditor. The required information includes: (i) the name of the auditor; (ii) the names, qualifications, and experience of the principals and managers; (iii) the approximate number of professional staff employed; (iv) a listing of some of the main audits currently and previously carried out by the auditor; and (v) a statement of the independence of the firm of auditors vis-à-vis the entity it is proposed to audit.

5.4.5. Issues in Auditor Selection

5.4.5.1. The scope and detail of an audit may also depend upon laws or regulations that may constrain a government auditor from providing the depth of examination required by ADB. For example, the following are unlikely to be acceptable auditors for ADB lending operations: (i) a government auditor whose staff may be required by laws or regulations to participate in the processing of financial transactions, (ii) an auditor who acts for an EA for the preparation of annual financial statements, or (iii) an auditor who designs and constructs components of the EA's financial management system. In each case, the financial analyst must thoroughly review the circumstances and have adequate support, if necessary, by seeking an independent opinion, for the exclusion of the proposed auditor from doing the auditing assignment.

5.4.5.2. In certain instances, staff constraints may cause the borrower and PIU to request an auditor to compile part or all of the annual or supplementary financial statements. Where this is necessary, to be eligible to carry out the audit, the auditor should play no part in any aspect of the decision making and/or management of the entity concerned, including maintaining and finalizing accounting and financial reporting preparation services for the current year of audit and at least the most recent preceding fiscal year of the project. The extent of the auditor's involvement in accounting should be discussed in the Management Letter.

5.4.5.3. It is essential that auditors are able to commence work at project start-up, and thereafter sufficiently early in each fiscal year to complete the audit expeditiously after the year-end; for example, the checking of stocks and balances at critical times in a year may require the presence of an auditor if a qualified report is to be avoided. Therefore, an auditor should be appointed by the borrower before the beginning of each fiscal year. The borrower will be expected to provide ADB with an assurance that the initial auditor has been notified of ADB's requirements, including the timing of the audit and issuance of the auditor's report. In all cases, this will not be later than the starting date of the project or the date of the ADB's Board approval to the loan, whichever is the earlier. Financial analysts are also encouraged to meet with the auditor at the first opportunity following their appointment.

5.4.5.4. Where a government auditor is to serve during execution and operation of a revenue-earning project until the loan period expires, the borrower will be expected to provide ADB with an assurance that the government auditor will begin and complete the audit operations within the timetable required. This timely appointment allows the auditor to carry out interim audits, therefore reducing their work at the year-end to facilitate timely reporting. Also, it allows the earlier identification of possible errors and frauds and enables quicker corrective actions where required.

5.4.6. Selecting Auditors

5.4.6.1. 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.

5.4.6.2. The EA, or its controlling authority, is normally responsible for this selection and appointment, except in cases where a government auditor is required by law to provide the service. Therefore, where no auditor is currently engaged, steps should be taken during project preparation to ensure that the borrower will engage an auditor acceptable to ADB by the date of loan signing or start up of the project.

5.4.6.3. Where an auditor is currently engaged, staff should ensure that they carefully review the past performances of the auditor with respect to the quality of reports and opinions, and management letters. If the capabilities and capacity of the auditor to perform to ADB-required standards would be questioned by the appraisal mission, the borrower/EA should be advised as to the possible deficiencies, and should be asked to convey these concerns to the auditor.

5.4.6.4. In cases where the auditor fails to respond to the concerns raised or the auditor is clearly unacceptable to ADB, the borrower/EA should be advised that another auditor be selected prior to loan signing.

5.4.6.5. When private or commercial auditors are to be used, staff may, if requested, assist borrowers to review the qualifications and experience of an auditor. For this purpose, to form a judgment on their competence, it may be necessary to visit the local offices of the auditors and request samples of their previous or ongoing work, including typical audit reports prepared by them.

5.4.6.6. Examination of data on auditors submitted to ADB prior to their engagement by a borrower should include the ability and track record of an auditor to meet the requirements set out in the *Handbook for Borrowers on the Financial Management of Investment Projects Financed by the ADB*. Borrowers should be notified on the auditors who do not meet these criteria.

5.4.6.7. An auditor's engagement should be kept under review to ensure consistent quality of performance, including ability to adapt to changes in an entity's accounting and general operations, and to adopt improved audit techniques. For example, development of computerized accounting would require complex and expensive auditing

techniques. Auditors inexperienced in this field may not be able to provide these services, or may be constrained from appropriate expansion of services by an inadequate audit fee. In such cases, inclusion of audit costs in the project costs would be appropriate.

5.4.6.8. Borrowers should therefore be encouraged to restrict audit engagements to relatively short-term assignments.

5.4.6.9. It is common practice in some countries to appoint the auditor each year. However, engagements should normally be long enough to enable an auditor to become familiar with the project or EA under audit and to permit efficient operation, but short enough to facilitate a change of auditor, if necessary. Engagements of 3 to 5 years are in the optimum range.

5.4.7. Terms of Reference for an Auditor

5.4.7.1. ADB requires that the auditor's opinion 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 implementing organization and type of operation being audited. For example, the TOR for the audit of a Financial Institution will require the auditor to pay particular attention to the loan portfolio, while the area of greatest emphasis for auditing of a public utility may be the accounting of its fixed assets and its accounts receivable.

5.4.7.2. ISAs suggest that the auditor determine the scope of the audit of financial statements in accordance with the requirements of legislation, regulations, and generally accepted auditing standards. The TOR must not restrict the auditor's obligations with respect to the above. The auditor should not be allowed to claim in the event of poor performance that the TOR prevented performance with respect to statutory, regulatory, or professional requirements.

5.4.7.3. However, the TOR provides the opportunity for drawing special attention to areas of concern that may not be covered or emphasized under a normal audit, such as compliance with loan covenants; for example, a special review of procurement documents. The TOR should always include in the scope of the audit the requirement to give an opinion on any specific items. A Management Letter will always be required.

Appointing an Auditor—Using the Model Terms of Reference

5.4.7.4. The Knowledge Management section of these Guidelines provides a Model TOR for an auditor.

5.4.7.5. Whenever ADB wishes to approve the TOR of an auditor to be engaged by a borrower or a project entity, it is preferable that staff should remain independent of the drafting thereof. Staff will hence be free to advise on the documentation prepared by a borrower or EA. There is no objection, however, to staff giving borrowers advice based on the model TOR.

5.4.7.6. The model should not be regarded as universally applicable to audits of ADB projects or project entities. Staff should select those components they consider appropriate for a particular audit engagement, omit inappropriate items and add relevant matters that are not in the model to develop a working draft.

5.4.7.7. This model relates only to the appointment of auditors to carry out an audit, as defined in these Guidelines. The model is not intended for the appointment of accountants for other forms of investigation, assessment, design, or installation of accounting or internal auditing systems.

5.4.7.8. The drafting of these TOR should neither restrict an auditor's obligations with respect to legislation, regulations, and generally accepted auditing standards, nor give reasons for an auditor to claim that adherence to the TOR prevented adequate statutory, regulatory or professional performance.

5.4.8. Contract or Engagement Letter of Auditor

5.4.8.1. The use of a Contract or Audit Engagement Letter is recommended. Where a formal contract is used, it is normally prepared by the PIU. A simple engagement letter is frequently used, often prepared by the auditor. The contract or letter sets out the responsibilities of the auditor and should include, but not be limited to:

- Confirmation of acceptance of the appointment including reference to the TOR;
- Borrowers' responsibilities, particularly the preparation of financial information (the financial statements);
- Provision of access to whatever premises, records, documentation (including Staff RRP, legal agreements, etc.) and any other information the auditor may request in connection with the audit;
- Form of audit reports;
- Arrangements regarding the involvement of internal auditors and of any other external auditors (such as the government auditor);
- Expected date of issuance of the audited financial statements, etc.; and
- Basis on which fees are computed and any billing arrangements.

5.4.9. International Standards on Auditing

5.4.9.1. The International Auditing Practices Committee (IAPC) of IFAC promulgates ISAs and International Auditing Practice Statements (IAPSs). The latter offer advice and guidance on the practical application of ISAs.

5.4.9.2. ADB expects auditors to conform to the ISAs and related auditing practices recommended in the IAPS. However, in some countries, the auditing profession may be required to comply with generally accepted local auditing standards prescribed either by law or by the national body of accountants.

5.4.9.3. Auditors when compiling their opinions and reports, often use the term “generally accepted auditing standards”. These standards differ from country to country, but are intended by the accounting profession to imply the highest standards of auditing practice. These standards are likely to be those adopted by professional accountants or associations of accountants, or standards prescribed by law, governments, or bodies responsible for regulating national financial reporting.

5.4.9.4. Although ISAs and IAPSs are widely recognized, it should not be assumed that these have been adopted by national accounting professions or governments, and are therefore automatically applicable to audits and auditors of project entities. Local standards may not conform partially or completely with international guidelines.

5.4.9.5. Therefore, at project identification, or during project preparation, analysts are required to accurately determine the auditing standards that will be applied by an auditor of annual financial statements of a borrower. If these do not correspond to ISAs and IAPS, the analyst must determine the extent and impact of variances in application of the local standards.

5.4.9.6. In the event that the impact of variances is sufficient to give rise to concerns for the adequacy and veracity of an audit, the analyst must request the EA to have the auditor adopt ISA and IAPS for the audit of the ADB-financed project and the project entity. Where applicable, an auditor who would adopt ISAs and IAPS may be engaged.²⁰

5.4.9.7. Failure by an EA to meet such requests must be reported in the Aide Memoire and the fact-finding BTOR. If agreement is not obtained by project appraisal, an Issues Paper should be prepared so that management can give guidance. The BTOR and the RRP should include confirmations of the acceptable auditing standards that will be used.

²⁰ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

5.4.9.8. Where necessary, the EA should also be requested to ensure that auditors be required by their terms of reference to indicate in their opinions and report, the extent of any differences, and the impact on the audit, by their use of local auditing (or other) standards compared to the use of the ISAs.²¹ For an example, see box that follows.

Auditing in a Computer Information Systems Environment

International Standard on Auditing—Auditing in a CIS Environment—requires possession of certain levels of skills and competence with regard to computing hardware and software by the auditor, and of those who they are supervising.

The TOR for an auditor should specifically call for a statement of the auditor's skills and competence in this field, and the report by the auditor should contain a statement indicating the extent to which they were able, or could not meet the requirements of this Guideline, and the impact on the audit of any deficiency on their part.

Such a requirement is relatively simple to check. In EAs which have computing facilities, if the auditor fails to confirm that they were able to comply with this Guideline, or to make any meaningful statement as to the capability and quality of their audit of information compiled by computing facilities in the agency, it must be questionable whether the audit report and opinion offered could be acceptable to ADB.

ADB = Asian Development Bank, EA = Executing Agency, CIS= Computer Information Systems ,
TOR = Terms of Reference

5.4.10. Government Auditors

5.4.10.1. In some countries where projects are to be executed by government controlled/sponsored entities, statutory requirements may specify the use of the government auditor. Under such circumstances, ADB will continue to require that the auditor is independent and competent; that the auditor has the capacity and professional capability to provide audit reports and opinions of the quality required by ADB, and 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 (e.g., by reporting directly to a legislature).

5.4.10.2. In circumstances where the government auditor is acceptable, but the auditor's report will be placed before a governing national assembly for approval (e.g., a Parliament), the borrower should provide ADB a draft of the report, certified by the Chief

²¹ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

Financial Officer and the auditor, immediately on completion of the audit. As specified in the loan agreement, the approved version of the auditor's report should be submitted to ADB as soon as this becomes available.

5.4.10.3. Circumstances exist where government auditors are involved directly or indirectly in pre-expenditure and revenue collection decision-making—a status that compromises their independence. ADB then may seek to agree with a borrower either that auditor, or that ADB, will be provided with opinions and reports prepared by an independent private or commercial auditor in addition to the report of a government auditor. A government auditor who does not control, and is not under the control of the department or agency of government to be audited, and who is not involved in any aspects of its management, may in some instances be considered as independent.

5.4.10.4. Where ADB has doubts with respect to the auditor's independence and/or competence, ADB will seek an agreement with the borrower to have the government auditor subcontract the audit to an independent and competent private auditor to carry out the audit on their behalf. In appropriate circumstance, ADB could include this expenditure in the loan. In general, ADB requires that private auditors, using their experience in the use of ISAs, carry out the audit of a commercial or revenue-earning entity.

5.5. Reviewing Financial Reports

5.5.1. Introduction

5.5.1.1. Project Administrative Instruction (PAI 5.09) sets out ADB's requirements for the delivery of audited annual financial statements of projects and EAs, including the monitoring requirements by ADB staff. PAI 5.09 also contains the remedial actions that ADB will undertake in the event of noncompliance with loan covenants relating to financial reporting and auditing.

5.5.2. Review Process: Late or Unacceptable Financial Reports

5.5.2.1. The Project Officer responsible for a particular project's implementation should ensure that all requirements on progress reporting are prepared in a timely manner acceptable to ADB. The Project Officer is responsible for maintaining records on the schedule of the date of submission of progress reports (and annual financial reports, auditor's reports and completion reports), the actual date of receipt by ADB, and date of completion of review.

5.5.2.2. The Project Administration Unit may have installed a computerized monitoring system for recording the receipt of covenanted audited and unaudited project accounts and financial statements. The Financial Analyst or Financial Management Specialist should in all cases review the interim or annual financial reports of the project, with or without auditors' reports and opinions.

5.5.2.3. The report should cover separately the submission of (i) unaudited and audited project accounts and, where applicable, (ii) the unaudited and audited financial statements of EAs. Where loan documents require submission of unaudited and audited financial statements beyond the closing date of the loan, the monitoring of submission of financial statements and compliance with financial performance covenants should continue. For additional guidance on compliance categories, refer to PAI 5.09

5.5.2.4. On the basis of this review, notice should be sent to the borrower and EA acknowledging receipt of the financial statements (and, where applicable, the Audit Report) and to point out any violation of the loan's financial and audit covenants. Remedial action to be taken within a reasonable time will be required from the borrower and EA.

5.5.2.5. The Operations Coordination Division, the Manager COPP, and the Assistant Controller, CTDO are informed of the review results only if: (i) the audited annual financial statements are unacceptable, (ii) the auditor's report contains significant findings that would affect loan proceeds and implementation of the overall project (or other accountability issues), or (iii) the auditor's report contains any findings on the imprest accounts and statements of expenditures.

5.5.2.6. A financial analyst should report downward compliance trends with financial or audit covenants to the Project Officer, which may ultimately result in noncompliance, when a time-bound remedial action plan would be needed.

5.5.2.7. Receipt of a response to a request for a time-bound plan of action should be closely monitored and if the response is not received within the specified time, the lack of a response must be noted as an issue to be addressed under the loan.

5.5.2.8. A decision by a financial analyst (or a Project Officer) not to recommend a time-bound remedial action plan should be made in writing, reviewed, and if appropriate, endorsed by the concerned regional department.

5.5.3. Compliance with Financial Performance Covenants

5.5.3.1. The majority, if not all, financial performance covenants for a project include the clause “except as ADB shall otherwise agree”. The exercise of the prerogative to “otherwise agree” rests exclusively with management.

5.5.3.2. In cases where noncompliance exists with a financial performance covenant, the regional department should analyze the adequacy of the proposed actions to be taken by the borrower and EA while assessing the probability of their being successfully implemented within the period specified.

5.5.3.3. The Project Officer should write a memo through the Operations Coordination Division outlining the review and conclusions. Recommendations on whether management should agree to a deviation from the covenant (including minor technical deviations), or such other actions as the regional department may propose, are put forward. The regional department should communicate its decision to the borrower and EA.

5.5.3.4. The memo should also specify whether the current auditor is acceptable to ADB or whether ADB should ask for a replacement.

5.5.4. Communication with Government Auditors

5.5.4.1. Communications requesting submission of audited financial statements should be addressed to the EA and/or the borrower. However, in some cases, compliance with the submission of audited accounts is delayed by difficulties encountered in the government audit office. When delays are attributable thereto, it is likely that similar problems are being experienced by other divisions/departments.

5.5.4.2. PAI 5.09 – *Submission of APAs and FSSs* – sets out the procedures for ensuring that APAs and CFSs are submitted by the agreed due date. PAI 5.09 also stipulates the actions to be taken when APAs and CFSs are not provided as agreed. While PAI 5.09 requires that regional divisions are responsible for communicating with EAs, with regard to government auditors, in the interests of avoiding the duplication of efforts and the possibility of inconsistencies in ADB’s position, it is desirable to coordinate all communication with government auditors through the Operations Coordination Division. Assistance from the Disbursement Operations Division in following up submission of audited accounts may be sought by the concerned Project Officer/Regional Division.

5.6. Reviewing Auditors' Reports

5.6.1. Introduction

5.6.1.1. ADB requires the borrower and the project 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:

- An assessment of 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;
- 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.

5.6.1.2. The examination of the annual financial statements of EAs is an important feature of project supervision and should be conducted in the same way as financial appraisal. Additional attention, however, should be given to actual performance against appraisal forecasts, compliance with financial covenants and review mission financial reports. Interim reports and unaudited annual financial statements may be the only up-to-date monitoring documents available on project progress, and their accuracy should be tested both during review missions and against audited annual financial statements. It is reasonable to expect that there should be no change between unaudited and audited financial statements.

5.6.1.3. It is useful to gain experience with individual EAs to identify those where ADB staff can reasonably depend on unaudited annual financial statements, and later to examine audited statements for exceptions. Before beginning this latter examination for a completed fiscal year, however, a review of the auditor's opinion on the statements is essential to ensure that the published results are likely to be valid.

5.6.1.4. The auditor's reports may not contain enough essential information for ADB to be able to rely on the data in the statements and thereby evaluate performance. Three principal features should be addressed when examining an auditor's report: (i) authenticity, form and timeliness of the report; (ii) quality, or tenor, of the opinion; and (iii) scope, significant accounting policies, auditing practices, qualifications, and other matters addressed by the auditor.

5.6.1.5. The wide sectoral coverage of ADB projects precludes giving advice for examining the opinions for each type of project. For general guidance, a checklist of matters that a reviewer of an auditor's report should consider is provided in the Knowledge Management section of these Guidelines (its application is discussed further in section 5.6.11). The checklist is not universally appropriate and staff will need to draw their own conclusions about its applicability to each project and related audit reports. While extensive, the checklist is not exhaustive and reviewers must exercise their own skills and common sense in deciding the adequacy of the completed audit. Similarly, reviewers should decide whether the auditor, in the manner of framing comments, is trying to convey a message of concern, which may be difficult to express explicitly.

5.6.1.6. If there are any "no" answers on the checklist, especially in areas of key concern to the project, then clarifications of the auditor's report should be sought from the borrower and/or the EA unless the audit itself is under development by use of technical assistance. If the omissions are serious and/or the quality of the report unacceptable, the matter should be discussed with the Operations Coordination Division and the OGC.

5.6.1.7. The borrower and/or the entity should be advised that the audit does not conform to standards and practices acceptable to ADB. The monitoring records should be annotated accordingly.

5.6.1.8. If a qualified opinion and report by an auditor is received, the materiality and extent of the qualification should be determined, particularly as regards accountability for project funds and the agency's financial position. In the case of substantial qualifications, the financial analyst should ascertain as soon as possible what remedial measures the borrower proposes to take.

5.6.1.9. If the borrower is unable or unwilling to take corrective action, staff should, after investigating the reasons, follow the course of action recommended in cases of noncompliance with covenants.

5.6.1.10. Qualifications which appear not to be of a material nature (limited inadequacies in accounting subsystems, failure by accounting staff to respond to inquiries, etc.) should be followed up with the borrower by correspondence or during review missions, to ensure that appropriate corrective action is taken.

5.6.1.11. In the same way that accounting systems need to be designed and installed over a period of time, auditing capability often also needs gradual development. In such cases, loan agreements should refer to the form and timing of this process.

5.6.1.12. The analyst should participate in review work in a manner that fosters improvement of the auditor's work. Early audit reports that lack quality and depth of performance should not readily be rejected. Instead, the EA and the auditor should be informed in writing of possible deficiencies and encouraged to produce either an improved audit report, or to improve presentation of next year's financial statements. Under such circumstances, it is important that the financial management and accounting functions of the entities involved be carefully supervised, so as to compensate as far as possible for inferior auditing ability. The foregoing does not, however, preclude ADB from requesting the replacement of an auditor, particularly if training or other support is unlikely to achieve short-run improvements.

5.6.2. Auditors' Reports and Opinions

5.6.2.1. ISA 700 advises auditors in detail on the form and content of an auditor's report, and ADB would expect an auditor to closely follow this advice. In particular, paragraph 17 of ISA 700 addresses the Opinion Paragraph of an auditor's report as follows:

"The auditor's report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements".

5.6.2.2. 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.

5.6.2.3. Section 5.6.3 provides examples of the body of typical auditor's reports and opinions for (i) an unqualified opinion for a nonrevenue-earning project; and (ii) an unqualified opinion for a revenue-earning project. The auditor should appropriately restate each example when qualifications or other modifications are necessary.

5.6.2.4. 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.

5.6.2.5. ADB prefers that auditors' report provide details on ADB's requirements, particularly with respect to receiving, among other requirements, an auditor's view on compliance with loan covenants and on ADB's requirements for project management.

5.6.2.6. 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.

5.6.2.7. 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.

5.6.2.8. 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).

5.6.2.9. 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 (if any), 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.²²

5.6.3. Model Audit Opinions

5.6.3.1. Audit opinion below is a representative sample from the International Standard on Auditing (ISA 700) issued by IFAC. The form and content of this is subject to change based on the standard. Changes need to be checked against the latest standard which the independent auditor should be familiar with.

²² Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

5.6.3.1. Model Audit Opinion for a Nonrevenue-Earning Project

To: Borrower (or designated agency)

We have audited the accompanying financial statements (pages ___ to ___) of the _____ Project financed under the Asian Development Bank Loan # _____ as of December 31, 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 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:

- (a) (1) 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 (2) which expenditures are eligible for financing under Loan Agreement No. ____.

- (b) (1) The Imprest Accounts (page __) give a true and fair view of the receipts collected and payments made during the year ending ____ ; and (2) these receipts and payments support Imprest Account liquidations/replenishments during the year.

[(a) and (b), above, are to be provided where the Loan Agreement requires separate Imprest Account and Statement of Expenditures audits and audit opinions.]

5.6.3.2. Model Audit Opinion for a Revenue Earning Project

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 # _____ as of December 31, 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 [auditing standards of the country of ____].²³ 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 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 _____],²⁴ 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

²³ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

²⁴ Financial Analysts have discretion to agree alternative arrangements (see paragraph 2.4.3).

from 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:

- (a) (1) 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 (2) which expenditures are eligible for financing under Loan Agreement No. _____.

(Required where an SOE audit is required under the Loan Agreement.)

- (b) The Imprest Accounts (page____) gives a true and fair view of the receipts collected and payments made during the year ending _____.

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

5.6.4. Compliance with Loan Covenants

5.6.4.1. 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 fiscal year concerned.

5.6.5. Compliance with ADB's Requirements

5.6.5.1. 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 requirements of ADB for the fiscal year concerned.

5.6.6. Types of Auditors' Opinion

5.6.6.1. An unqualified opinion indicates the auditor's satisfaction in all material respects with the following matters:

- The financial information has been prepared in accordance with (a) for a project—the reporting format agreed; and (b) for a revenue-earning entity—accounting standards and practices acceptable to ADB have been consistently applied;
- The financial information complies with relevant regulations and statutory requirements;
- The view presented by the financial information as a whole is consistent with the auditor’s knowledge of the project/entity;
- There is adequate disclosure of all material matters relevant to the proper presentation of the financial information. Any changes in accounting principles or method of their application and effects thereof have been properly determined and disclosed; and
- Additional requirements that may have been requested in the TOR have been met.

5.6.6.2. When a qualified opinion, adverse opinion, or a disclaimer of opinion is given, the audit report should state in a clear and informative manner all of the reasons for such opinion. ISA provides guidance to auditors on the form and content of the auditor’s report issued in connection with the independent audit of the financial statements of any organization.

5.6.6.3. A qualified opinion is issued when the auditor concludes that an unqualified opinion cannot be issued, but that the effect of any disagreement, uncertainty or limitation of scope of the audit is not so material as to require an adverse opinion or a disclaimer of opinion. The subject of the qualification and its financial effect must be clearly stated in the auditor’s report.

5.6.6.4. An adverse opinion is issued when the possible effect of a disagreement is so pervasive and material to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

5.6.6.5. A disclaimer of opinion is issued when the possible effect of a limitation on the scope of the audit or of an uncertainty is so significant that the auditor is unable to express an opinion on the financial statements.

5.6.7. Materiality

5.6.7.1. ISA 320 states among other things:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on

the size of the item of error judged in the particular circumstances of its omission or misstatement. Thus materiality provides a threshold or cut-off point, rather than being primarily qualitative characteristic which information must have if it is to be useful”

5.6.7.2. Some auditors (particularly government auditors) provide reports listing all mistakes, irrespective of their materiality. ADB requires a clear opinion. Thus, irregularities and instances of noncompliance with government or institutional rules and regulations that do not give rise to a qualified or disclaimed opinion should not be subjects of the report of the auditor. Where an auditor has comments that are not material to the opinion, these should be set out in the Management Letter.

5.6.8. Use of Technical Experts

5.6.8.1. For certain types of expenditures to be financed from ADB loans/credits, 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 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 may be acceptable to ADB.

5.6.8.2. 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.

5.6.8.3. 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).

5.6.9. Statements of Expenditure and Imprest Accounts

5.6.9.1. Where the legal agreement of a project requires the separate audit of the SOE 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.

5.6.10. Reviewing Audit Management Letters

5.6.10.1. The scope of the engagement as set out in the TOR should require the auditor 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. (It should be noted that a Representation Letter is different to a Management Letter and is purely a representation of issues from the EA to its auditor. ADB does not need to nor should it request a representation letter from the auditors).

5.6.10.2. 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.

5.6.10.3. An auditor may use the Management Letter as a means of obtaining financial management and accounting systems and internal control improvements that would likely make the audit work easier and less time consuming to complete. An effective Management Letter, properly responded to by a client can reward the latter with a less expensive audit operation.

5.6.10.4. ADB wishes to review all Management Letters, and the project officer, Financial Analyst or Financial Management Specialist should ensure that copies are forwarded to ADB by the EA concerned at the same time as the audited annual financial statements are issued.

5.6.10.5. The Project Officer should ensure that a Financial Analyst or Financial Management Specialist reviews each Management Letter. The financial analyst should advise the Project Officer of any matters to which the auditor has drawn attention that may adversely affect the operation of the EA and project implementation.

5.6.11. Audit Report Questionnaire

5.6.11.1. The Audit Report Questionnaire that is provided in the Knowledge Management section of these Guidelines is provided only as an example of the nature and type of questions that should be considered when reviewing the report of an auditor. Financial analysts should have regard to the nature of the organization under audit and frame their questions accordingly.

5.6.11.2. Agencies operate in a wide range of sectors and activities, and therefore the form and nature of their financial statements will vary equally widely. Furthermore, approaches to, and the quality of auditing is variable. Therefore, the questions set out in the questionnaire should be regarded with some caution, because these may not have sufficient breadth or depth for some institutional statements and audits. Conversely, these may also be considered too extensive for some EAs, their activities and the audit services available.

5.6.11.3. Nevertheless, by using this questionnaire, or a suitably modified version thereof to reflect the nature and form of the EA concerned, a financial analyst should be able to obtain a reasonable view of the acceptability of the financial statements concerned and the audit thereof.