

OPERATIONS MANUAL BANK POLICIES (BP)

These policies were prepared for use by ADB staff and are not necessarily a complete treatment of the subject.

FINANCIAL MANAGEMENT SYSTEMS, FINANCIAL ANALYSIS, AND FINANCIAL PERFORMANCE INDICATORS

A. Introduction

1. Article 14(xi) of the *Agreement Establishing the Asian Development Bank* (the Charter) requires ADB to take necessary measures to ensure that the proceeds of any loan made, guaranteed, or participated in by ADB are used only for the purposes for which the loan was granted and with due attention to considerations of economy and efficiency. In addition, Article 14(xiv) of the Charter requires ADB to be guided by sound banking principles in its operations.

B. Definitions

1. Executing Agencies

2. Executing agencies are agencies that are responsible for designing, implementing, and/or operating a project. The term "executing agency" also applies to the borrower.

3. Executing agencies may be classified broadly as

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

4. Executing agencies are also classified as "revenue earning" and "nonrevenue earning" for project processing and implementation purposes in order to determine the extent and depth of analysis required by ADB.

2. Revenue Earning

5. The term "revenue earning" is applied to executing agencies and projects that are implemented, and in most cases operated, by executing agencies that are commercially oriented, or that generate substantial revenues either by consumer charges or by forms of sector-specific local taxation or through financial intermediation such as water supply or drainage taxes, and have authority to decide on the use of these

funds. Executing agencies and projects that do not fall within the foregoing description are termed "nonrevenue earning."

3. Financial Management Systems

6. The term "financial management systems" covers the policies and practices regarding financial planning, programming, accounting, monitoring and reporting, internal auditing, checking and controlling, external auditing, funding, organization, and personnel of a project or of an executing agency. Good financial management promotes overall fiscal discipline and efficient allocation of resources to priority needs.

4. Financial Analysis

7. The term "financial analysis" comprises a quantitative and qualitative examination in sufficient depth to determine the reliability of the financial data pertaining to a project, a sector, and an executing agency.

5. Financial Performance Indicators

8. Financial performance indicators refer to financial ratios used to assess and monitor the project's financial sustainability, the financial viability of the executing agency, and the project's impact on the borrower's fiscal balance.

C. The Policy

9. As an integral part of project preparation, ADB requires the use of financial analysis and an assessment of the financial policies and the capacity of the financial management systems practiced or proposed by the borrower or executing agency to support project implementation and operation. The executing agency must be capable of providing correct and timely information on the progress of project implementation and, where appropriate, on its operation.

10. Executing agencies are to maintain a financial management system that ensures accountability, efficiency, economy, and solvency.

11. For revenue-earning projects, ADB requires the preparation and presentation of financial statements and projections for the project and financial performance indicators of the executing agency (especially public sector enterprises and utilities), with an analysis thereof and the determination of appropriate financial performance indicators.

12. In the case of nonrevenue-earning executing agencies, ADB requires sound financial policies, adequate accounting records, proper internal control systems, timely reporting to management, and sound and timely auditing practices. The executing agency is to ensure the sustainability of the project within its implementation period and thereafter.

13. Financial analysis is to be undertaken so that the financial viability of the project and, in appropriate cases, of the executing agency, before, during, and after the investment in the project is established to the satisfaction of ADB.

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14. Financial performance indicators to be recommended for use in financial covenants in loan agreements are to be formulated on the basis of financial policies pertaining to the sector, the project, and the executing agency, and ADB's requirements for financial viability for a revenue-earning project and its executing agency. These indicators, including the manner in which they are calculated, are to be discussed during project preparation with appropriate levels of the borrower's administration, including the executing agency. The agreement reached is to be reflected in the memorandum of understanding and supported by an appendix showing financial statement projections that demonstrate that compliance is practicable.

D. Scope of the Policy

15. The policy applies to investment projects and project executing and implementing agencies. Consequently, the policy relates mainly to identifiable investment activities that have been undertaken with support from project, sector, and private sector loans. This also applies where program loans include discrete, identifiable investment components. The policy also applies to private sector operations and is likewise relevant to project preparatory technical assistance.

Basis: This OM section is based on:

ADB. 2001. Guidelines for the Financial Governance and Management of Investment Projects Financed by the Asian Development Bank, November. Manila.

This OM section is to be read with OM Section G2/OP.

Compliance: This OM section is subject to compliance review.

For inquiries: Questions may be directed to the Director, Governance and Regional Cooperation Division, Regional and Sustainable Development Department.

This supersedes OM Section No. 35/BP
issued on 10 January 2002.

Development Department and issued by
the Strategy and Policy Department
with the approval of the President.

OPERATIONS MANUAL OPERATIONAL PROCEDURES (OP)

These procedures were prepared for use by ADB staff and are not necessarily a complete treatment of the subject.

FINANCIAL MANAGEMENT SYSTEMS, FINANCIAL ANALYSIS, AND FINANCIAL PERFORMANCE INDICATORS

A. Introduction

1. ADB's policy requires executing agencies to maintain a financial management system that ensures accountability, efficiency, economy, and solvency. The scope of assessment of the financial management systems, the extent of financial analysis required, and the formulation of financial performance indicators are detailed below. The procedures are applied to ensure that ADB is provided with correct and timely information to assure it of the financial viability of its investments and of the developing member country's executing agencies, and that the expenditures incurred are for the purposes stated in the report and recommendation of the President (RRP), loan agreement, and project agreement.

B. Application of the Policy

2. The assessment of financial management systems; the financial analysis of projects and the executing agencies; and the financial projections, including assumptions used in the projections, are to be incorporated into the RRP.

1. Financial Management Systems

3. Financial management systems are reviewed by the project team during project preparation and reported to the management review meeting (MRM). Based on further examination after MRM, or as required, the RRP describes¹ clearly the financial management system for the project and the executing agency. The RRP makes specific statements as to the adequacy of the financial management systems concerned. If inadequacies or gaps are identified, then all necessary remedial measures, their timing, and the likely impact on the project and executing agency until completion are to be specified in the RRP and, if appropriate, in the loan and project agreements.

4. The standards of financial management assessment employed by ADB in reviews of systems are to be sufficient to satisfy ADB of the capability and capacity of an executing agency to produce timely and reliable financial data and reports, and to achieve standards of performance that will ensure

- (i) achievement of the financial benefits estimated to be generated by the project, including the financial internal rates of return, where specified in the RRP; and

¹ If the financial management system is fully satisfactory, the description can be relatively brief but is to state explicitly the grounds for satisfaction.

- (ii) where applicable, achievement of the financial policy objectives represented by the financial performance indicators in the financial covenants in the loan and project agreements.

5. Where executing agencies are revenue earning, ADB endeavors to ascertain their solvency, liquidity, and profitability.

2. Financial Analysis

6. Financial analysis comprises a quantitative and qualitative examination in sufficient depth to determine the reliability of the financial data pertaining to a project, a sector, and an executing agency, and to determine the acceptability to ADB of the following elements:

- (i) Sector analysis:
 - (a) assessment of the existing structure, policy, and regulation of the sector against its capacity to support cost-effective service delivery, especially to poor people, and to enhance economic growth;
 - (b) assessment of financial performance against appropriate benchmarks to identify scope for improvement; and
 - (c) identification of policy and regulatory changes, notably tariff and competition policy, aimed at improving financial sustainability;
- (ii) Analysis of the executing agency:
 - (a) assessment of the adequacy of the investment cost and the financing plan for the project, including its coverage of recurring costs (operations and maintenance [O & M] expenses);
 - (b) evaluation of recent historical, current, and expected future performance of the executing agency: key assumptions and financial statements, with an emphasis on cash flows, financial ratios and debt service capacity; accounting and financial policies; and the viability of the executing agency, including actual and proposed cost recovery policies (where appropriate, taking explicit account of the form and amount of subsidies received for financing its operations);
 - (c) assessment of the executing agency's ability to fund recurring costs (including O & M, and capital expenditures), using all sources of revenue including user charges and subsidies;
 - (d) assessment of project implementation and operational practices of the executing agency of a nonrevenue earning project;

- (e) sensitivity analysis on key risks affecting the achievement of the project's development objectives and assessment of the financial policies and the actual and forecast efficiency and viability of the

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executing agency's financial operations as well as the financial performance indicators adopted as covenants for project monitoring; and

- (f) assessment of the executing agency's solvency, liquidity, and profitability during the period of ADB's loan;

(iii) Analysis of the project:

- (a) discounted cash flow analysis demonstrating that the project's unleveraged cash flow has an acceptable financial internal rate of return, and a positive net present value, using a discount rate that reflects the financial cost of capital;
- (b) assessment of project cash flows to ensure adequate liquidity, solvency, and profitability;
- (c) identification of the scope for requiring subsidies to ensure financial viability at the project level, and ensuring that arrangements are in place to fully finance the project's construction, and O & M cost;
- (d) recommendations and agreement with the borrower on a program to improve the project's financial sustainability; and
- (e) sensitivity analysis on key risks affecting the financial performance of the project, and measures for mitigation of risks thereof, if possible.

Basis: This OM section is based on OM Section G2/BP and the documents cited therein.

Compliance: This OM section is subject to compliance review.

For inquiries: Questions may be directed to the Director, Governance and Regional Cooperation Division, Regional and Sustainable Development Department.

issued on 10 January 2002.

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