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, COST ESTIMATES, FINANCIAL ANALYSIS, AND FINANCIAL PERFORMANCE INDICATORS

A. Introduction

1. Article 14(xi) of the *Agreement Establishing the Asian Development Bank* (the Charter) requires the Asian Development Bank (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.[1]

B. Definitions

1. Executing and Implementing Agencies

2. Executing and implementing agencies for ADB projects may be classified broadly as follows:

(i) public corporations, which are legal entities that are owned or controlled by central or local governments and created for the purpose of producing goods or services for the market (these entities include development banks, public utilities, and port and other authorities);

(ii) private sector and other nongovernmental entities (i.e., entities that are owned or controlled by private interests, whether for-profit or not-for-profit, including nongovernmental organizations); or

(iii) general government sector units, which include central and local units that are primarily engaged in nonmarket operations (these units include ministries and departments).[2]

2. Financial Management

3. Financial management comprises multiple processes, including financial accounting, management (and cost) accounting, asset management, cash and treasury management, financial reporting, internal controls, and internal and external audit. Each of these processes should incorporate subprocesses and techniques including management, forecasting, strategic planning, planning and budgeting, procurement, disbursement, control, and communications and reporting.

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1 The requirements also apply to grant financing for ADB projects.

2 Classifications (i) and (iii) are consistent with International Monetary Fund. 2001. *Government Finance Statistics Manual*. Washington, DC.

3. Cost Estimates

4. Project cost estimates are prepared at the concept stage, refined throughout the project-preparation process, and updated during implementation.

4. Financial Analysis

5. Financial analysis is the transformation of financial data into a form that can be used to monitor and evaluate an entity's financial position, plan future financing, and assess the entity's size and growth rate. It includes the use of financial projections and financial performance indicator analysis.

5. Financial Evaluation

6. Financial evaluation (financial cost–benefit analysis) is the process of comparing the financial benefits of a project or project component (as indicated by the financial internal rate of return [FIRR]) to the financial costs (as indicated by the weighted average cost of capital [WACC]). The purpose of financial evaluation is to assess the financial viability of a project or project component.

6. Financial Performance Indicators

7. Financial performance indicators are used to evaluate an entity's liquidity, solvency, return on investment, operating performance, asset utilization, and market measures. To be meaningful, a given financial performance indicator for a given period should be compared with prior periods and industry norms.

C. Policy

8. ADB's project preparatory activities involve the completion of a financial management assessment of executing and implementing agencies and the preparation of cost estimates and a financing plan, a financial analysis, and, where applicable, the financial evaluation of the project (or project components). Sufficient analysis is required to be undertaken to determine whether the project is financially viable and sustainable.

9. A financial management assessment (FMA) is required to assess the capacity of executing and implementing agencies and their systems in the areas of planning and budgeting, management and financial accounting, reporting, auditing, and internal controls. The FMA also includes a review of proposed disbursement and funds-flow arrangements, and identifies measures for addressing identified deficiencies.

10. Cost estimates are required to be prepared during project processing. The executing agency is responsible for the preparation of the cost estimates. The cost estimates should identify the principal cost components needed to determine the financing requirements and support effective project management, including monitoring of costs and physical progress during implementation. The cost estimates should be supported by verifiable data. The cost estimates will comprise the base cost, reasonable physical and price contingencies, and financial charges during implementation.

11. A financing plan is required to be prepared, showing that sufficient resources are available to cover the base cost, physical and price contingencies, and applicable financial charges during implementation. The executing agency is responsible for the preparation of the financing plan.

12. Where the executing and/or implementing agency is a public corporation, or a private sector or other nongovernmental entity, the preparation and presentation is required of historical and projected financial statements for the executing and/or implementing agency. The financial statements should reflect the financial impacts of the project or project component and present an analysis of key financial performance indicators.

13. Where the executing and/or implementing agency is a general government sector unit the preparation and presentation is required of projected incremental recurrent costs associated with the project or project component, assessed against the capacity of the executing and/or implementing agencies to cover these costs.

14. In cases where a project or project component is intended to recover all or a portion of costs through increased revenues and/or efficiency improvements or cost savings, a financial evaluation (cost–benefit analysis) is required to assess financial viability. The financial evaluation is completed in real terms on an after-tax basis.

15. If the financial analysis (paragraph 12 and 13) and/or financial evaluation (paragraph 14) identifies significant risks to project financial sustainability or viability, ADB normally requires that relevant financial performance indicators are incorporated in financial covenants in the project legal agreements. These indicators are to be formulated on the basis of financial policies pertaining to the sector, the project, and executing and/or implementing agencies (e.g., tariff policies and regulations, and prudential regulations), as well as ADB’s requirements for financial viability and sustainability of projects and their executing and/or implementing agencies. 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 and/or implementing agencies. The agreement reached is to be reflected in the memorandum of understanding and supported by an appendix showing financial projections that demonstrate that compliance is practicable.

D. Scope of the Policy

16. This OM section applies to all ADB-financed investment projects that have a discrete and identifiable investment component, and the executing and/or implementing agencies of such projects.[3]

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[3] This OM Section applies to such projects irrespective of whether they are financed by an ADB loan, a grant from the Asian Development Fund (ADF), or a combination of ADB loan and ADF grant. This OM Section does not apply to nonsovereign operations, which are covered by OM Section D10 (Nonsovereign Operations), or to policy-based loans, which are covered by OM Section D4 (Policy-Based Lending).

Basis: This OM section is based on:

ADB. 1966. *Agreement Establishing the Asian Development Bank.* Manila.

ADB. 2009. *Regulations of the Asian Development Fund*. Manila.

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

For other background information and references, see:

ADB. 2005. *Financial Management and Analysis of Projects*. Manila.

ADB. 2014. *Preparing and Presenting Cost Estimates for Projects and Programs Financed by the Asian Development Bank: Financial Management Technical Guidance Note*. Manila.

Compliance: This OM section is subject to compliance review.

For inquiries: Questions may be directed to the Senior Advisor (Financial Management), Financial Management Unit, Operations Services and Financial Management Department.

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12 March 2014
This supersedes OM Section G2/BP issued on 29 October 2003.

Prepared by the Operations Services and Financial Management Department and updated 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, COST ESTIMATES, FINANCIAL ANALYSIS, AND FINANCIAL PERFORMANCE INDICATORS

A. Introduction

1. The Asian Development Bank (ADB) requires executing and implementing agencies to have financial management processes that ensure accountability, efficiency, economy, and solvency. The scope of the financial management assessment (FMA), the preparation of cost estimates and financing plans, and the extent of financial analysis and evaluation required are detailed in paragraphs 2–9.

B. Application of Policy

2. The FMA; the cost estimates, including their underpinning assumptions; the financing plan; the financial analysis, and where appropriate financial evaluation, of projects and executing and implementing agencies; and the financial projections, including assumptions used in the projections, are to be summarized in the report and recommendation of the President (RRP) and incorporated in linked documents.

1. Financial Management Assessment

3. The objective of the FMA is to ensure that the executing and implementing agencies are technically, managerially, and financially capable of efficiently and effectively implementing the proposed projects or programs. Specifically, the FMA should (i) determine whether the financial management arrangements are sufficient to justify loan and/or grant approval, (ii) identify financial management development needs that should be addressed during project implementation, and (iii) confirm that the financial management arrangements are sustainable.

4. The results of the FMA will be reported to the management review meeting or staff review meeting. The RRP and project administration manual (PAM) will describe the financial management arrangements for the project and for the executing and implementing agencies. The RRP and PAM will specifically conclude as to the adequacy of the financial management arrangements for the project. If inadequacies or gaps are identified, then necessary remedial measures, their timing, and the likely impact on the project and the executing and implementing agencies until completion are to be specified in the PAM, the risk assessment and risk management plan and, if appropriate, in the legal agreements.

2. Cost Estimates

5. Summary cost estimates are to be included in the RRP, while detailed cost estimates are to be included in the PAM. Detailed cost estimates will be prepared taking the following points into consideration:

(i) the cost estimates will be designed so that they provide (a) an understanding of the principal cost components, (b) an estimate of the total financing required, and (c) useful information for cost monitoring and control purposes during implementation;
(ii) the base cost estimates are prepared using actual market prices, where available, for the various project inputs prevailing at the time of preparation. Where possible, unit cost estimates should be compared to contract prices for completed and ongoing projects;
(iii) the RRP will indicate the date of the cost estimates. If the cost estimates will be more than 6 months old by the time the project is presented to ADB's Board or Management, the cost estimates should be revised, unless the base cost has not changed materially in the intervening period;
(iv) contingencies are an integral part of the expected total project cost and normally are necessary for all project items involving significant expenditures. Contingency allowances should reflect probable (forecast) physical and price changes, as well as costs arising from special risks that can reasonably be expected to increase the base cost estimate. The basis for computing physical and price contingencies should be clearly stated in the RRP; and
(v) the cost estimates will be reviewed by the executing agency and ADB, and updated by the executing agency as necessary to reflect changes in project design and costs.

3. Financing Plan

6. The financing plan will be prepared taking the following points into consideration:
(i) the financing plan will be sufficient to cover the base cost, physical and price contingencies, financial charges during implementation, and projected foreign exchange gains or losses as applicable; and
(ii) the veracity of the financing plan will be assessed by reviewing the capacity of the executing and implementing agencies to meet self-financing obligations; determining whether specific budget allocations have been made on central or local government budgets to cover counterpart financing requirements; and assessing the firmness of local bank, commercial, or official cofinancing.

4. Financial Analysis

7. Financial analysis is required for all ADB-financed projects to which this OM applies, but the requirements depend on the classification of the executing and implementing agencies. Where the executing or implementing agency is a public corporation, or a private sector or other nongovernmental entity, the coverage of the financial analysis will normally include the following:
(i) assessment of the existing structure, policy, and regulation of the sector in which the executing and implementing agencies operate, in terms of support for cost-effective service delivery;
(ii) identification of policy and regulatory changes in the sector, notably in tariff and competition policy, aimed at improving financial sustainability;
(iii) assessment of the adequacy of the cost estimates and financing plan of the project, including its coverage of incremental recurrent costs as appropriate;

(iv) review of the historical and current financial performance of the executing and implementing agencies;
(v) preparation and presentation of historical and projected income statements, balance sheets, and cash flow statements for the executing and/or implementing agencies, including key assumptions and computation of key financial performance indicators;
(vi) assessment of project and entity cash flows to ensure adequate liquidity, solvency, and profitability;
(vii) review of proposed cost-recovery and tariff policies (where appropriate, taking explicit account of the form and amount of subsidies received for financing operations), including an analysis of affordability;
(viii) sensitivity analysis on key risks affecting the achievement of the project's development objectives; and
(ix) recommendations and agreement with the borrower on financial performance indicators to be adopted as covenants for project monitoring; and on actions required, if necessary, to improve the project’s financial sustainability.

8. Where the executing or implementing agency is a general government sector unit, the financial analysis will normally include the following:
(i) projection of incremental recurrent costs, including operating and maintenance expenditures required to ensure sustainability of project or program benefits; and
(ii) assessment of the capacity of the executing and implementing agencies to fund recurrent costs.

9. Where required (see paragraph 14 of OM G2/BP), a financial evaluation (cost–benefit analysis) will normally involve the following:
(i) computation of the FIRR of the project or component’s incremental cash flows in real terms on an after-tax basis;
(ii) computation of the WACC in real terms on an after-tax basis;
(iii) assessment of the sensitivity of the FIRR and WACC to various scenarios; and
(iv) the FIRR is expected to exceed the WACC under all scenarios. In exceptional circumstances, there may be an economic or development rationale for proceeding with a project or component where the FIRR does not exceed the WACC. In such cases, the justification for the project should address issues of financial sustainability.

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 Senior Advisor (Financial Management), Financial Management Unit, Operations Services and Financial Management Department.