

# Project Administration Instructions

PAI No. 5.07  
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## FINANCIAL REPORTING AND AUDITING OF LOAN- AND GRANT-FINANCED PROJECTS

### A. Introduction

1. This project administration instruction (PAI) provides the principles and rules that elaborate the requirements of the Operations Manual Section J7: *Project Financial Reporting and Auditing*. Technical guidance notes should be referred to for detailed guidance.<sup>1</sup>
2. Where necessary, guidance on the application of this PAI, including with respect to project-specific requirements and application, should be sought from the Procurement, Portfolio and Financial Management Department (PPFD).

### B. ADB's Requirements

#### 1. Basic Requirements

3. The Asian Development Bank (ADB) requires the annual submission of the audited project financial statements and the audit report for each financial reporting period (fiscal year) from the date of loan effectiveness until the loan closing date.<sup>2</sup> For financial intermediation loans, an audited statement of utilization of funds may be submitted in lieu of the audited project financial statements for financial reporting and auditing purposes.<sup>3</sup> The audited project financial statements and audit reports will be presented in the English language.
4. When an independent entity's annual financial statements are subject to audit under the statutory or regulatory requirements of the developing member country (DMC), or where these are required for project monitoring<sup>4</sup>, such entity will submit to ADB the audited entity financial statements. When applicable, the audited entity financial statements will be submitted to ADB annually for each reporting period (fiscal year) from the date of loan effectiveness<sup>5</sup> until the loan closing date or as agreed for the purpose of the project. These financial statements will be submitted to ADB in the English language within 1 month of their approval by the relevant authority.

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<sup>1</sup> Financial Management Resources. <http://www.adb.org/projects/operations/financial-management-resources>.

<sup>2</sup> In cases where the legal agreements provide for retroactive financing, the submission of the audited project financial statements and the audit report will be from the approved date of retroactive financing, i.e., the date when costs that were approved for retroactive financing were incurred.

<sup>3</sup> For financial intermediation loans with non-financial components, audited project financial statements for the non-financial components will be prepared separately.

<sup>4</sup> This refers to monitoring of entity financial projections and financial performance indicators, which cannot be incorporated in project financial statements. Financial performance indicators are used to evaluate an entity's liquidity, solvency, return on investment, operating performance, asset utilization, and market measures, and may be incorporated as financial covenants. To be meaningful, a given financial performance indicator for a given period should be compared with prior periods and industry norms. See OM G2/BP, paragraphs 5 and 7.

<sup>5</sup> The first audited entity financial statements will be for the first fiscal year which includes the date of loan effectiveness (or the date of retroactive financing, as applicable).

## 2. Form of Annual Financial Statements

5. ADB accepts project financial statements prepared in accordance with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), International Public Sector Accounting Standards (IPSAS) promulgated by the International Public Sector Accounting Standards Board (IPSASB), or national equivalents<sup>6</sup>.

6. The audit of the project financial statements will be conducted in accordance with auditing standards acceptable to ADB and carried out by independent auditors acceptable to ADB. ADB recognizes the use of the International Standards on Auditing (ISA) as issued by the International Auditing and Assurance Standards Board and requires borrowers and executing agencies to engage auditors conforming to ISA. In that connection, ADB also accepts (i) national auditing standards when deemed sufficiently equivalent to ISA, and (ii) the ISA-based International Standards of Supreme Audit Institutions as issued by the International Organisation of Supreme Audit Institutions. The audited project financial statements may be incorporated within an independent entity's financial statements.

7. The financial management assessment undertaken during project processing will include an agreement between the borrower and ADB on the form, content, and timing of the project financial statements that are to be audited. These arrangements will be set forth in the memorandum of understanding or aide-mémoire for the fact-finding mission and detailed in the project administration manual (PAM).<sup>7</sup> During implementation, project financial reporting and auditing requirements detailed in the PAM will be reviewed with project counterparts, particularly after a change in personnel.

## 3. Public Disclosure

8. In compliance with ADB's Public Communications Policy (PCP), 2011, ADB will agree with the borrower on a country-specific basis<sup>8</sup>, the procedures for and timing of disclosure of the audited project financial statements for sovereign projects, including the auditor's opinion on the audited project financial statements. The management letter, additional auditor's opinions, and the audited entity financial statements, if applicable, will not be disclosed.<sup>9</sup> The audited project

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<sup>6</sup> National standards are considered equivalent to IFRS or IPSAS and are acceptable to ADB if their application results in sufficient and reliable financial information (including disclosures in the notes to the financial statements) that conforms in all material respects with the form and substance of financial statements prepared using IFRS or IPSAS. For instance, financial statements prepared under the accounting principles generally accepted in the United States of America are considered national equivalents of the international standards. The assessment of the national standards is part of the financial management assessment and is detailed in the project administration manual (PAM).

<sup>7</sup> Where a project is cofinanced with one or more multilateral or bilateral financiers, the financial reporting and auditing requirements should be harmonized such that the borrower, executing and/or implementing agency is required to submit only one set of audited project financial statements and audit report to all financiers. These harmonized requirements will be set forth in the PAM. Where there is no agreement on the financial reporting and auditing requirements, the requirements for ADB's financing will follow this PAI.

<sup>8</sup> This requirement applies to sovereign projects for which the invitation to negotiate was issued on or after 2 April 2012. During project processing, regional departments will arrange meetings as appropriate with the Ministry of Finance, the ministry responsible for foreign-financed projects, and the supreme audit institution to discuss the application of ADB's public disclosure requirements in light of any relevant provisions in the country's constitution, laws and procedures. Country-level arrangements will be recorded in the memorandum of understanding or aide memoire and will form the basis of project-level arrangements to be incorporated into the legal agreement and detailed in the PAM.

<sup>9</sup> This type of information would generally fall under public communications policy exceptions to disclosure. ADB. 2011. *Public Communications Policy*. Paragraphs 97(iv) and/or 97(v).

financial statements and the auditor's opinion on the audited project financial statements will be disclosed no later than 14 calendar days of ADB's confirmation of their acceptability.

#### **4. Appointment of Auditors**

9. ADB requires that auditors acceptable to ADB are selected and appointed for all ADB-financed projects. To be acceptable, auditors must be independent, objective, competent, well-established and reputable, and with appropriate and relevant working experience required for the project.

10. The borrower, executing and/or implementing agencies are required to appoint auditors acceptable to ADB within a sufficient period to enable them to conduct the audit.

11. The requirements for selecting and appointing auditors will be set during project processing, at or before the start of project activities, and for each fiscal year until the loan closing date.

#### **5. Auditor's Opinions**

12. Auditors are engaged to provide an independent and objective opinion on whether the financial statements present fairly, in all material respects, or give a true and fair view of, the project/entity's financial position, its financial performance and cash flows in accordance with the applicable financial reporting standards. The auditor's opinion is necessary to establish the credibility, or otherwise, of the project/entity financial statements.

13. The auditor will also provide additional opinion(s) covering:

- (i) Use of loan proceeds: ADB requires that the auditor confirms whether the proceeds of the loan were used only for the purpose(s) of the project.
- (ii) Compliance with financial covenants (where applicable): The auditor is required to confirm the level of compliance for each financial covenant contained in the legal agreement for the project. The auditor will also indicate, where applicable, the extent of any non-compliance by reference to the specified (required) and actual performance measurements for each financial covenant for the fiscal year concerned.

14. Other specific audit requirements may be agreed between ADB and the borrower (e.g., performance audit, audit of resettlement expenditures, procurement, spot audit). The requirements for the auditor's opinion(s) will be included in the auditor's terms of reference.

#### **6. Management Letter**

15. The audit of financial statements includes consideration of the internal control system relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may, however, identify deficiencies in internal control during the assessment of risks and the conduct of the audit including irregularities in the use of ADB's advance fund procedures (where applicable), the statement of expenditure procedures

(where applicable), or the procurement process. Any deficiencies or weaknesses noted will be communicated by the auditors to project management or to the executing agency on a timely basis through a management letter.<sup>10</sup>

## **C. Compliance with ADB's Requirements**

### **1. Reporting Deadline**

16. The audited project financial statements and audit report will be submitted annually within 6 months after the end of the executing or implementing agency's fiscal year-end. On an exceptional basis, this reporting deadline may be extended to up to 9 months from fiscal year-end after concurrence by PPF, in cases of decentralization where logistical considerations impact the physical flow of information. The financial management assessment during project processing will include the justification for the extension of the reporting deadline.

17. The audited financial statements of an independent entity will be submitted to ADB within 1 month of their approval by the relevant authority.

### **2. Monitoring Compliance**

18. The submission of the audited project financial statements and the related audit report will be actively monitored by the project team leader to ensure compliance, and the timely implementation of resolutions or actions in cases of non-compliance. Consultations with the Office of Cofinancing Operations (OCO), Office of the General Counsel (OGC), and PPF, as appropriate, should be sought when taking mitigating actions. **Table 1** provides recommended approaches in monitoring submission of audited financial statements and the related audit reports.

19. Receipt of the audited project financial statements, the audit reports, and the audited entity financial statements, where applicable, will be processed and reviewed in accordance with ADB's requirements and guidelines,<sup>11</sup> or in case of projects with external financing, in accordance with the terms of the cofinancing agreement.<sup>12</sup> In case of justified delays, unaudited financial statements may be submitted to ADB within the agreed timeframe. However, unaudited financial statements should not be used to determine compliance with the financial covenants. The executing or implementing agency should submit the audited financial statements and related documents to ADB within the timeframe agreed with ADB. PPF and OGC will be consulted if there is any proposed revision to the financial covenants.

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<sup>10</sup> ADB. 2006. *Handbook for Borrowers on the Financial Management and Analysis of Projects*. Manila.

<sup>11</sup> Footnote 1.

<sup>12</sup> Where a project is cofinanced with one or more multilateral or bilateral financiers, the financial reporting and auditing requirements should be harmonized such that the borrower, executing and/or implementing agency is required to submit only one set of audited project financial statements and audit report to all financiers. These harmonized requirements will be set forth in the PAM. Where there is no agreement on the financial reporting and auditing requirements, the requirements for ADB's financing will follow this PAI.

**Table 1: Recommended Approach for Monitoring Submission of Audited Financial Statements**

<b>When</b>	<b>Who</b>	<b>Approver</b>	<b>What</b>
3 months before due date, or as frequent as may be required	project team leader	sector or country director	Remind the borrower/executing and/or implementing agencies of ADB's requirements for submission of the audited project financial statements and the audited entity financial statements on or before the due date, as agreed in the legal agreement and detailed in the PAM.
On due date	project team leader	sector or country director	Notify the borrower/executing and/or implementing agencies of ADB's requirements that are overdue, and advise that submission is required immediately within the next 6 months from due date. The notice will include a statement that failure to submit within the extended period may result in requests for new contract awards and disbursements (such as new replenishment of advance accounts, processing of new reimbursement, and issuance of new commitment letters) to be withheld.
6 months after due date	project team leader	sector or country director	<p>Withhold processing of requests for new contract awards and disbursements, such as new replenishment of advance accounts, processing of new reimbursement, and issuance of new commitment letters.</p> <p>Inform the borrower/executing and/or implementing agencies of ADB's actions, and advise that compliance is required immediately within the next 6 months. The notice may include a statement that failure to submit within the extension period may result in loan suspension.</p> <p>Inform PPF, OGC and CTL (and OCO, if the project is cofinanced) of the status of submission and the actions taken.</p>
12 months after due date	sector or country director	director general and vice-president	<p>Determine whether loan is to be suspended in accordance with the provisions of PAI 4.03 and advise the director general. The director general, after review of the pertinent justifications, may recommend cancellation or suspension for approval by the vice-president.</p> <p>Inform the borrower/executing and/or implementing agencies of ADB's actions.</p> <p>Inform PPF, OGC and CTL (and OCO, if the project is cofinanced) of the decision.</p>

CTL = Controller's Department, OCO = Office of Cofinancing Operations, OGC = Office of the General Counsel, PPF = Procurement, Portfolio and Financial Management Department, PAI = project administration instruction, PAM = project administration manual.

Note: The above approaches apply also to the audited project financial statements and the related audit opinions.

20. The submission of the audited project financial statements is required for all projects regardless of size or number of financial transactions that occur within a year. However, in exceptional cases supported by sufficient justifications, the borrower, executing and/or implementing agency may request for a deferment of the submission of the first audited project

financial statements. In making decisions on whether to approve the request for deferment, the benefits of receiving the audited project financial statements must be assessed and weighed against the risks arising from the delayed submission given the level of financial activity. A request for deferment will be processed in accordance with Appendix 1 (Interpretation Guidelines), and discussed with PPF, as applicable.

21. The final audited project financial statements will include all eligible expenditures incurred up to the loan closing date. The final audited project financial statements will be prepared in accordance with the following:

- (i) Where the DMC's regulations mandate the preparation and audit of annual project financial statements, the project financial statements will be prepared annually regardless of the amount of financial activity or the remaining period between the previous fiscal year-end up to loan closing date. In this instance, it is expected that the project management unit or the entity responsible for the preparation of the project financial statements will remain in force, and that the final audited project financial statements may cover a full or partial year.
- (ii) Where the DMC's regulations do not mandate the preparation and audit of annual project financial statements, and where the period between the previous fiscal year-end up to the loan closing date is 6 months or less, the final project financial statements may cover a longer financial reporting period of 18 months, i.e., 12 months for the previous fiscal year and 6 months from the fiscal year-end up to the loan closing date. For financial statements prepared under the accrual basis of accounting, the final audited project financial statements will accrue the value of expenditures incurred up to the loan closing date that are expected to be disbursed in the succeeding period. For financial statements prepared under the cash basis of accounting, where disbursements are made after the loan closing date, the final audited project financial statements will include information such as the "receivables, payables, borrowings and other liabilities, non-cash assets and accruing revenues and expenses" that are not normally recognized under cash accounting in the notes to the financial statements<sup>13</sup>.

22. In addition to the audited project financial statements, unaudited interim project financial statements will be included in project progress reports and reviewed in compliance with PAI 5.01. Where the review identifies any issues of potential concern, these will be communicated to the executing or implementing agency to seek explanations and discuss remedial actions.

### **3. Reviewing Audited Financial Statements and Audit Reports**

23. The audited financial statements and the audit report should be reviewed by the project team leader within 8 weeks of receipt by ADB to: (i) determine their acceptability and the level of compliance with financial covenants, (ii) analyze the financial information as part of project progress and financial performance monitoring, and (iii) undertake necessary measures as necessary.

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<sup>13</sup> IPSASB. 2014. *Handbook of International Public Sector Accounting Pronouncements. Cash Basis IPSAS – Financial Reporting Under the Cash Basis of Accounting*. Sections 1.3.10 and 1.3.11. New York.

24. Determination of acceptability is an analytical process and is based on professional judgment. To aid this determination, the review will be performed in accordance with ADB's requirements and guidelines<sup>14</sup> and will consider the form, quality and timeliness of financial statements, scope and quality of audit and its opinion(s), the magnitude and frequency of deficiencies in internal control, and the operating and financial performance of the project/entity.

#### **4. Communicating Review Results**

25. The results of the review will be documented, and the proposed remedial actions will be discussed with the borrower, executing and/or implementing agency. The discussion will include:

- (i) whether the audited financial statements are acceptable. If unacceptable, the reasons for unacceptability and any recommended action(s) to correct the deficiencies;
- (ii) any substantial modification in auditor's opinion and audit findings reported in the audit report which may adversely affect project implementation, the operation of the independent entity, or the level of fiduciary risk to ADB;
- (iii) the adequacy of actions taken, proposed, or the lack of it, by the executing and/or implementing agencies on current and previous audit findings reported in the audit report; and
- (iv) any recommended actions for ADB or the executing and/or implementing agencies.

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<sup>14</sup> Footnote 1.

**Table 2: Reviewing Audited Financial Statements and Audit Reports**

<b>What</b>	<b>Who</b>	<b>Approver</b>
Acknowledge receipt of documents.	project team leader	not applicable
Update financial reporting covenants, and review the audited project financial statements, audit report, and audited entity financial statements (where applicable). <ul style="list-style-type: none"> <li>• Upload scanned copies of documents in eOperations.</li> <li>• Review the audited project financial statements and related audit report.</li> <li>• Review the audited entity financial statements (where applicable).</li> </ul>	project analyst	project team leader
Prepare summary list of issues and key findings, and upload into eOperations together with review checklists. In the first instance, the project team leader and/or project analyst will consult on issues with the regional financial management specialist. The regional financial management specialist will review the submitted documents at the request of the project team leader, and may consult with CTL, PPF, OGC, and DOC, as appropriate, for technical advice in cases of significant deficiency in quality of audited financial statements, significant deficiency in the quality of auditor's opinion, or serious concerns contained in the management letter.	project analyst	project team leader
Update the summary list of issues and key findings based on the review results provided by the regional financial management specialist.	project analyst	project team leader
Determine gravity of issues and findings, and discuss material issues with the director general, as necessary, to identify appropriate course of actions.	sector or country director	director general
Prepare and agree a time-bound action plan with the borrower, executing and/or implementing agencies to address the issues and key findings. The borrower, executing and/or implementing agencies should provide a response within a specified time.	project team leader	sector or country director
Highlight the issues and key findings, including the lack of response from the borrower, executing and/or implementing agencies (as applicable) in the project performance report in accordance with PAI 6.05.	project team leader	sector or country director
Inform PPF, CTL, OGC and OCO of the results of the review of the audited project financial statements, audit reports, and audited entity financial statements (where applicable), including remedial actions taken.		
Disclose audited project financial statements and auditor's opinion thereon. <ul style="list-style-type: none"> <li>• Determine disclosure eligibility and initiate disclosure in accordance with ADB's PCP.</li> </ul>	project analyst	project team leader
Monitor compliance by the borrower/executing and/or implementing agencies with the agreed time-bound action plan through written communications and/or missions, and document in the back-to-office report and project performance report.	project team leader	sector or country director

CTL = Controller's Department, DOC = Department of Communications, OCO = Office of Cofinancing Operations, OGC = Office of the General Counsel, PPF = Procurement, Portfolio and Financial Management Department, PAI = project administration instruction, PCP = Public Communications Policy.



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## PROCESSING DEFERMENT OF THE FIRST AUDITED PROJECT FINANCIAL STATEMENTS

### A. Key Rules

1. The following rules set out the requirements when processing requests for deferment of the first audited project financial statements (APFS).

- (i) The submission of the APFS together with the audit report thereon commences on the date of loan or grant effectiveness or on the date of the first expenditure (if the legal agreement provides for retroactive financing) whether funded by Asian Development Bank (ADB), cofinancier, or government.
- (ii) The submission of APFS will be monitored on an annual basis.
- (iii) The first APFS includes all project costs financed by ADB loan or grant, counterpart funds, and cofinanciers (except parallel cofinancing arrangements).
- (iv) Limited financial activity means the total of actual expenditures including direct payments and outstanding unliquidated advances to advance accounts, must be less than or equal to 3% of total project costs.
- (v) The cumulative disbursements (including ADB, cofinancing, and counterpart funds) as reported in the quarterly progress report will be the basis for the project team's assessment of the financial activity during the reporting period for which deferment is being sought (section B of Appendix 1 of PAI 5.01).
- (vi) Requests for deferment and, consequently, the extension of the next reporting period will originate from the borrower or executing agency.
- (vii) Information on the overall project financial activity and the financial management risk rating are mandatory requirements when processing requests for deferment.

### B. The Decision Matrix

2. **Table A1.1** presents the factors to be considered when processing requests for deferment, the relationship among these factors, and the recommended approaches. This decision matrix, however, does not attempt to diminish or replace the professional judgment to be employed by project analysts and officers, and by financial management specialists in making such decisions. Due care and diligence must be employed at all times. In case of clarifications, consultations and discussions with the Public Financial Management Division (PFFM) of the Procurement, Portfolio and Financial Management Department (PPFD) must be sought.

**Table A1.1: APFS Deferment Considerations and Approaches**

<b>Total extended financial reporting period (in months)<sup>a</sup></b>	<b>Financial Management Risk Rating<sup>b</sup></b>	<b>Financial Activity<sup>c</sup></b>	<b>Approach</b>
Up to 24 months	Low or Moderate	$0 \leq X \leq 3\%$	Defer with extension of period
Any	Substantial or High	$0 \leq X \leq 3\%$	Consult with PFFM
Any	Any	$X > 3\%$	Do not defer Or Consult with PFFM

<sup>a</sup> Refers to the total number of months covered by the next reporting period from loan or grant effectiveness (or from the first disbursement, whichever is earlier) up to the close of the fiscal year-end. For example, if a loan was made effective on 15 June 2015 with a 31 December fiscal year-end, with no retroactive financing, and the executing agency requests for deferment of the covenant for APFS 2015, then the first APFS submission would cover the 18.5-month extended financial reporting period from 15 June 2015 to 31 December 2016. In a case involving retroactive financing, where the first expenditure was on 1 May 2015 and loan effectiveness was on 15 June 2015, with a 31 December fiscal year-end, then the first APFS submission would cover the 20-month extended financial reporting period from 1 May 2015 to 31 December 2016.

<sup>b</sup> This refers to the pre-mitigation financial management risk rating reflected in the financial management assessment based on a four-point scale of low, moderate, substantial, and high. In the absence thereof, a financial management risk rating will be assigned by the project team in consultation with the regional financial management specialist.

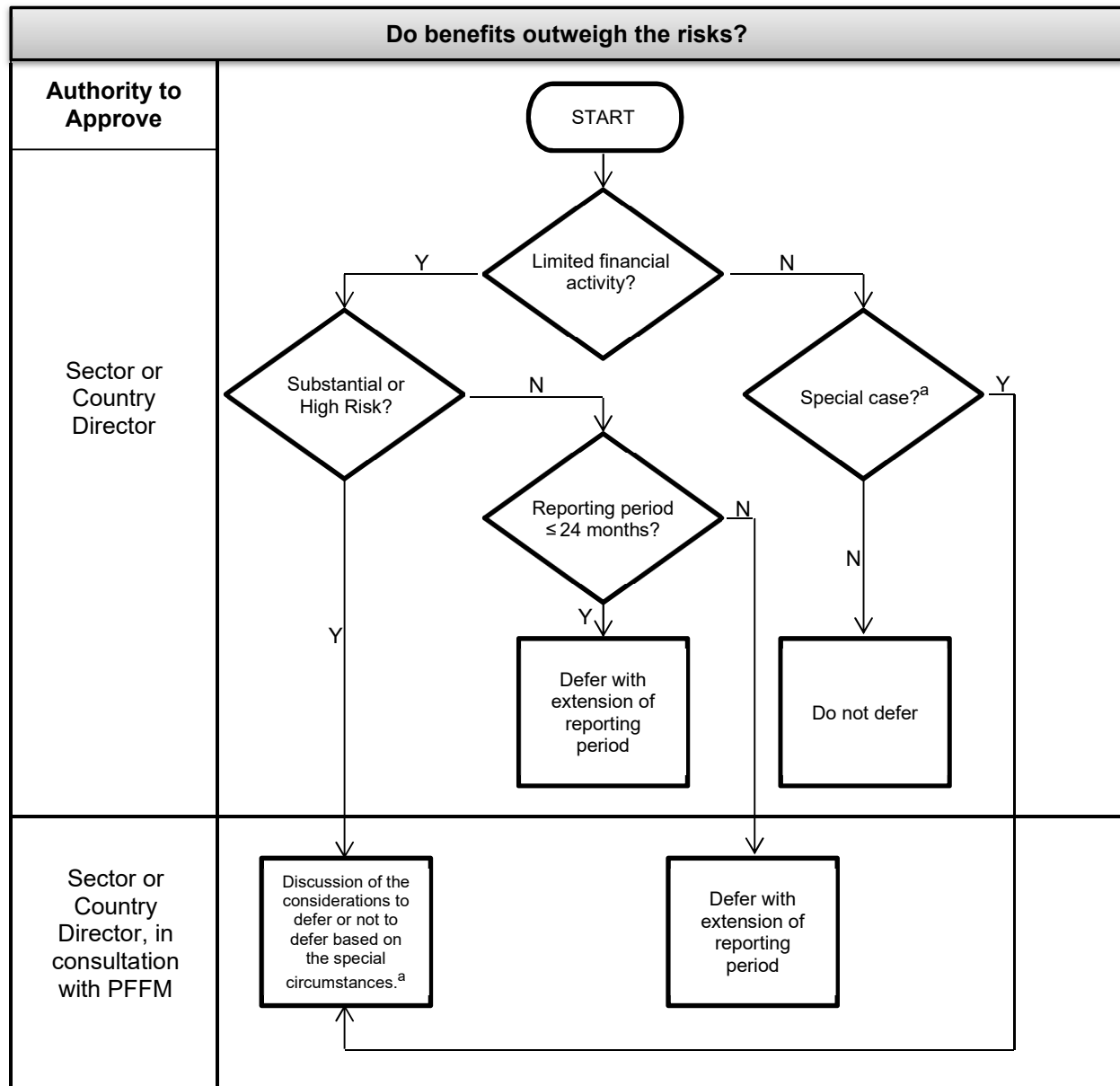
<sup>c</sup>  $X = (\text{Actual expenditures for the first fiscal year-end including direct payments plus outstanding unliquidated advances to imprest account}) / (\text{Total project cost})$ . Expenditures include ADB, counterpart, and cofinancing funds except parallel cofinancing arrangements. Estimated expenditures may be used in exceptional cases after consultation with the regional financial management specialist.

PFFM = Public Financial Management Division, PPFM.

**C. The Decision Tree**

3. **Figure A1.1** presents the process and considerations in concluding whether benefits outweigh the risks of non-submission of the APFS. This chart should be read in conjunction with the Decision Matrix.

**Figure A1.1: APFS Deferment Decision Tree**



<sup>a</sup> In some circumstances, the nature and complexity of the project may require critical analysis; in which case, the decision to defer will be made after consultation with PFFM and Office of the General Counsel (OGC).