

Financial Management Assessment

November 2020

Bhutan: Phuentsholing Township Development
Project – Additional Financing

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List of Abbreviations

ADB	–	Asian Development Bank
APFS	–	Audited Project Financial Statements
AEFS	–	Audited Entity Financial Statements
ALDTP	–	Amochhu Land Development and Township Project
CDCL	–	Construction Development Corporation Ltd
COVID-19	–	coronavirus disease
CEO	–	Chief Executive Officer
CPS	–	Country Partnership Strategy
DHI	–	Druk Holdings and Investment Ltd
DPA	–	Department of Public Accounts
EAP	–	Externally Aided Project
FMA	–	Financial Management Assessment
FMR	–	Financial Monitoring Report
IAS	–	International Accounting Standard
km	–	kilometers
MOF	–	Ministry of Finance
Nu	–	Ngultrum
PAC	–	Project Advisory Committee
PEFA	–	Public Expenditure Financial Accountability
PFS	–	Project Financial Statements
PIC	–	project implementation consultant
PIU	–	project implementation unit
PMU	–	project management unit
QPR	–	Quarterly Project Report
RAA	–	Royal Audit Authority
SOE	–	Statement of Expenditure

EXECUTIVE SUMMARY

1. The Financial Management Assessment (FMA) was conducted in accordance with ADB's Guidelines¹, by updating the FMA of the Phuentsholing Township Development Project (ongoing project), in April 2020. The FMA focused on the Construction Development Corporation Limited (CDCL) which is a wholly owned subsidiary of Druk Holding and Investments (DHI), which in turn is wholly owned by the Government of Bhutan. The FMA covered the areas of fund flow arrangements, governance, staffing, budgeting, accounting and financial reporting systems, internal control procedures, financial information systems, and internal and external audit arrangements.
2. Due to the lockdown of government offices because of the coronavirus diseases (COVID-19) emergency, the updating of the FMA was conducted remotely based on the following: (i) assessment of financial management performance under the ongoing project (BHU Loan 3668); (ii) financial management questionnaire and desk review of documents; (iii) interviews conducted with the staff of the implementing agency; and (iv) lessons learnt from ongoing ADB projects in the country.
3. The FMA found that CDCL has adequate financial management capacity to: (i) record the required financial transactions, (ii) provide reliable annual financial statements and audit reports in a timely manner; (iii) safeguard the financial assets; and (iv) manage the advance accounts Statement of Expenditure (SOE) procedure up to a threshold of \$100,000 in accordance with ADB disbursement handbook.
4. The assessed pre-mitigation financial management risk is *moderate* because of following: (i) complex financing structure with five sources of financing; (ii) there is scope for improving the quality of financial reporting under the ongoing project; and (iii) the audited project financial statements under the ongoing project were submitted with a significant delay. Main risk mitigation actions include: (i) providing training in ADB's financial reporting and audit requirements as well as disbursement procedures and systems; (ii) including comprehensive financial information in the quarterly progress reports; (iii) including the project in the audit plan of CDCL's internal audit function; and (iv) ensuring the audit of the project financial statements is concluded in a timely fashion.

¹ ADB. 2009. [Financial Due Diligence: A Methodology Note](#). Manila

I. INTRODUCTION¹

1. Bhutan's annual urban population growth rate from 2000 to 2010 was 5.7%, the highest in South Asia. This rapid growth has created severe pressure on existing facilities leading to problems of water shortages and under capacity sanitation and waste disposal facilities. The government is addressing these problems with urban development programs, particularly in Thimphu and Phuentsholing. However rural-urban migration continues causing encroachment onto either valuable irrigated agricultural land or unstable steep terrain. In Phuentsholing, recent expansion has encroached onto the unsafe riverbanks of the Amochhu River which threatens the city from floods and erosion. The government desires that future urban growth happens in a planned manner, and it be concentrated in proximity to established economic centres to have the highest potential for providing employment and economic growth opportunities. Phuentsholing is the country's largest commercial and industrial hub and main trading gateway with India. The city is also located on two trading corridors that have been developed under the framework of the South Asia Subregional Economic Cooperation.

2. The overall project is the first phase of the government's larger development plan called Amochhu Land Development and Township Project (ALDTP) that will develop 464 hectares (ha) of riparian land near Phuentsholing Thromde (Municipality) located along both sides the Amochhu River on Bhutan's south-western border with India. ALDTP will provide protection from floods and erosion and construct smart urban infrastructure to allow phased urban expansion. The new township development provides space for public services such as health facilities and schools, and commercial businesses. This will contribute to expansion of the country's services sector and diversify the economy from heavy reliance on hydropower.

3. A FMA update has been carried out as a part of the due diligence of the project.² The fiduciary assessment of Construction Development Corporation Limited (CDCL) is carried out to determine the degree to which the financial management arrangements are adequate to manage fiduciary risks and provide reasonable assurance that ADB funds will be used for their intended purpose.

II. PROJECT DESCRIPTION³

4. The Phuentsholing Township Development Project (ongoing project) was approved by ADB on 5 June 2018, and the loan and grant agreements were signed by ADB and the Ministry of Finance on 3 July 2018. The loan and grant were declared effective on 26 July 2018. The investment project finances Zone A of the government's planned ALDTP. The project financing includes: (i) a concessional loan in an amount of \$28.74 million from ADB's ordinary capital resources; and (ii) a grant not exceeding \$24.26 million from ADB's Special Funds resources (Asian Development Fund); and (iii) \$10.00 million government contribution. The investment project will be implemented over 7 years from 2018 to 2025.

5. The ongoing project outcome is ensuring balanced and sustainable development of human settlements and applying smart growth principles in planning and development to promote Phuentsholing's cultural and social vibrancy. The project outputs are (i) installing flood and erosion protection measures along about 4.4 kilometers (km) of the left bank of the Amochhu River,

¹ Project Administration Manual (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).

² The assessment was carried out by ADB financial management consultant (Mr. P.R. Devaraj)

³ ADB (South Asia Department). 2019. *Proposed Loan and Grant Nepal: Priority River Basins Flood Risk Management Project. Project Concept Paper*. July 2019 (internal).

adjacent to Phuentsholing township; (ii) constructing new municipal infrastructure on 66 ha of newly reclaimed land; and (iii) establishing township management systems. The executing agency is Druk Holding and Investments Limited (DHI), which is a state-owned entity, and the implementing agency is CDCL, a fully owned subsidiary of DHI.

6. The ongoing project's procurement plan comprises three works packages, three consultant firm packages, and three individual consultant packages. The first consultant firm package and first works contracts were awarded prior to project approval through advance contracting: (i) CS-01: Project Implementation Consultant (\$5.26 million of which ADB financing is \$5.16 million); and (ii) CW-01: Construction of River Training and Embankment Works (\$38.44 million of which ADB financing is \$32.24 million).⁴ An individual consultant has also been recruited as the independent environmental monitoring expert (\$75,000 of which ADB financing is \$74,550) (footnote 1). Works under package CW-01 are ongoing and have achieved 37% physical progress with an elapsed contract period of 64%. Draft bidding documents for the second works package, CW-02: Common Urban Infrastructure, were recently submitted to ADB for review with an engineer's cost estimate of \$22.8 million. Per the original implementation schedule, the CW-02 package is to be awarded in Q4 2020 and completed in Q3 2024. The remaining works package, CW-03: Flood Warning System, and the four remaining consulting services packages, which are for sustainable township management capacity building and investor promotion and transaction advisory services, will be procured during implementation of CW-02. These remaining five packages amount to about \$2.80 million. Two civil works packages for the power transmission infrastructure and ICT infrastructure will be undertaken by forced account through government finances.

7. As of 20 August, cumulative contract awards amount to \$37.67 million (96.4% of baseline projections) and cumulative disbursement is \$22.76 million (more than 100% of baseline projections). The elapsed project period is 25%.

8. The additional financing will finance cost increases experienced under the ongoing project and include additional flood and erosion protection works along 360 meters of riverbanks on the Omchhu River, which flows through Phuentsholing and ongoing project area before joining the Amochhu River. The cost increases experienced under the ongoing project are due to (i) higher than expected award price for the CW-01 package (37% more than the engineer's estimate); (ii) increase in material quantities experienced under the CW-01 package, which amount to about \$0.20 million, and \$2.00 million to cover contract price adjustments and for which contract variation still needs to be processed;⁵ (iii) extension of the river protection upstream of the ongoing project boundary to the Omchhu bridge by 360 meters for an additional cost of \$1.60 million; and (iv) increase in the cost estimate for the CW-02 package from \$11.90 million when the ongoing project was approved to \$20.8 million (175% increase) based on the submitted draft bid documents.

9. The overall project is estimated to cost \$93.00 million, including additional financing of \$23.00 million which ADB is providing \$28.50 million comprising \$18.50 million concessional ordinary capital resources and \$10.00 million ADF grant. The government will finance \$1.50 million of the proposed additional financing project

⁴ Award amounts are shown in USD equivalents as of 20 April 2020.

⁵ Changes in quantities are due to differences in survey datums used during design and construction phases and the dynamic nature of working within an alluvial riverbed.

10. The impact and outcome of the overall project will remain unchanged from those of the ongoing project. The proposed additional financing will increase the performance indicator for output 1 from 4 km to 4.77 km of climate- and erosion-resilient river walls constructed to protect against 100-year probable flood. The revised design and monitoring framework is in Attachment 1 of the Project Administration Manual (PAM), (footnote 1).

11. DHI is the executing agency for the project and CDCL, the implementing agency. The project management unit (PMU) has been established by CDCL led by the Project Director and accommodated within CDCL offices in Thimphu. Under the PMU, CDCL has established a project implementation unit (PIU) in Phuentsholing near the project area.

III. COUNTRY AND SECTOR FINANCIAL MANAGEMENT ISSUES

12. The inherent financial management risk is considered *moderate*. According to Transparency International, in 2019 Bhutan received a Corruption Perceptions Index score of 68/100 ranking the country as 25th out of 180. The domestic perception of corruption has also been fairly stable.

13. The 2016 Public Expenditure and Financial Accountability (PEFA) assessment, covering all 10 ministries of the Royal Government of Bhutan, oversight institutions such as the Royal Audit Authority (RAA) and legislative committees, autonomous agencies funded by the Royal Government of Bhutan, and local government bodies, reported notable improvements and reforms from the previous assessment (2010). According to the report, since 2010, major reforms have been implemented, including the following:

- (i) Aggregate expenditure and domestic revenue out-turn remain strong and are further strengthened by implementation of the web-based Multi-Year Rolling Budget and Revenue Administration Management Information System.
- (ii) Adoption of Classification of Functions of Government classification of expenditure.
- (iii) Introduction of a formula-based system for fiscal transfers to local governments.
- (iv) Strengthened monitoring of fiscal risk over public enterprises.
- (v) A more active Tax Appeals Board.
- (vi) A formal cash flow forecasting system.
- (vii) Improved effectiveness of internal audit.
- (viii) Introduction of a formal system of in-year budget execution reporting.
- (ix) Constitution of a Finance Committee for legislative scrutiny of budgets.
- (x) A more active Public Accounts Committee for scrutiny of audit reports

14. In 2013, a new initiative was launched on performance management. Some of these reforms are ongoing or still being consolidated.

15. In particular, the 2016 PEFA report highlighted the following strengths:

- (i) Fiscal discipline is assisted by the comprehensive coverage of the Royal Government of Bhutan Public Expenditure Management System, orderly execution of the budget, good control over expenditure commitments and fiscal risks, risk-based administration of revenue, timely and reliable financial reporting, and continued improvements in external audit and legislative scrutiny.
- (ii) Strategic allocation of resources is assisted by a strong planning and budgeting system that translates the Five-Year Plans into sectoral strategies, programs and annual budgets within a rolling three-year fiscal framework.

- (iii) Efficient use of resources for service delivery is assisted by competitive procurement, which yields greater value for money. The recent adoption of a performance management system, based on annual performance agreements is potentially a powerful tool for cost control and efficiency savings, though it is not yet fully developed.

16. Furthermore, the PEFA report notes that the recommendations of RAA are timely addressed by the audited agencies. The follow-up on unresolved and pending audit issues is carried out by the Follow-up and Clearance Division of RAA in accordance with the provisions of the Audit Act of Bhutan 2006, through the Audit Information Management System. The RAA also maintains a bank account called Audit Recoveries Account with Bank of Bhutan. All recoveries made through audit are deposited into this account. The mandatory requirement of audit clearance for the purpose of training, promotion, further studies, contract renewal, retirement and superannuation for civil servants and for election for politicians facilitates the follow-up work conducted by the RAA.

17. Despite the reported strengths and the implemented reforms, the areas of Accounting and Reporting, Transparency of Government and Budget Reliability still show scope for improvement. In particular, indicators related to Expenditure arrears, Payroll controls, Internal audit effectiveness and Annual financial reports are still not at the desired level. Consequently, the government is implementing a public finance management reform action plan that covers five reform measures, with three of those measures already fully implemented: (i) developing a government performance management system; (ii) developing a web-based inventory and revenue administration management system; and (iii) establishing a separate revenue intelligence and investigation division.

18. In accordance with the country partnership strategy for Bhutan, 2019–2023⁶, ADB-assisted projects will continue to use the country systems for public financial management whenever these meet ADB requirements. In this regard, ADB will prepare project financial statements (PFS) in accordance with the government's accounting laws and regulations, to be audited by the RAA in accordance with the International Standards of Supreme Audit Institutions.

19. In light of the above analysis, the following activities should be considered a part of project processing and implementation to further improve the quality of financial management:

- (i) capacity building of selected government employees, especially at the local level, in project financial management and ADB procedures,
- (ii) capacity building of the RAA to further improve timeliness and the quality of project audit reports, and
- (iii) strengthening the effectiveness of internal audits.

IV. DETAILED FINANCIAL MANAGEMENT ASSESSMENT

A. Overview of the executing agency/implementing agency

20. CDCL was legally established by incorporation under the Companies Act of the Kingdom of Bhutan in 2009. In 2015, the company had a turnover of about Nu475 million (approximately \$7.00 million) and employed about 400 persons (of which about 200 were permanent employees). The company is specialized in the construction of roads, bridges, hydropower dams and other

⁶ ADB. 2019. [Country Partnership Strategy, Bhutan, 2019-2023– Fostering Diversification and Reducing Disparities](#). Manila

civil engineering works. It has implemented an ADB-financed project (the Samdrupcholing-Samrang Road and Bridge Project) and constructed many roads and bridges financed by the Government of India. CDCL has an Internal Audit Section, which is a staff unit under the Chief Executive Officer (CEO) and a Finance and Investment Section and Accounts Section that form part of the company's Corporate Services Department. Organogram of DHI given in Appendix 1 and of CDCL given in Appendix 2.

21. CDCL is a wholly owned subsidiary of DHI, which is the commercial arm of the Royal Government of Bhutan. DHI was established by Royal Charter in 2007 with the objective "to hold and manage the existing and future investments of the Royal Government for the long-term benefit of the people of Bhutan." At present, DHI is the largest company in Bhutan, and has shareholdings in 21 companies operating in the manufacturing, energy, natural resources, financial, communication, aviation, trading and real estate sectors. All shares of DHI are owned by the government; there are no other shareholders. In the second quarter of 2016, DHI announced that it will merge CDCL with DHI Infra, another wholly owned subsidiary. The merger completed in 2017.

B. Strengths and weaknesses

22. The company employs qualified and experienced accountants and financial managers, has a well-developed internal control system (with an internal audit section established directly under the CEO), and its accounts are audited annually by an external auditor in accordance with International Accounting Standards. Audited financial statements are available on a timely basis (within 6 months from the end of the financial year) and are published on the CDCLs website.⁷ ADB Controller department stated that there are no disbursement related issues under BHU: Loan 3668 and Grant 0573.

C. Organization and staffing

23. CDCL is managed by highly qualified individuals with many years of relevant work experience. The company has set up a project team for the development of ALDTP, also with highly relevant academic background and work experience (see Table 1; refer to paras 20–21 for details about accounting staff). CDCL established a dedicated PMU.

24. Key personnel of CDCL team and project team are listed in Table 1 given below.

Table 1: Key Personnel of CDCL and the Project Team

CDCL Management	Project Team
CEO: Mr. Phuntsho Gyeltshen Qualification: MSc in Civil Engineering Years of relevant work experience: 32	Chief Architect: Mrs. Kamala Thapa Qualification: MSc in Urban Management and Development Years of relevant work experience: 20
Acting CEO & Director, Department of Hydro power & Mechanical Engineering: Mr. Karma Gayley Qualification: MSc in Hydropower Development Years of relevant work experience: 20	General Manager of finance division: Mrs. Dechen Wangmo Qualification: ACCA Years of relevant work experience: 20
Project Director: Mr. Tshering Dupchu Qualification: Master of Engg. Science in Project Management	GM of HRAD: Kencho Tshering Qualification: Master of Human Resources Years of relevant work experience: 18

⁷ Construction Development Corporation Limited. <https://www.cdcl.bt/annual-report/>

Years of relevant work experience: 24	
Project Manager: Mr. Kamal Dhakal Qualification: MSc in Water Management Years of relevant work experience: 18	GM of CPBD: Sangay Dhendup Qualification: CPA Years of relevant work experience: 18

25. The organization chart of DHI is given as Appendix 1, and that of the CDCL is given as Appendix 2. Staffing details of Finance and Accounts Section given in Appendix 3. Finance and Accounts section is having qualified and experienced persons with external-aided projects. They are now implementing the ADB-funded project (BHU: Loan 3668) and need training in the ADB policies and procedures for the additional staff inducted.

D. Accounting Policies and Procedures

26. CDCL uses accrual accounting, and follows Bhutan Accounting Standards, which are equivalent to International Financial Reporting Standards. If the company wishes to adopt new accounting policies, these must be approved by the Board of Directors. CDCL adopted the project implementation procedures for the project based on an existing implementation manual for projects currently undertaken by the company. The Internal Audit Section and various external auditors verify compliance with prevailing accounting policies and procedures. The company's chart of accounts adequate to properly account for and report on project activities and disbursement categories. The general ledger, as well as any subsidiary ledgers, is reconciled monthly and any differences are resolved immediately.

27. The retention of accounting records by DHI and CDCL is governed by the Financial and Accounting Manual of the Royal Government of Bhutan. As per the manual, the minimum period for preservation of accounting records is 24 months for records of release of funds, 12 months after liquidation of the borrowings for loan agreements, 12 months after the completion of the project for grant agreements, and 36 months for other books of accounts. The minimum period is reckoned from the date of completion of audit by the RAA and settlement of audit observations pertaining to the contents of the records. The company's existing company's Service Rules and Regulations, as well as DHI's corporate governance code and procurement manual have proven effective in protecting CDCL from conflict of interest and related party transactions.

28. As part of the ongoing project, the accounts are maintained in accordance with cash basis of accounting as per the Government financial rules and regulations 2016

29. **Internal controls.** CDCL has established large number of internal controls. Apart from the Internal Audit Section, the most important of these can be summarized as follows:

- (i) **Segregation of duties.** Different persons perform the functions of ordering, receiving, accounting for, and paying for goods and services. Similarly, different persons authorize or execute a transaction, record the transaction, and reconcile financial records related to the transaction.
- (ii) **Checking of invoices.** All invoices are cross-checked for arithmetical errors.
- (iii) **Review of unusual items on bank reconciliation.** Yes, these are reviewed by the Finance Manager and require approval by the Head of the Finance and Investment Section.
- (iv) **Safekeeping of cheques and passwords.**
- (v) **Minimize cash balances.** No large cash balances are maintained either at head-quarters or field offices.
- (vi) **Regular inventory of physical assets.** The internal auditor is required to conduct a physical audit of assets quarterly. Also, subsidiary records of fixed assets, inventories and stocks are up to date and all fixed assets are appropriately labelled

and reconciled with control accounts.

- (vii) **Regular reconciliation between head office and branch accounts.** Reconciliations between CDCL's head office and its site or branch offices are carried out by the Accounts Section monthly.

E. Internal Audit

30. CDCL established an Internal Audit Section in 2015. At present, the section consists of three full time staff (two internal auditors and one assistant internal auditor). These persons are having practical work experience in the internal audit field, mostly with projects financed by the Government of India, but not with ADB-financed projects. Training to be imparted to these staff on ADB policies and procedures for an effective Internal Audit.

31. The Internal Auditor reports administratively to the CEO and functionally to the Audit Committee of the Board of Directors. A charter for the Board Audit Committee has been drafted and is being used. All internal audit activities are free of influence from any element in the organization, including matters of audit selection, scope, procedures, frequency, timing, or report content to permit maintenance of an independent and objective mental attitude necessary to produce unbiased reports.

32. The scope of work the Internal Audit Section is governed by the Internal Audit Terms of Reference, which was prepared in 2016. In principle, all activities of CDCL fall within the remit of the internal audit, including but not limited to all operational and management controls and is not restricted to the audit of systems and controls necessary to form an opinion on the financial statements. The Head of the Internal Audit Section will periodically assess whether the purpose, authority, and responsibility, as defined in the Terms of Reference, continue to be adequate to enable the internal audit function to accomplish its objectives. The result of this periodic assessment is communicated to senior management and the Board of Directors through the Audit Committee.

33. The Internal Audit Section develops and undertakes an annual work program based on its Terms of Reference. The Audit committee reviews the progress of the annual work program of the section semi-annually. As required by the Corporate Governance Code of DHI, there should not be fewer than four Board Audit Committee meetings in any one year, and the Internal Audit Section files a quarterly progress report which is discussed during these meetings.

34. Internal audit findings are discussed starting from the concerned individual, division, department, the company's management and finally in the Board's Audit Committee. To date, the Internal Auditor has not found major issues about availability and completeness of records. He has, however, identified minor deficiencies, which were mostly concerned incorrect bookings and missing documents. These were reported and resolved.

F. External Audit

35. The financial statements of CDCL are audited annually by statutory auditors as approved by the RAA. The present statutory auditor is M/s S. Jaykisha, Kolkata, India appointed by RAA. The external audit is conducted in accordance with International Accounting Standards (IAS). The RAA also conducts an audit of CDCL once in every year (depending on the availability of resources) to assess its compliance with the Royal Government of Bhutan's rules and regulations about payment and procurement. In addition, the Department of Revenue conducts a tax audit once every 2 years to assess compliance with the Income Tax Law of Bhutan (2000).

36. As on the date of review, CDCL has not experienced delays with external audits. During the past 3 years, the external auditor has not noted any major accountability issues, or issues concerning the availability of financial records or supporting documents, and all its recommendations have been implemented promptly by CDCL. There are no indications of major material issues that were not covered in CDCL's audited financial statements of the past 3 years. The Audited Entity Financial Statements (AEFS) covering the FY 2018 was qualified due to inconsistencies in the use of accounting standards when estimating the residual value of Property Plant and Equipment (PPE) and booking depreciation and items for disposal and unusable assets, etc. However, the amounts are not considered material. Furthermore, the review noted that the AEFS for CDCL were submitted to ADB 12.5 months after the end of the fiscal year and as a result the is scope for improving the timeliness of the AEFS submission to comply with good practices,

37. Because the proposed ADB-financed loan for the project will be co-financed by the government through an equity investment by DHI, the RAA will be responsible for auditing the project's financial accounts in addition to the external audit that will be conducted by CDCL's statutory auditor. The RAA has audited government agencies and companies involved in the management of ADB-funded projects for a considerable time so it has sufficient knowledge of ADB's guidelines and procedures. To ensure that RAA that has sufficient recourses at its disposal to conduct the audit, CDCL (through DHI) will request the Authority to include the audits of the project in its work plan.

38. Under the ongoing project, the first audited project financial statements (APFS) covering the fiscal year 2018 was received almost 6 months after the deadline. Initially, it was thought that the project will follow the government's fiscal year (i.e., ending 30 June); however, CDCL's fiscal year ends every 31 December and requesting RAA to conduct audits twice was not possible due to their limited staff. The end of the fiscal year also needed to be adjusted in ADB's system, which uses the government's fiscal year for sovereign projects. The audit was conducted by the RAA in accordance with International Standards of Supreme Audit Institutions.

39. The auditor provided an unqualified opinion on the PFS. In addition, the auditor reported the following:

- (i) The ADB financing proceeds were utilized for the intended purpose.
- (ii) All expenditure reported and claimed under ADB financing were eligible for financing.
- (iii) With respect to SOE, adequate supporting documentation has been maintained.
- (iv) The flow of funds from the advance account and balance thereon could be fairly relied upon and the control mechanism put in place for the operation of the account could also be fairly relied upon.

40. No management letter was received but RAA confirmed that an management letter is only issued in case internal control weaknesses are identified as part of the audit since there were no issues/internal control weaknesses identified for the audit period no management letter was issued. The review also noted that the Financial reporting could be improved by including a statement of Budgeted vs actual expenditures (including analysis of significant variances). The APFS reconciled with the ADB's disbursement reports.

G. Financial Reporting Systems

41. CDCL prepares financial statements twice a year (at the end of the second quarter and at year end), following reporting requirements established by DHI and the company's external auditors. The company uses its accounting software Tally ERP 9 to prepare draft statements, which are then manually adjusted to ensure compliance with International Financial Reporting Standards and government tax regulations. Financial statements are actively used by management and contain comparisons of actual and budgeted income and expenses. They do not, however, permit the linking of financial with physical data.

42. As part of the ongoing project the following has been noted:

- (i) The PMU prepares quarterly progress reports but there is scope to include more detailed financial management information in the reports. It was agreed that in the future the quarterly project report (QPR) will include a section on financial management with detailed information on the status of Financial Management Action Plan and the status of past audit observations. Furthermore, the QPR will also include a detailed Reconciliation of Project records and ADB's. A QPR template was also shared by ADB with the PMU in March 2020.
- (ii) The PFS consisted of the following:
 - a. Consolidated statement of Receipts and payments
 - b. Statement of Withdrawal applications
 - c. Statement of mobilization of advances to the contractor/consultant
 - d. Statement of Government equity funding
 - e. Statement of PIU expenditures
 - f. Statement of O&M expenditures
 - g. Statement of direct payments
 - h. Notes & significant accounting policies.

43. The PFS reconciled with the ADB's disbursement reports, but the Financial reporting could be improved by including a statement of Budgeted vs actual expenditures (including analysis of significant variances).

44. It is recommended to include comprehensive financial management information in the quarterly progress reports to be submitted to ADB within 45 days after the quarter. The established QPR template under the ongoing project may be used for the proposed project as well.

H. Information Systems

45. CDCL has an accounting system in place that allows for the proper recording of project financial transactions, including the allocation of expenditures in accordance with the respective components, disbursement categories, and sources of funds. The company is currently using Tally ERP 9, an off-the-shelf stand-alone software package, to manage its accounts and intends to use the same software for the management of the project accounts. Tally ERP 9 can automatically produce project financial reports but requires manual adjustments to generate periodic financial statements or produce the information that DHI needs to consolidate CDCL's statements. This is in line with general industry practice. Additionally, CDCL's staff is adequately trained in the use of the system, and the data generated by Tally ERP 9 meets the company's standards with regards to confidentiality, integrity and availability of accounting data.

46. To facilitate tracking of Withdrawal applications and ensuring project books of accounts continue to reconcile with ADB's disbursement records for all four financing instruments, the continuous use of ADB client portal for disbursement and Loan and Grant Financial Information Services will be important.

I. Budgeting

47. The Head of the Finance and Investment Section is responsible for preparation of budgets, including budgets for individual projects. The Head will first compile a budget in September and present the budget to the management for endorsement in October. After endorsement, it will be presented to the Board of CDCL for approval before the start of the financial year in January. Budgets include physical and financial targets in sufficient detail to allow meaningful monitoring of subsequent performance. Approval for variations from the budget are required in advance; without prior approval, expenditures must not exceed the budget.

48. In recent years, there were no major revisions to budgeted expenses, and actual expenses were lower than the budget in the past 3 years (Table 2). In 2015 and 2018, the variance was higher than in preceding years because of unexpected delays in obtaining environmental clearances for major construction projects. However, budgets are regularly revised mid-year at the request of the government to undertake public projects. In 2015 and 2018 the actual expenditure is lesser than the budget allocation. There is therefore a risk that unexpected requests of funds for other government projects may cause delays in the provision of counterpart funds reserved for the project.

Table 2: Budgeted vs. Actual Expenses of CDCL, 2015–2019
(Nu million)

	2015	2016	2017	2018	2019
Budgeted Expense	534.43	509.298	655.850	1,171.138	1,453.334
Actual Expense	435.05	567.373	696.698	730.651	1,908.176
Variance (Budgeted Vs. Actual Expense)	(99.38)	58.075	40.848	(440.487)	454.842
Variance as % of Budgeted Expense	(18.6)	11.4	6.2	(37.6)	31.3

Source: CDCL financial reports (2015–2019).

J. Disbursement Arrangements

49. The loan proceeds will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time),⁸ and detailed arrangements agreed upon between the government and ADB. Online training for project staff on disbursement policies and procedures is available.⁹ Project staff are encouraged to avail of this training to help ensure efficient disbursement and fiduciary control.

50. The project is funded by ADB on Advance Account basis, Reimbursement basis and also Direct Payment. The statement of expenditure (SOE)² procedure will be used to reimburse eligible expenditure for payments under Advance Account procedure. SOE records will be maintained

⁸ The handbook is available electronically from the ADB website: <https://www.adb.org/documents/loan-disbursement-handbook>

⁹ Disbursement eLearning: http://wqr4.adb.org/disbursement_elearning

and made readily available for review by ADB's disbursement and review mission or upon ADB's request for submission of supporting documents on a sampling basis, and for independent audit.

51. Pursuant to ADB's Safeguard Policy Statement, 2009.¹⁰ ADB funds may not be applied to the activities described on the ADB Prohibited Investment Activities List set forth at Appendix 5 of ADB's Safeguard Policy Statement, 2009. The DHM should ensure that the investments comply with applicable national laws and regulations and will apply the prohibited investment activities list to all subprojects financed by ADB.

52. CDCL will be responsible for: (i) preparing disbursement projections; (ii) requesting budgetary allocations for counterpart funds; (iii) collecting supporting documents; and (iv) preparing and sending withdrawal applications to ADB. Before the submission of the first withdrawal application, the DHM shall submit to ADB sufficient evidence of the authority of the person(s) who will sign the withdrawal applications on behalf of the borrower, together with the authenticated specimen signatures of each authorized person. The minimum value per withdrawal application is set by ADB's Loan Disbursement Handbook. Individual payments below this amount should be paid (i) by the executing agency and/or implementing agency and subsequently claimed to ADB through reimbursement, or (ii) through the direct payment method procedure, unless otherwise accepted by ADB.

53. All disbursements under government financing will be carried out in accordance with regulations of the Royal Government of Bhutan for the government component and ADB procedure followed for ADB component.

K. Fund Flow Mechanism

54. Two separate advance accounts will be opened for expenses under the ADB additional financing loan and additional financing grant. These will be established at the Royal Monetary Authority. ADB funds will be disbursed to additional financing advance accounts at Royal Monetary Authority in US Dollar (loan) and US Dollar (grant) in favor of DHI. The fund will be then transferred to five projects account maintained by CDCL at the Bank of Bhutan, the country's most reputable commercial bank (one account for loan proceeds, one for grant proceeds, one account for additional financing loan proceeds, one for additional financing grant proceeds and one for counterpart fund contributions). The project accounts will be for the exclusive use of the project. This Advance Accounts is operated in accordance with the agreement entered into by Royal Government of Bhutan and ADB, and also with the Disbursement Handbook 2017 (as amended from time to time). CDCL submits a withdrawal application to ADB for direct payment as well as reimbursement and replenishment. All financial transactions are compiled and consolidated by CDCL and financial reporting is made to the concerned authorities in accordance with the Royal Government of Bhutan and ADB requirements. With the Royal Government of Bhutan support, there may not be any problem in arranging the counterpart funding by the CDCL. It is reasonably considered that DHI shall be able to allocate and provide required funds without delay.

55. CDCL will open a project account at the Bank of Bhutan. The Bank of Bhutan is the country's oldest and largest bank, and has substantial experience with executing foreign and local currency transactions, issuing and administering letters of credit (L/C), handling a large volume of transaction, issuing detailed monthly bank statements promptly and providing other relevant banking services. Payments to contractors, suppliers and service providers will be made from the

¹⁰ Available at: <http://www.adb.org/Documents/Policies/Safeguards/Safeguard-Policy-Statement-June2009.pdf>

project account at the request of the PMU. DHI will also transfer its counterpart fund contributions to this account.

56. Detailed funds flow diagram given in Appendix 4.

V. RISK DESCRIPTION AND RATING

57. During implementation, the CDCL might face some risks that can generally be divided in two main categories: (i) country level; and (ii) organization/project level. The identified risks, risks ratings and mitigation actions are summarized in the table below. These risk and mitigation actions will need to be monitored and updated throughout the life of the Project. The overall assessment of the project financial management risks and internal control assessment are presented in Table 3 below:

Table 3: Financial Management, Internal Control and Risk Assessment and Risk Management Plan

Risk	Risk Assessment and Risk Description	Mitigation Measures or Action Plans
1. Country-specific risks	M Generally robust PFM systems in place. There is scope for improving the capacity of the Royal Audit Authority to provide timely audit reports and to strengthen the effectiveness of internal audits.	Not applicable.
2. Entity-specific Risks	M DHI is the executing agency for the project and CDCL, the implementing agency	Not applicable.
3. Project-specific Risks	M -The scope of the additional financing is the same as in the ongoing project. Under the PMU, CDCL has established a PIU in Phuentsholing near the project area	No project specific mitigation actions.
Overall Inherent Risk	M	
Control Risk		
1. Implementing Entity	M -CDCL is implementing the ADB funded project. A PMU and PIU have been established under the ongoing project	ADB to provide training to CDCL internal auditor, financial managers, accountants. Other Specific mitigation actions listed below.

Risk	Risk Assessment and Risk Description	Mitigation Measures or Action Plans
2. Fund Flow	<p style="text-align: center;">M</p> <p>-Several sources of financing including 2 ADB loans and 2 grants</p> <p>-Potential delays in reconciliation of project account with advance accounts, resulting in delayed preparation of withdrawal applications and receipt of funds. To date disbursement targets have been met.</p>	<p>-Separate Advance and sub advance accounts to be maintained for each ADB financing source.</p> <p>-CPD and L/GFIS to be used on a weekly basis to track WAs and to ensure books of accounts and ADB disbursement records reconcile.</p> <p>-All withdrawal applications will be prepared by the CDCL and all supporting documentation will be kept centrally.</p> <p>-DHI and CDCL will ensure with MOF the provision of sufficient budget for the counterpart fund and ensure release of the replenishment of funds received from ADB.</p> <p>-Royal Government of Bhutan to request Department of Public Accounts to reconcile project sub-accounts with advance accounts at Royal Monetary Authority.</p>
3. Staffing	<p style="text-align: center;">M</p> <p>-training to be imparted to the newly recruited staff.</p>	<p>-The capacity of the CDCL to be strengthened through continuous training on the ADB FM and disbursement policies procedures and disbursement systems. Project should keep the trained staff till end of the project.</p>
4. Accounting Policies and Procedures	<p style="text-align: center;">M</p> <p>-Proper well documented policies and procedures and scope for improvement in the implementation of PEFA recommendations.</p>	<p>-Existing BAS policies and procedures are followed. The compliance status of project loan covenants will be reported and assessed through the quarterly progress reports and verified by ADB review missions.</p>
5. Internal Audit	<p style="text-align: center;">M</p> <p>-The function may lack capacity to conduct internal audits on a quarterly basis.</p>	<p>-include PTDP in the internal audit work plan on quarterly basis during project implementation. Internal auditors to be included in the training provided to the PMU.</p>
6. External Audit	<p style="text-align: center;">M</p> <p>-The APFS may be submitted with a delay. Timely completion of the external audit and submission of the audit report.</p> <p>-Auditors issued Qualified opinion on the AEFS due to inconsistencies in the use of accounting standards.</p>	<p>-The PFS to be completed within 2 months after the end of fiscal year. Implementing agency, PMU to coordinate with RAA to ensure the APFS is completed on time and submitted to ADB within 6 months after the end of the fiscal year.</p> <p>-Audit qualifications reported as part of the entity audit need to be addressed.</p>
7. Reporting and Monitoring	<p style="text-align: center;">M</p> <p>-The QPR format has been established as part of the ongoing project.</p> <p>-PFS does not include variance analysis. an</p>	<p>-PMU to issue quarterly financial reports within 45 days after the reporting period in a format agreed with ADB, including physical vs financial progress and disbursement reports.</p> <p>-The PFS to be improved to include a statement of budgeted vs actual expenditures and analysis of significant deviations.</p>

Risk	Risk Assessment and Risk Description	Mitigation Measures or Action Plans
8. Information Systems	M No specific risk identified (CDCL uses a computerized accounting information system, the output of which is adjusted manually for producing tax reports and inputs for consolidated financial statements at holding level).	-Continuous use of ADB disbursement systems CPD and L/GFIS.
Overall Control Risk	M	
Overall FM risk	M	

ADB = Asian Development Bank, AEFS= Audited Entity Financial Statements, AF = additional financing, CDCL = Construction Development Corporation Limited, CPD= Client Portal for Disbursements, DHI = Druk Holding and Investments Limited, FM = financial management, L/GFIS= Loan and Grant Financial Information System, MOF = Ministry of Finance, PEFA= Public Expenditure Financial Accountability, PFM = Public Financial Management, PFS = Project Financial Statement, PIU = project implementation unit, PMU = project management unit, PTDP = Phuentsholing Township Development Project, QPR=Quarterly Project Report, RAA = Royal Audit Authority, WA = withdrawal application.

Source: Asian Development Bank.

58. DHI and CDCL have agreed to implement an action plan as key measures to address the risks. The financial management action plan is provided in Table 4.

VI. TIME-BOUND FINANCIAL MANAGEMENT ACTION PLAN

59. Based on the identified risks, the below action plan is recommended.

Table 4: Financial Management Action Plan

Key risks and Agreed action	Responsibility	Timeframe
1. All project records and supporting documentation filed centrally, backed up regularly and made available for auditors and ADB for inspection staff, as necessary.	CDCL	Throughout the life of the project.
2. Training in ADB's financial management and disbursement policies, procedures, and systems to be provided for project staff and internal audit staff.	ADB and CDCL	Continuous throughout project implementation.
3. Ensure timely release of Counterpart Fund by the DHI.	CDCL	Throughout the life of the project.
4. Proactive use ADB's LFIS as well as national systems to track withdrawal applications and reconcile ABD and project records under each financing source. Follow up on any discrepancies.	CDCL	Monthly.
5. Include the project in audit plan of the internal audit function and implement audit recommendations on a timely manner.	CDCL	Continuous throughout the project implementation.
6. Develop an action plan to resolve the qualifications raised by the entity auditor in the audit reports for FY 2018	CDCL	By effectiveness of the additional financing.
7. Include comprehensive financial management information in the quarterly financial reports to be submitted to ADB.	PMU/CDCL	Within 45 days after the end of each quarter.

Key risks and Agreed action	Responsibility	Timeframe
8. Prepare consolidated PFS within 2 months after the end of the FY and Improve the quality of the PFS by including a statement of Budgeted vs actual with any significant deviations explained in the notes.	CDCL	Annually within 2 months after the end of the FY.
9. Engage with RAA to ensure the audit is completed on time and the consolidated APFS is submitted to ADB within the deadline specified in the legal agreements.	CDCL	Within 6 months after the end of the FY.

ADB = Asian Development Bank, APFS = Annual Project Financial Statement, CDCL = Construction Development Corporation Limited, DHI = Druk Holding and Investments Limited, DMEA = Department of Macroeconomic Affairs, FY = fiscal year, LFIS = Loan Financial Information System, MOF = Ministry of Finance, PFS = Project Financial Statement, PMU = project management unit, RAA = Royal Audit Authority.

Source: ADB, based on discussions with CDCL (2016).

60. For effective implementation of the project, it is recommended that ADB follows up and reviews with CDCL the status of recommendations on Financial Management. ADB review missions to review the status on a half yearly basis and suggest remedial measures, as necessary.

VII. SUGGESTED COVENANTS

61. Schedule 5 of the legal agreement shall require the implementation of the Financial Management Action Plan as stipulated in the PAM.

VIII. SUPERVISION AND IMPLEMENTATION SUPPORT PLAN

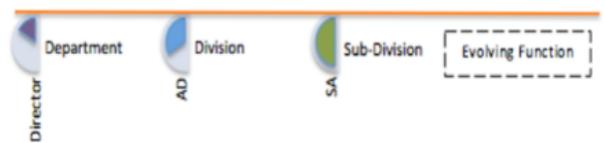
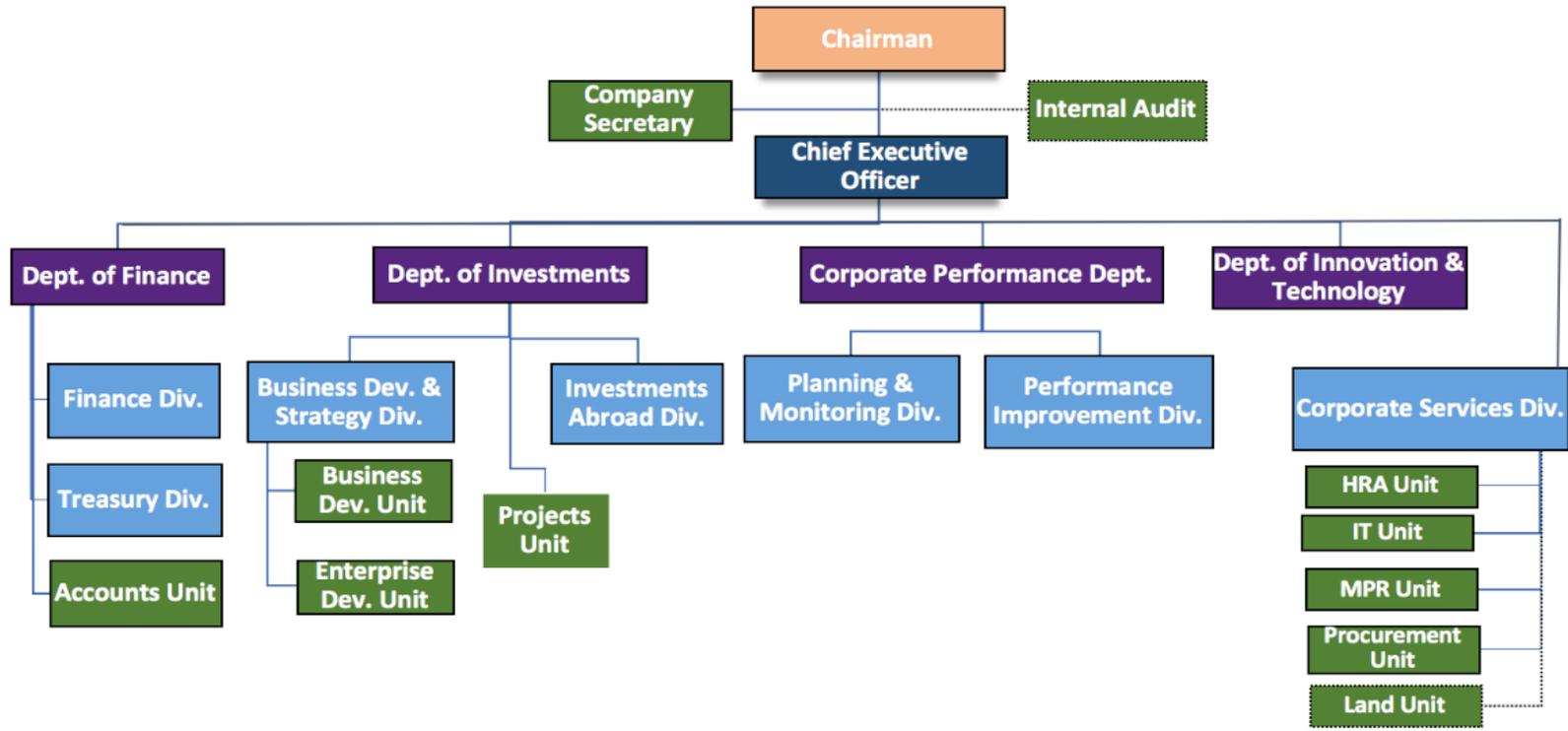
62. it is recommended that a financial management specialist (ADB staff or consultant) will participate in a mission annually (subject to availability of resources) to supervise and provide implementation support to the project and follow up the fiduciary risk at various levels including the use of the SOE.

63. In light of the risk assessment, in the first 2 years of implementation the supervision plan of the project will especially focus on the following actions:

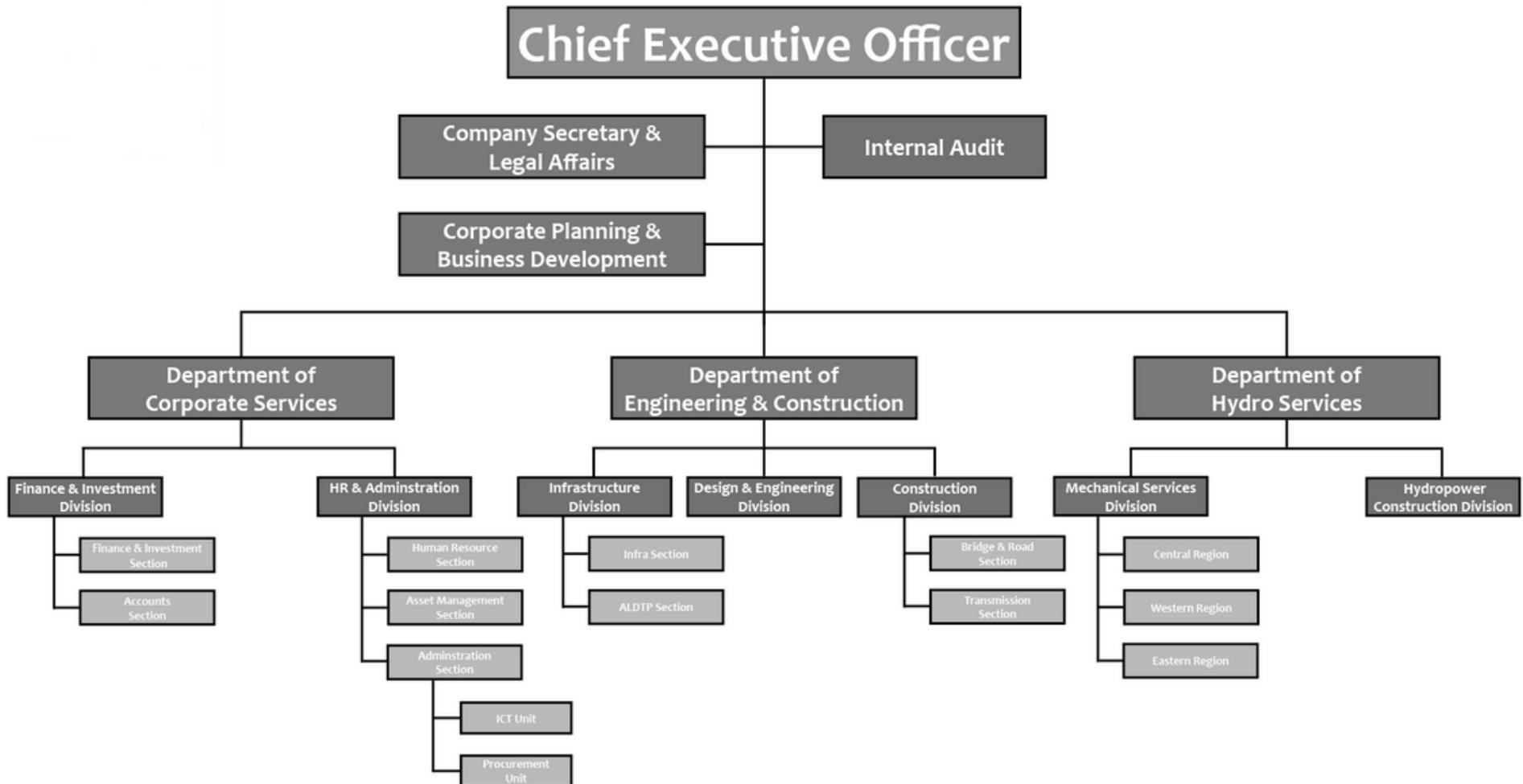
- (i) Detailed review of the status of the financial management action plan outlined in the PAM;
- (ii) Detailed review of adequacy of the staffing arrangements at the financial management unit within the PMU, including the Terms of Reference and performance of the financial staff and training needs identification;
- (iii) Detailed review of the project financial management and accounting procedures in use;
- (iv) Detailed review of the accounting software and financial reports produced by the accounting software and the use of budget controls;
- (v) Review of overall flow of funds (and resolving any bottlenecks) and a detailed review of the operation of the Advanced account (including monthly reconciliations);
- (vi) Detailed review of the use of the SOE procedure and the adequacy of supporting documentation;
- (vii) Follow-up on the staffing and the work performed by the internal audit function;
- (viii) Detailed review of records management, filing and information back up;
- (ix) Follow-up on audit (internal& external) recommendations; and
- (x) Follow-up on recommendations from past supervision missions.

64. The supervision process will be complemented by desk review of financial information included in the QPRs and APFS.

Appendix 1: Organization Chart of DHI



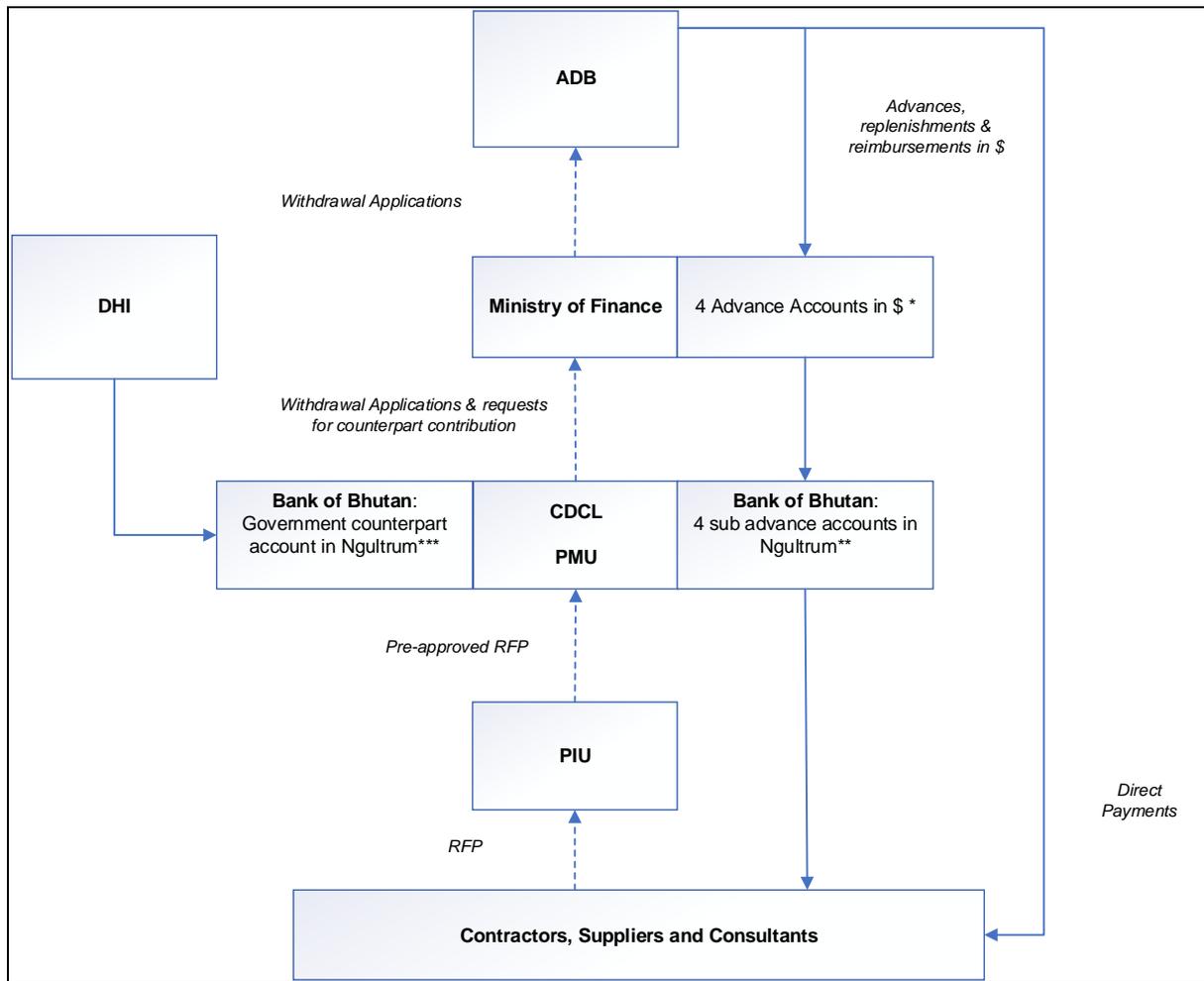
Appendix 2: Organization Chart of CDCL



**Appendix 3: Staffing of Finance and Investment Division
and Internal Audit Section**

Dechen Wangmo - General Manager
<ol style="list-style-type: none"> 1. Premika Kr. Tamang, Finance Manager 2. Phurpa Dorji, Finance Manager 3. Karma Tshering, Finance Manager 4. Yeshey Dorji, Asst. Finance Manager 5. Chimi Rinzin, Asst. Finance Manager 6. Tshering Wangdi, Asst. Finance Manager 7. Kinley Namgyel, Asst. Finance Manager
<ol style="list-style-type: none"> 8. Tshering Choiden, Accountant 9. Sumzang Choden, Accountant 10. Monikalal Subba, Accountant 11. Chimi Dorji, Accountant
INTERNAL AUDIT SECTION
<ol style="list-style-type: none"> 1. Singye Dorji, Internal Auditor 2. Kinzang Lhamo, Asst. Internal Auditor 3. Sonam Tobgyel, Asst. Internal Auditor.

Appendix 4: Flow of funds diagram



Fund Flow = solid line

Document Flow = Dotted line

RFP: Request for Payments

* Four foreign exchange accounts in Royal Monetary Authority (one \$ account for the ADB grant proceeds, one \$ account for ADB loan proceeds, one \$ account for the ADB additional grant proceeds, one \$ account for ADB additional loan proceeds)

** Four Ngultrum sub-advance accounts in Bank of Bhutan (one account for the ADB grant proceeds, one account for ADB loan proceeds, one account for the ADB additional grant proceeds, one account for ADB additional loan proceeds)

*** One Ngultrum project account for counterpart fund contributions from DHI