

## FINANCIAL MANAGEMENT ASSESSMENT

### A. Introduction and Scope

1. The proposed policy-based loan (PBL) to the Government of Nepal will use country systems for financial management, procurement, and anticorruption systems. Accordingly, in line with ADBs requirements for due diligence,<sup>1</sup> a financial management assessment (FMA) has been carried out between October 2016 and February 2017, in accordance with *ADB's Guidelines for the Financial Management and Analysis of Projects (2005)*, *Financial Due Diligence: A Methodology Note (2009)*, and *Financial Management Technical Guidance Note (2015)* and is intended to determine the degree to which the systems, procedures, and regulations for public financial management (PFM), procurement management, and anticorruption measures will be able to manage fiduciary risks. The FMA updates the country level governance risk assessment performed as part of the country partnership strategy<sup>2</sup> as well as considers fiduciary risks at the sector and program level for the Department of Customs (DOC) and its field offices. The assessment focuses on planning and budgeting, fund flows, internal controls, internal and external audit, management information systems, accounting, financial reporting, staffing, and capacity.

2. This assessment borrows from the most recent country level fiduciary assessment conducted for Nepal under the program for supporting school sector development plan.<sup>3</sup> The ADB Financial Management Assessment Questionnaire (FMAQ) tool was also used in gathering information and is available upon request. The assessment was also informed by previous PFM diagnostic studies conducted by various agencies and consultants on behalf of the government and development partners. The main diagnostic studies reviewed include: (i) the ADB Public Finance Management Assessment 2005, (ii) a review of Public Sector Accounting and Auditing in Nepal (2007),<sup>4</sup> (iii) the World Bank Public Expenditure Review (2010),<sup>5</sup> (iv) Public Expenditure and Financial Accountability Assessments in 2008 and 2015,<sup>6</sup> (v) an operational risk assessment of public financial management reform in Nepal (2013),<sup>7</sup> and (vi) Nepal's Public Financial Management Reform Strategy/Program (PFMRP) Phase II (2016/2017–2025/2026).<sup>8</sup>

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<sup>1</sup> Operations Manual Bank Policies (OM D4/BP) 'Policy-Based Lending' (PBL) paragraph 7 states that since financial support under a PBL is absorbed into a developing member country's public expenditure, fiduciary arrangements need to be in place to ensure efficient utilization of overall resources through sound public financial management (PFM). This financial management and risk assessment is carried out in accordance with the OM D4/BP as well as the Second Governance and Anticorruption Action Plan (GACAP II) at the country, sector, and program level to evaluate PFM and corruption issues.

<sup>2</sup> ADB. 2013. *Country Partnership Strategy 2013–2017 Nepal, (Summary) Risk Assessment and Risk Management Plan*. <https://www.adb.org/sites/default/files/linked-documents/cps-nep-2013-2017-ra-summary.pdf>

<sup>3</sup> ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Nepal for Supporting School Sector Development Plan*. Manila.

<sup>4</sup> World Bank. 2007. *Nepal Public Sector Accounting and Auditing: A Comparison to International Standards Country Report*. Washington, DC.

<sup>5</sup> World Bank. 2010. *Nepal – Public Expenditure Review Report No. 55388-NP*. Washington, DC.

<sup>6</sup> Government of Nepal, Ministry of Finance, Office of the Auditor General and Financial Comptroller General Office. 2008. *PEFA Public Expenditure and Financial Accountability: An Assessment of the Public Financial Management Performance Measurement Framework as of fiscal year (FY) 2005/2006*. Kathmandu; Government of Nepal, Ministry of Finance and PEFA Secretariat. 2015. *Public Expenditure and Financial Accountability Assessment: Nepal PFM Performance Assessment II as of FY2013/2014*. Kathmandu.

<sup>7</sup> Centre for Aid and Public Expenditure. 2013. *Operational Risk Assessment of Public Financial Management Reform in Nepal: A Review of Challenges and Opportunities*.

<sup>8</sup> Government of Nepal, Ministry of Finance. 2016. *Nepal's Public Financial Management Reform Strategy/ Program Phase II*. Kathmandu. <http://www.pefa.gov.np/wp-content/uploads/Second-Phase-PFM-Reform-Actionplan.pdf>

Various reports from the Nepal Public Expenditure and Financial Accountability (PEFA) secretariat provided information on progress in implementation of reforms to strengthen PFM in Nepal.<sup>9</sup>

## B. Program Description

3. The proposed program intends to support (i) improved national policy and legal framework for trade facilitation in line with international standards, (ii) improved customs procedures to reduce costs of trade, (iii) strengthened institution for effective and sustainable trade facilitation; and (iv) institutionalized capacity development plan to strengthen operational capacities in a sustainable manner. The program will use the PBL modality, with two tranche releases.

4. The ADB-funded South Asia Subregional Economic Cooperation (SASEC) Customs Reform and Modernization for Trade Facilitation Program will support the implementation of the Customs Reform and Modernization Strategies and Action Plan (CRMSAP) 2017–2021 which is the fifth customs reform and modernization plan covering the period July 2017–July 2021 with a vision of “excellence in customs services to support the economic and social prosperity of Nepal.”<sup>10</sup> The DOC will develop its managerial and technical capacity to attain the ultimate objective. At the onset, it is envisaged that the successful implementation of CRMSAP would initiate paperless Customs services in the country.

5. All financing for the program, including contributions from development partners, will be managed through the regular budget, budget execution, accounting and auditing procedures of the Government of Nepal, i.e., the contributions from the development partners will be recorded as revenue for the government consolidated fund and released through the regular budget execution process. Funds from ADB will be credited to the Treasury account at the central bank adding to the overall resource envelope of the Government of Nepal’s annual budget. The execution of the program, including donor support, will be based on the transfer of budget amount from the Treasury account to the Financial Comptroller General's Office (FGCO) account, which will release the amount to the District Treasury Controller Officer (DTCO) to accommodate payment requests coming from DOC or concerned government agencies.

## C. Executive Summary

6. Country Level: The country PEFA assessment report of 2015 had shown improvement in 16 public financial management performance areas out of 28, compared to the assessment in 2008. The implementation of Government Finance Statistics and Treasury Single Account (TSA) has increased the transparency of budget execution. However, there remain weaknesses in internal controls and oversight as well as capacity shortfalls, especially at district and field office levels. Lack of timely action on audit observations prevents the smooth functioning of the system and overall improvements in planning and budgeting are also required.

7. Sector and Program Level: Overall fiduciary risk for the program is assessed to be **Moderate**. This is primarily due to: (i) the lack of an internal audit service segregated from

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<sup>9</sup> Nepal Public Financial Management Multi-Donor Trust Fund, six monthly progress reports various years.

<sup>10</sup> Government of Nepal, Ministry of Finance, DOC. 2017. *Customs Reform and Modernization Strategies and Action Plan 2017–2021*. Kathmandu.

processing of payments, (ii) the capacity challenges in procurement and automation, and (iii) the perception of customs revenue leakages.

8. Identified risks will be mitigated under the program through a continuous initiative of system improvements, in particular the information system upgrade and institutional restructuring to meet information technology and procurement staffing requirements at DOC and its 23 field offices. The requirement under the development policy matrix to revise the organigram, allocate adequate resources, and train relevant DOC staff in DOC's priority areas including automation, procurement, and integrity will ensure that adequate attention is given to staff capacity building. This will be supported by the stand-alone technical assistance of \$1 million, associated with the program to assist in achieving its outputs.<sup>11</sup> A key feature of the program is that the Ministry of Finance (MOF) has committed to allocate all the loan proceeds from the program to the implementation of CRMSAP 2017–2021, by formally approving the strategy's budget plan with funding source information which will significantly enhance the sustainability of the investments proposed under the program, and the predictability and reliability of budget allocation and release.

9. An additional impact of the program itself in addressing corruption is the enhanced automation of customs clearance, which will minimize opportunities for revenue leakages and capacity development in staff integrity issues.

10. A major countrywide initiative is the planned roll out of the Computerized Government Accounting System (CGAS) that will provide more timely and accurate financial management reporting. The program's financial agreement will include financial covenants to require the roll out of CGAS by the DOC.

11. ADB is also implementing the Strengthening Public Management Program (SPMP) in Nepal. SPMP has 23 activities in the form of policy actions under four outputs, namely: (i) improved local government budget and fiscal management; (ii) strengthened fiduciary risk management at the local government level; (iii) an enhanced public procurement system; and (iv) strengthened oversight and accountability institutions. MOF is the executing agency.

12. In addition, the government has envisaged a number of PFM reform actions under its PFM Reform Strategy 2015–2016 to 2025–2026, which will address some of the risks in the program (Table 2). Specifically, processes are underway to revise the legal framework for an internal audit service as well as capacity building interventions by the PEFA secretariat to support the Public Accounts Committee (PAC) to improve processes and procedures for follow up to the auditor general (AG) findings.

13. The financial management arrangements are considered satisfactory given the following measures: (i) enhanced customs automation and its potential to reduce revenue leakages, (ii) roll out of the CGAS web-based accounting software to the DOC and its field offices, (iii) additional staff resources and training particularly in procurement, information technology, and integrity, and (iv) added interventions by the national PEFA secretariat to strengthen internal audit and budgeting, and adopt the Nepal Public Sector Accounting Standards.

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<sup>11</sup> Associated Technical Assistance (accessible from the list of linked documents in Appendix 2).

14. The overall financial management internal control and risk assessment is given in Table 1, which includes an assessment of the inherent<sup>12</sup> country risks and the control risks<sup>13</sup> attributed to the DOC:

**Table 1: Financial Management Internal Control and Risk Assessment**

<b>Risk Type</b>	<b>Risk Description</b>	<b>Risk Rating</b>	<b>Mitigation Measures</b>
<b>Inherent Risk</b>			
Country-level risks	Budget execution and finalizing of annual budgets may be delayed, leading to an uneven pace of expenditure.	Moderate	Budget for FY2016–FY2017 was approved in May 2016, which already includes DOC allocation of \$11 million, inclusive of earlier ADB assistance. Similar to ADB's previous program, <sup>a</sup> funds under the PBL are expected to be entirely allocated to the DOC.
Agency-specific risks	Lack of qualified procurement staff in DOC. Some technical positions are still to be filled which is impacting program supervision and monitoring.	Moderate	The establishment of the steering committee at the national level and the DOC's Program Implementation Framework will support program implementation. Policy matrix also requires a revised organogram and training of staff in procurement as a condition for second tranche release.
<b>Overall Inherent Risk</b>		<b>Moderate</b>	
<b>Control Risk</b>			
Planning, budgeting, and fund flow	<p>The Government of Nepal has a well-defined budget calendar with budget allocations linked to annual work plans. However, budget allocations are often not based explicitly on meeting the goals and targets and achieving results.</p> <p>Cash management and budget releases are managed through a TSA management system with daily reconciliation with bank statements. Payments are generally processed without delays. Budget releases for capital expenditures are often delayed due to slow approval of programs and delayed stage-</p>	Moderate	A key feature of the program is that while it is at government discretion how much of the PBL is allocated to the implementing agency, the Government of Nepal intends to allocate the full loan amount under the PBL to the DOC, similar to the previous intervention, by formally approving the CRMSAP 2017–2021's budget plan with funding source information. This will provide DOC with the predictable budget allocation to achieve its targets under the program. The Finance Minister's budget speech also indicates activities under the CRMSAP as a priority area, with funds allocated to it. <sup>14</sup>

<sup>12</sup> Inherent risk is the susceptibility of the program financial management system to factors arising from the environment in which it operates, such as country rules and regulations and the agency's working environment (assuming the absence of any counter checks or internal controls).

<sup>13</sup> Control risk is the risk that the program's accounting and internal control framework is inadequate to ensure that funds are used economically and efficiently, and that funds use is properly reported.

<sup>14</sup> Government of Nepal. Ministry of Finance. 2016. *Budget Speech of Fiscal Year 2016/17*. Kathmandu. [http://www.mof.gov.np/uploads/document/file/Budget\\_Speech\\_final\\_2016\\_20160602105902.pdf](http://www.mof.gov.np/uploads/document/file/Budget_Speech_final_2016_20160602105902.pdf)

Risk Type	Risk Description	Risk Rating	Mitigation Measures
	wise completion that prevents further instalments.		
Accounting and internal control	<p>While accounts are to be reconciled between budget holders (DOC and subordinated institutions) 7 days after close of each month, actual reconciliations and controls are made by DTCOs ex-post at infrequent intervals by DTCOs.</p> <p>CGAS is still to be rolled out in DOC and its subordinate institutions.</p> <p>At present DOC and its subordinate institutions are using Excel-based software for reconciliation and reporting purpose.</p>	Moderate	The roll out of CGAS, the web-based standardized accounting software to all district level offices and consolidation of subordinate institutions' reports at DOC using simple Excel-based software will enable effective financial monitoring of DOC budget execution and timely reconciliations of balances between TSA and DOC accounts.
Financial reporting	Interim financial reports on payments made (cash basis) is produced timely from the TSA system that registers real time online transactions, each transaction made by functional, institutional (budget holder at central and district levels), and economic codes.	Low	Implementation of CGAS at all DOC spending levels will improve timely presentation of expenditure by institutional, functional, and program/activity categories. This will be included as a loan assurance. MOF is also planning to adopt NPSAS for the preparation of its financial statements, which will include financial results of the DOC.
Internal audit	The function is undertaken by DTCOs who are limited to inspection of vouchers and supporting documentation for payment requests. The inspection is done at infrequent intervals.	Moderate	Processes are underway to revise the legal framework for an internal audit service and for capacity building interventions by the PEFA secretariat to support PAC in order to improve follow up on AG findings.
Statutory (external) audit	OAG reports are generally submitted timely and with the scope and comprehensiveness required as per INTOSAI standards. There is evidence of effective follow up to audit findings.	Low	Not applicable.
<b>Overall Control Risk</b>		<b>Moderate</b>	
<b>Overall Risk</b>		<b>Moderate</b>	

<sup>a</sup> ADB. 2012. *SASEC Trade Facilitation Program*. Manila. (Grant 0332).

ADB = Asian Development Bank, AG = Auditor General, CGAS = Computerized Government Accounting System, CRM= Customs Reform and Modernization Unit, CRMSAP = Customs Reform and Modernization Strategies and Action Plan, DOC = Department of Customs, DTCO = District Treasury Controller Officer, FY = fiscal year, INTOSAI = International Organization of Supreme Audit Institutions, OAG = Office of the Auditor General, PAC = Public Accounts Committee, PBB = Program Based Budgeting, PBL = policy-based loan, PEFA = Public Expenditure and Financial Accountability, TSA = Treasury Single Account.

Source: Asian Development Bank.

#### **D. Agency Capacity and Staffing**

15. The DOC is one of the five departments under the MOF. There are 23 main border customs offices including International Airport Customs Office, under the DOC. The mission of the department is to promote and facilitate legitimate trade, protection of society, and collecting revenue. The DOC has implemented several development partner-funded projects. Among these are ADB-financed Subregional Transport Enhancement Project (STEP) and the South Asia Subregional Economic Cooperation (SASEC) Trade Facilitation Program.

16. The executing and implementing agency will be the DOC. The program will be implemented over 4 years starting July 2017, coinciding with the national strategy of CRMSAP 2017–2021. A program steering committee, chaired by the Director General of the DOC, will be formed to guide and monitor implementation. Members will be drawn from the Ministry of Finance, Ministry of Commerce, Department of Industry, and the DOC. Members of the Customs National Trade Facilitation Committee (CNTFC), representing trade-related public and private sectors, and ADB will be invited to the steering committee meetings. The steering committee will present the progress and discuss issues on program implementation at regular CNTFC meetings.<sup>15</sup>

17. The government proposed the following program implementation framework to be formed at the working level, headed by its Deputy Director General (Management), supervising five thematic task forces of: (i) coordination; (ii) legislation; (iii) automation; (iv) risk management; and (v) organization and development.

18. An undersecretary heads the financial administration section at the DOC assisted by three subordinates. At DOC's field level offices, the accounts section is either headed by an accounts officer, assisted by his subordinates. There are job descriptions for all positions in the Government of Nepal civil service regulation, and functional responsibilities of the officials involve in financial matters are defined in the financial regulations and subsequent circulars of MOF and Financial Controller General's Office (FCGO).

19. As per the provision of the Civil Service Act, government officials are eligible for transfer to other offices after serving for 2 years, but records show that personnel in key financial positions of DOC and its entities have been serving in their positions for several years. As an example, in DOC, the chief of finance has been serving for 3 years, and other subordinate officials (accountant) are working for the past 6 years.

20. A 5-week orientation training is provided to new staff upon recruitment, and continuous in-service trainings are conducted by the FGCO.

#### **E. Planning and Budgeting**

21. The government budget is guided by a Medium-Term Expenditure Framework (MTEF). The MTEF is intended to translate policy targets into priority spending to meet policy objectives. The MTEF serves as a tool to link spending to results. The earthquake in April 2015 had an impact on the completion of MTEF for which there has been no MTEF in the last two fiscal years. However, the preparation of a sectoral medium-term expenditure framework has started

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<sup>15</sup> The committee meets at approximately 4 month intervals.

again and formed the basis for the budget process for FY2017. The MTEF is the main instrument for the government in aligning budget allocations to medium-term policy targets and ensuring that current level of investments do not exceed future recurrent cost requirements to maintain the investments.

22. The budget is prepared through a clearly defined budget calendar but remains split between the National Planning Commission, which manages the MTEF and capital (development) expenditure budget process, and MOF, which manages annual recurrent expenditure and overall budgeting. The lack of full integration between the MTEF and annual budget preparation process results in parallel and disjoint activities. Accordingly, the annual budget continues to be prepared on an incremental basis without sufficient consideration for sector strategies and results reflected in the MTEF, and ensuring future recurrent cost requirements from current level of investment are considered in the budget process.

23. DOC prepares its annual work and budget reports for the sector program with inputs from its entities integrated in the plan. This includes, among others, a detailed description of activities, results, budget, and source of finance.

## **F. Budget Execution**

24. The key challenges related to budget execution are weaknesses in expenditure prioritization, cash management, and delays in the approval of budget that impact on development spending and delivery of results. In the previous years, the budget of the Government of Nepal used to be submitted to the parliament only a few days prior to the beginning of the new fiscal year and budget used to be approved several months after the budget was tabled at the parliament. As a result, the execution of program and spending of the budget used to be done only during the last months of the fiscal year.

25. This issue has been addressed by the government by shifting the budgetary session few months prior to the beginning of the fiscal year. The budget speech was given on 28 May 2016, almost 2 months prior to the commencement of the FY2017.<sup>16</sup>

26. Monitoring of budget execution, especially arrears, has improved over the years and in particular after the introduction of TSA system, which has improved cash management significantly, among others, through more timely processing of payments and improved monitoring of available cash to accommodate expenditures as they occur. However, for some ministries, expenditure overruns as well as changes in composition of expenditure remains a challenge.

27. For FY2017, DOC was allocated an annual budget of NRs 2.04 billion (\$19.03 million) inclusive of ADB grants (NRs 690 million [\$6.44 million] from SASEC Trade Facilitation Program Tranche Releases and NRs 181 million [\$1.69 million] from STEP). While DOC is no exception to Nepal's administrations in suffering from low fund absorption capacity, its capital and recurrent expenditures in the preceding years have shown an increasing trend from \$9.9 million in FY2015 to \$11.10 million in FY2016, with ADB project and program support accounting for a significant percentage. DOC is committed to meet annual budget expenditure targets,

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<sup>16</sup> Government of Nepal, Ministry of Finance. 2016. *Budget Speech of Fiscal Year 2016/17*. Kathmandu. [http://www.mof.gov.np/uploads/document/file/Budget\\_Speech\\_final\\_2016\\_20160602105902.pdf](http://www.mof.gov.np/uploads/document/file/Budget_Speech_final_2016_20160602105902.pdf)

particularly to increase its capital expenditures by fostering greater procurement capacity, which constitutes one of the actions relating to policy conditions under the proposed program.

28. The legal framework provides line ministries with considerable virement powers, i.e., reallocation of budget among expenditure heads where required. Significant budget reallocations take place across spending categories during the year. While this does provide flexibility to line ministries to adjust according to changing circumstances, combined with weaknesses in internal controls, it results in weak accountability of resource use. Reallocation of unspent funds within capital spending has increased to an average of 30% of the total capital budget overall, but only 12% for DOC. The implementation of Program-Based Budgeting (PBB)<sup>17</sup> is expected to improve alignment of spending to sector targets, help monitor budget implementation, and reduce expenditure variances. Among others, the introduction of program budget heads more in compliance with Classification of the Functions of Government (COFOG) standard and use of activity codes has helped in budgeting and monitoring expenditures linked to subsector targets.

29. MOF monitors the budget execution of ministries and departments through regular budget meetings and comparison of budget outturns as reported by TSA with the information contained in the Budget Information System and the subsidiary Line Ministry Budget Information System (LMBIS). The review includes analysis of deviations from originally approved budget.

## **G. Accounting and Internal Controls**

30. DOC reporting requirements follow the Government of Nepal's financial regulations, which among others requires each entity to reconcile their accounts with DTCOs and submit monthly expenditure returns to MOF and FCGO before subsequent budget releases are made. All payments are recorded in the government's TSA system. Separate systems with partial consolidation of information like CGAS, TSA, LMBIS, etc., are together labelled Integrated Financial Management Information System (IFMIS). The target, however, is to have one IFMIS, but this will require new design for it to function effectively. Accounts are maintained manually by DOC and subordinated institutions,<sup>18</sup> using Excel versions of cashbook and ledger. The accounting includes recording of revenues and expenditures by institutional, functional, and economic categories of expenditures as well as segregation of expenditures by projects and sources of funds at transaction level.<sup>19</sup>

31. Accounting information has become more transparent after the implementation of the Government Finance Statistics classification and the TSA. Progress has been made in piloting the Nepal Public Sector Accounting Standards (NPSAS), which are compliant with international

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<sup>17</sup> Program-based budgeting links budget allocation and expenditure to results. In practice, it means adding a new dimension to the budgeting process with program and activity codes i.e., in addition to the conventional functional and economic codes. The aim is to improve the efficiency and effectiveness of public spending by systematically linking budget allocations to results and making use of performance information to monitor efficacy and effectiveness of spending.

<sup>18</sup> Some government ministries and agencies are using the FCGO CGAS system on a stand-alone basis, but this does not include the DOC.

<sup>19</sup> The chart of accounts consists of a 21-digit code. The classification system enables segregation of allocations and expenditures by administrative units with budget and sub-budget heads (ministries, departments and agencies), functional and subfunctional areas and type of expenditures i.e., recurrent and capital (economic classification codes).

financial reporting standard (cash-based IPSAS), and MOF expects to adopt NPSAS for their financial reporting in line with their PFM Reform Strategy.<sup>20</sup>

32. The rollouts of the TSA system for payment processing to all 75 districts have provided reliable and up-to-date information on budget execution. Fiscal reports are publicly available. However, they are not comprehensive and many autonomous government agencies and donor projects operate outside the government budget and accounting framework.

33. Interviews conducted as part of this assessment suggest that payments are executed in a timely fashion and usually within one day after receiving the requests from the budget holders with only few exceptions. The payments are recorded in the FCGO web-based integrated accounting system (TSA) and reconciliation of DTCO accounts are done with the bank by the end of the day by uploading bank statements to the system. Reconciliation with cost centers (DOC and field offices) are to be done within 7 days after the end of each month. The account reconciliation process provides a reasonable assurance concerning financial reporting.

34. There is a comprehensive set of financial regulations guiding budget execution and providing internal controls including adequate segregation of duties and controls over assets, payments, and payroll. The FCGO has been providing regular training to staff working under the finance section, and will continue to supplement this as required.

35. FCGO through its DTCOs serve as the paymaster general. A separate unit within each DTCO serves as the internal auditor. The budget release is authorized by the MOF, while actual processing of payments are made by DTCOs on presentation of payment requests signed by the unit or entity under DOC and the FCO at respective unit (i.e., DOC, field offices).

## **H. Internal Audit**

36. The DTCO internal audit function is an ex-post sample testing of the existence of supporting documentation (invoices, etc.) available at cost centers in support of the payment requests processed by DTCO. This “inspection” takes place sometimes bi-monthly, sometimes less frequent pending the level of capacity of the DTCO.

37. There is no internal audit service in the respective ministry or subordinate levels like DOC. The internal audit function is maintained by DTCOs but is limited to verification of documentation. As the DTCO is also the same entity executing the payments, questions can be raised as to the integrity of the internal controls by non-segregation of duties between different entities.

38. Internal audits are being carried out by DTCO thrice a year. The Auditor General's Office's (AGO) annual audit is not possible without submission of the internal audit report to AGO.

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<sup>20</sup> The NPSAS, based on IPSAS, was developed by the Accounting Standards Board, Nepal, for FY2009/2010 and was approved by the Cabinet in September, 2009. The Government piloted the NPSAS in two ministries in FY2013/2014 and for FY2014/2015 all ministries, DTCO, and entities are required to prepare consolidated financial statements compliant with IPSAS by using AG form no. 13 (Statements of Expenditure), no.14 (Statements of Advances), no. 15 (Statements of Bank Accounts), no. 9 (Statements of Revenue), and no. 17 (Annual Financial Statements).

39. Under the government's PFM reform strategy, processes are underway to revise the legal framework for an internal audit service as well as capacity building interventions by the PEFA secretariat to support PAC to improve on process and procedures for follow up to AG findings.

## **I. External Audit**

40. The auditor general conducts financial and compliance audits on a majority of government revenues and expenditures using International Organization of Supreme Audit Institutions (INTOSAI)-based standards. The audit is conducted through a risk-based approach based on some indicators of materiality and risk of non-compliance with financial regulations.

41. Through a rating system, decisions are made on frequency of audits (annually, biannually, or every three years) for which entity to conduct a full scope audit.

42. The latest audit report (in Nepali) by the AGO, dated 11 April 2016 for FY2015, based on the audit conducted for DOC in 2016 had shown 17 irregularities. Out of these, 14 irregularities were pointed out under the categories of procedural noncompliance for which report provided suggestive measures to follow in the future. Three irregularities were pointed out under the categories of non-compliance and unsubstantiated expenditures (non-submission of documentary evidence) in which the total amount was NRs2 million. The report also indicated that the reconciliation of noncompliance irregularities were converted to complaints when the Financial Administration section of DOC produced the relevant documents to the AGO at a later date.

43. Similarly, the annual report of AGO, dated 11 April 2016 for FY2015, indicated 13 irregularities in relation to less than actual revenue collections by the border customs offices due to application of different harmonized commodity classification code in the declaration forms. AGO report has instructed relevant customs offices to recover such difference from the concerned importers/exporters. Likewise, there were five irregularities pointed out with respect to excise duty collection, four irregularities pointed out with respect to revenue exemption, and four irregularities were pointed out with respect to other issues, which were specified in the AGO report. Similar instruction has been commanded by AGO to relevant customs for recovering of such amount, which was also specified in the Report. There were no irregularities mentioned in the report with respect to expenditure of the budgeted amount.

44. DOC generally responds to the audit observations raised in AGO management letters but the challenge is lack of follow up. PAC has not been effective in enforcing measures recommended by the auditor general that are for implementation by the respective ministry/agency. PAC calls the auditees, like MOF, to stand before the committee. The secretaries of the ministries meet with PAC where they are asked to prepare action plans to address the challenges. A challenge is that the action plans do not contain any timeline on when they will be implemented.

45. The executive summary of the Auditor General's Report for FY2014–FY2015<sup>21</sup> states that "On the basis of information received from different sources including custom data from

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<sup>21</sup> Government of Nepal, Office of the Auditor General. 2016. *Fifty-Third (53rd) Annual Report of the Auditor General 2072 (2016): Summary*. Kathmandu. [http://www.oagnep.gov.np/downloadfile/Executive%20Summary%202072%20\(English\)\\_1466591502.pdf](http://www.oagnep.gov.np/downloadfile/Executive%20Summary%202072%20(English)_1466591502.pdf)

ASYCUDA of the Customs Department, it is revealed that NRs49.01 billion revenue exemption was provided on goods and services imported by different organizations during this year. A total amount of NRs5.77 billion collected in the government treasury towards value-added tax on ghee, oil, and mobile export has been refunded. Although international good practices exist for tabling the details of revenue exemption along with budget speech in Parliament, revenue lost due to such exemption has not been tabled. Ministry of Finance has stated that software for recording such exemption has been prepared this year.”

46. The audited project financial statement under the previous grants and loans under STEP implemented by DOC (L-2685 and G-0225) have been received for FY2015 on time, within the specified deadline, and with an unqualified audit opinion, indicating some minor control issues and overpayments to which management has responded.

## **J. Anticorruption**

47. The Constitution of Nepal gives provisions for an independent judiciary with courts consisting of the Supreme Court, Appellate Court, and District courts. In addition, it gives provisions for a number of constitutional bodies such as the Commission for the Investigation of Abuse of Authority, Auditor General, Public Service Commission, and Attorney General as key institutions to combat and oversee that constitutional rights are adhered to and address any misuse of public office by any government employee.

48. The Anti-Corruption Act of 1952, the new and revised act of 1960 with the establishment of an Anti-Corruption Department in the form of Special Police Department to control corruption, and the formation of a Commission on Controlling Abuse of Authority in 1977 were the preface to the establishment of the Commission for the Investigation of Abuse of Authority (CIAA) in 1990. The interim constitution of Nepal 2007 put renewed emphasis on CIAA to investigate and probe cases against persons holding public office who are considered to have abused their authority by way of corruption or other forms of misconduct.

49. Data on perception of corruption are available from various survey data. As per the Corruption Perception Index 2016 published by Transparency International, Nepal scored 2.9, ranking 131st out of 176 countries. Since 2004, Nepal's score is always below 3 except in 2013 when it scored 3.1, i.e., as per Transparency International classification as “corruption rampant countries”. The Control of Corruption Index 2015 published by the World Bank, gives Nepal a score of 35.6 (out of 100) where lower values indicate weak governance ratings.

50. In the latest Global Corruption Barometer (GCB) Bi-annual Survey of TI from 2013, 72% of respondents in Nepal stated that corruption has increased over the years. The GCB survey for Nepal also revealed political parties (90%) as highly corrupt institutions in Nepal, followed by public officials and civil servants (85%), police (80%), parliament (79%), judiciary (77%). As many as 45% of respondents stated that education system in Nepal is corrupt/extremely corrupt although only 3% of respondents reported paying bribe for Education Services (as compared to police and judiciary with 37% and 30%, respectively).

51. With respect to corruption perception, more specific to customs in Nepal, the Enabling Trade Index – Nepal 2016<sup>22</sup> indicates that “Customs Transparency” index has slightly improved at 108 out of 136 in 2016 (compared to 112 out of 134 in 2014) and the “Irregular Payments and Bribes for import/export” Indicator shows Nepal as 127th in the global ranking out of 136 in 2016.

52. Company perspectives on Nepal’s nontariff measures published by the International Trade Centre Perception indicate that 15% of procedural obstacles are perceived to be attributable to corruption. The report states that “*Informal payments to get the necessary paper work issued, clear shipment or expedite the process account for 15% of the reported Procedural Obstacles. Close to two-thirds of issues related to informal payment happen in Nepalese agencies while the other third occur in customs of destination markets or transit countries. .... Similarly, corruption and lack of adequate testing facilities in the country is the second and third most problematic trade-related business environment hindering the companies’ ability to trade – according to 73% and 57% of respondents respectively. Furthermore, it must be noted that a big majority of respondents think that problems with ..... and corruption have deteriorated in the past five years.*”<sup>23</sup>

53. The nature of the program supports reduced revenue leakages through the risk-based compliance mechanism and enhanced automation. The commitment for the CRMSAP is evidenced by references in his Honorable Finance Minister Budget Speech (para. 54). Additionally, the proposed PBL’s capacity development covers DOC staff training on integrity, in addition to procurement and other core technical areas.

54. The Finance Minister’s Budget Speech on 28 May 2016 stated that “Custom clearance will be made more effective by way of employing risk indicators so as to protect both the social concerns and revenue. Besides, post clearance audit system will be strengthened. ...Web-based ASYCUDA system for customs clearance will be expanded to 10 main Customs Offices. ....Coordination and capacity enhancement of all Government Offices related to the export and import will be enhanced for the facilitation of international trade. ...For this purpose, infrastructure of Nepal National Single Window System will be developed and operated by 2020. The construction of Integrated Custom Check Post will be completed and operated in Sirsiya of Birgunj for Modernization of Customs. Similarly, the infrastructure for integrated Custom Check Post will be developed in Biratnagar, Bhairahawa and Nepalgunj. I have arranged for installation of modern X-ray machine in major custom offices for the facilitation of clearance of passengers and goods.”<sup>24</sup>

## **K. Summary of Risks and Mitigating Measures**

55. The latest PEFA from 2015 confirmed many of the same challenges as the 2008 PEFA, i.e., challenges related to compliance with financial management rules and regulations despite

<sup>22</sup> World Economic Forum and the Global Alliance for Trade Facilitation. 2016. ‘Nepal: Economy Profiles.’ *Global Enabling Trade Report 2016*. Geneva. <http://reports.weforum.org/global-enabling-trade-report-2016/enabling-trade-rankings/>

<sup>23</sup> International Trade Centre. 2016. *Nepal: Company Perspective on Non-Tariff Measures—Summary of Findings, NTM Business Survey*. Geneva. [http://ntmsurvey.intracen.org/media/2727/itc\\_ntm-survey-in-nepal\\_results-summary.pdf](http://ntmsurvey.intracen.org/media/2727/itc_ntm-survey-in-nepal_results-summary.pdf)

<sup>24</sup> Government of Nepal. Ministry of Finance. 2016. *Budget Speech of Fiscal Year 2016/17*. Kathmandu. [http://www.mof.gov.np/uploads/document/file/Budget\\_Speech\\_final\\_2016\\_20160602105902.pdf](http://www.mof.gov.np/uploads/document/file/Budget_Speech_final_2016_20160602105902.pdf)

progress in several areas by the implementation of interventions by the national PEFA secretariat supported by a Multi Donor Trust Fund.

56. As part of the Government PFM Reform Strategy Phase 2, 2016–2025,<sup>25</sup> the government's detailed roadmap addresses various areas of weaknesses, some of which will also contribute to addressing the risk under the PBL (Table 2). While these are over a longer time frame and require centralized support from MOF and FCGO, government's focus on resolving PFM issues will contribute to risk reduction for the program.

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<sup>25</sup> Government of Nepal. Ministry of Finance. Public Expenditure and Financial Accountability (PEFA) Secretariat. 2016. *Nepal's Public Financial Management Reform Strategy/Program (PFMRP) Phase II*. Kathmandu. <http://www.pefa.gov.np/wp-content/uploads/Second-Phase-PFM-Reform-Actionplan.pdf>

**Table 2: Summary of Government of Nepal PFM Reform Strategy Actions FY2016–FY2025**

	<b>Government of Nepal PFM Reform Strategy Actions FY2016–FY2025</b>	<b>Responsible</b>	<b>Supported under Program for DOC</b>
1	Redesign the BMIS to record information on quarterly estimates of both the government and donor fund	MOF	
2	Systems (BMIS, LMBIS, FMIS, RMIS and TSA) harmonized and interconnected by building interfaces	MOF	
3	Allocate a separate budget code to identify the budgetary support flow donor-wise	MOF	
4	Prepare internal control manual/ guideline by all line ministries and implement for enhancing degree of compliance with rules for processing and recording financial transactions	MOFALD	
5	Develop capacity for producing NPSAS based consolidated financial statements on annual basis by all the line ministries and government central agencies	MOFALD	Yes
6	Improve current initiation for interfacing, interconnecting and harmonizing BMIS, LMBIS, FMIS, RMIS and TSA	FCGO	
7	Implement NPSAS in all economic entities and enhance skill of PFM staffs for preparing NPSAS report through advanced training	FCGO	
8	Upgrade and implement of CGAS in all spending units of the Government of Nepal	FCGO	Yes
9	Prepare and implement a comprehensive plan of action for reform of internal control system of the Government of Nepal	FCGO	
10	Prepare and implement a comprehensive plan of action for Internal Auditing System reform	FCGO	
11	Enhance the monitoring system of bank reconciliation of expenditures and revenue in FCGO through TSA and RMIS	FCGO	
12	Establish a unit (Audit Committee) in all line ministries with assigned duties to settle the audit irregularities within stipulated time frame as per the existing legal provision	OAG	Yes
13	Establish Regional/Provincial Offices of OAG to facilitate the auditing and clearance of audit irregularities	OAG	
14	Review and update the existing Risk based and Performance Audit Guidelines/Manual	OAG	
15	Make legal provision that the Secretary (as a chief accounting officer) has authority to make clearance of irregularities with due investigation and recommendation	OAG	
16	Trainings to auditors to develop capacity for risk-based and performance-based audit approach	OAG	
17	Use ICT for audit documentation and follow up of audit report	OAG	

BMIS = budget management information system, CGAS = Computerized Government Accounting System, DOC = Department of Customs, FCGO = Financial Controller General's Office, FMIS = Financial Management Information System, ICT = information and communication technology, LMBIS = Line Ministry Budget Information System, MOE = Ministry of Education, MOF = Ministry of Finance, MOFALD = Ministry of Federal Affairs and Local Development, NPSAS = Nepal Public Sector Accounting Standards OAG = Office of Auditor General, PFM = public financial management, RMIS = revenue management information system, TSA = treasury single account.

Source: <http://www.pefa.gov.np/wp-content/uploads/Second-Phase-PFM-Reform-Actionplan.pdf>