

FINANCIAL MANAGEMENT ASSESSMENT

Executive Summary

The financial management assessment considered financial management capacity of the Ministry of Megapolis and Western Development (MMWD) and Ministry of Provincial Councils, Local Government and Sports (MPCLGS) in their roles as executing agencies and implementing agencies of the proposed Urban Project Preparatory Facility (UPPF), including funds-flow arrangements, staffing, accounting and financial reporting systems, financial information systems, and internal and external auditing arrangements.

The UPPF aims to strengthen project readiness in the urban development sector by completing advanced feasibility studies, detailed designs, and procurement actions to meet the financing requirements of the Asian Development Bank (ADB) and build capacities of the executing and implementing agencies in the urban sector prior to project approval. The UPPF has two components: (i) strategic cities component to be implemented by MMWD, and (ii) secondary towns component to be implemented by MPCLGS.

Both MMWD and MPCLGS have sufficient experiences in implementing externally funded projects. MPCLGS has also been implementing the ongoing Additional Financing for Local Government Enhance Sector Project (LGESP-AF) financed by ADB while MMWD does not have experience in implementing ADB financed projects.

The project management unit (PMU) of MMWD for the ongoing Strategic Cities Development Project (SCDP) funded by the World Bank and PMU of MPCLGS for the ongoing LGESP-AF funded by ADB will continue to implement the UPPF. The PMUs of MMWD and MPCLGS are responsible for all day-to-day management of the UPPF, including but not limited to (i) preparing an overall facility implementation plan and detail work program; (ii) providing overall monitoring and guidance on the implementation; (iii) monitoring and supervising all management activities; (iv) preparing facility progress and facility completion reports; (v) financial planning and budgeting including contract awards and disbursements; and (vi) ensuring full compliance with ADB's resettlement, environmental, and other safeguard policies.

The major risk factors identified by assessment that need to be addressed include:

- (i) lack of MMWD's experience in implementing and managing ADB funded projects may hamper the timely preparation and implementation of UPPF;
- (ii) occasional delays in the release of the government's counterpart funds may cause delays in the timely and efficient implementation of UPPF;
- (iii) inadequate procurement capacity of PMUs may hamper the timely implementation of UPPF; and
- (iv) weak internal audit system in PMUs may cause delays in the timely identification of issues.

Despite the highlighted risks, the financial management arrangements are satisfactory given that MMWD and MPCLGS have significant experience in implementing a number of donor-funded projects. In addition, the project design and procurement consultants (PDPCs) and financial management consultants to be recruited under UPPF will support the MMWD, MPCLGS, and PMUs in enhancing their financial management capacity. The overall risk assessment for the proposed financing is "Moderate". The action plan for mitigating the foreseen risks includes the following measures:

- (i) extending full training and capacity building support for enhancing the financial management capacity of PMU of MMWD;
- (ii) commitment of the Ministry of Finance and Mass Media, MMWD, and MPCLGS for the timely allocation and disbursement of the government's counterpart funds;
- (iii) providing adequate support through hiring PDPCs for enhancing the procurement capacity of PMUs; and
- (iv) commitment of PMUs to ensure that internal audits are done on annual basis.

I. INTRODUCTION

1. This financial management assessment (FMA) was conducted in accordance with ADB's Guidelines for the Financial Management and Analysis of Projects (2005), the Financial Due Diligence: A Methodology Note (2009), and the Financial Management Technical Guidance Note (2015).¹

2. The financial management capacity of (i) the Ministry of Megapolis and Western Development (MMWD) which is the executing agency and implementing agency for 'strategic cities component'; and (ii) the Ministry of Provincial Councils, Local Government and Sports (MPCLGS) which is the executing agency and implementing agency for the 'secondary towns component' was assessed along with their PMUs, focusing on funds flow, staffing, accounting policies and procedures, segregation of duties, budgeting system, payments, policies and procedures, cash and bank, safeguard over assets, contract management and accounting, internal controls, financial reporting and monitoring, and information systems in relation to administering the proposed Urban Project Preparatory Facility (UPPF).

3. The key aspect of FMA is to evaluate the risks associated with financial arrangements of UPPF. The principal concern of the Asian Development Bank (ADB) is to ensure that facility funds are used economically and efficiently for the purposed intended. In support of this, it seeks the assurance that the financial management system of MMWD and MPCLGS can report on the source and use of project funds.

4. The assessment is based on the results of an FMA questionnaire, perusal and review of various reports and/or documents, and discussions with relevant senior officials of MMWD and MPCLGS.

II. BRIEF PROJECT DESCRIPTION

5. The UPPF aims to strengthen project readiness in the urban development sector by completing advanced feasibility studies, detailed designs, and procurement actions to meet ADB's financing requirements and build capacities of executing and implementing agencies in the urban sector prior to project approval. The UPPF, financed by a technical assistance (TA) loan (\$10 million) and TA grant (\$1 million) will improve the start-up efficiency of projects in 25 secondary towns (under MPCLGS) and 4 strategic cities (under MMWD) by: (i) preparing feasibility studies and detailed designs, (ii) preparing bidding and safeguards documents for advanced start-up during the inception stage, and (iii) strengthening institutional capacity of relevant agencies involved in project planning and implementation.

6. The UPPF will contribute to enhancing portfolio performance of urban sector projects and incorporating good practices in climate and disaster resilience and gender mainstreaming. The attached TA grant titled Capacity Building for Secondary Towns and Strategic Cities will support institutional strengthening components of the facility in critical areas of project implementation and management, and urban governance improvement.

7. The impact of UPPF would be urban projects in strategic cities and towns implemented in a timely manner² and the outcome would be high level of urban project readiness achieved. The

¹ ADB. 2005. *Financial Management and Analysis of Projects*. Manila; ADB. 2009. *Financial Due Diligence: A Methodology Note*. Manila; and ADB. 2015. *Financial Management Technical Guidance Note*. Manila.

² Government of Sri Lanka. 2017. *Vision 2025: A Country Enriched*. Colombo.

outputs of UPPF include: (i) feasibility studies and detailed designs of urban projects completed, (ii) advance implementation support for two ensuing projects provided; and (iii) institutional capacity of project agencies strengthened.

8. The UPPF will be followed by ensuing loans for the implementation of development works under the two components mentioned in para 2..

III. COUNTRY AND SECTOR FINANCIAL MANAGEMENT ISSUES

9. Since the end of the military conflict in 2009, Sri Lanka has experienced significant economic growth with the average gross domestic product (GDP) growth of 4.7% between the fiscal years of 2014 to 2016. The Government of Sri Lanka (the government) has prioritized its commitment to improve public financial management (PFM) while preserving fiscal sustainability and macro-economic stability and growth.

10. However, it will take some time for PFM reforms to be developed and implemented. In Sri Lanka, one of the main issues is that the three PFM components - fiscal sustainability, strategic allocation of resources, and operational efficiency - are not interlinked. According to the report commissioned by United States Agency for International Development (USAID), “the Ministry of Finance and Mass Media (MOFMM) appears to lack the necessary capacity and technical instruments to lead planning, execution, and oversight of the budget process.”

11. The government needs to vigorously address the weak PFM implementation and financial administration and it has publicly declared its intent to improve PFM and support other important reforms, in its aim to improve governance. The current vision of the MOFMM is “to create a sound public finance regulatory framework to improve transparency, accountability and service delivery in the public sector.” In the recent past, implementation of the accrual accounting and the use of Sri Lanka Public Sector Accounting Standard (SLPSAS) by the public institutions is a major improvement in the PFM. New requirement of the MOFMM to have the Internal Audit units in all projects also is also a step forward towards the improvement of PFM.

12. **Institutional capacity.** According to the International Monetary Fund (IMF), the capacity of Sri Lankan MOFMM is insufficient and inadequate to manage the expansion, implementation, and oversight of the national budget, which has grown dramatically in size and complexity over the last 10 years. The regulatory framework, information technology (IT) capacity, and human resources to elaborate and execute the budget have seen few updates over the past 20 years. Also, the recent vision document of government deals on strengthening policies of good governance. It expresses commitment to embark upon an extensive reform agenda, incorporating elements of constitutional reform, economic policy changes, improved governance, and transitional justice. The vision commits to fight against corruption, unaccountability, non-transparency and inefficiency in the public service.

13. There is an ongoing project to introduce the financial management information system (FMIS) to systematize budget processes and procedures throughout the public administration. Furthermore, there is a need for capacity improvement of the MOFMM staff to increase the ministry’s efficiency including training of the new employees. Currently, the MOFMM still uses a manual, paper-based process to transmit decisions to line ministries and government agencies and to receive updates from them.

14. **Procurement capacity.** The procurement processes are guided by the government regulations. There are cases where procurement and budget processes have been bypassed to

accelerate priority infrastructure projects that are often costly. The Auditor General Department (AGD) played a limited role in scrutinizing procurement processes and practices which resulted in the absence of proper checks and balances. This has led to inefficiencies and mismanagement of the procurement process. However, to increase discipline in procurement process, the government has constituted a National Procurement Commission (NPC) with adequate powers and responsibilities to streamline procurement processes, administration and regulations. The NPC's vision is 'to achieve highest professional standards in ensuring best value for money in all Government procurement processes' and with a mission to "formulate fair, equitable, transparent competitive and cost effective policies, procedures and processes for the procurement of goods and services, works, consultancy services and information systems performed by the government institutions in timely manner. "The key activities include (i) formulation of procurement guidelines, (ii) oversight of public procurement, and (iii) capacity building in public procurement.

15. **Financial management risks.** Given the above situation in Sri Lanka, there are significant financial management risks that need to be addressed in the coming years. Some of the main areas of PFM risks are on budget preparation and approval, planning, budget execution, budget control and transparency, and procurement. The risks, which have been identified as issues in the USAID study, have not been rated but are likely to be high or substantial.

16. The country partnership strategy (CPS) for Sri Lanka, 2018—2022 identifies the following:³ key development challenge is to maintain the momentum of rapid inclusive and sustainable growth. On growth and structural transformation, the CPS mentions that economic growth averaged about 6% per annum during 2007–2016, bringing Sri Lanka close to becoming an Upper Middle Income Countries (UMIC), with per capita GDP of \$3,835 by the end of 2016.⁴ The structure of the economy has undergone a change. Agriculture now accounts for a mere 8.2% of GDP, industry 29.6% (of which manufacturing is 16.9%), and services 62.2%.⁵ However, poverty has reduced, social indicators improved, and basic infrastructure provided. The macroeconomic and development challenges are (i) fiscal imbalances; (ii) pressure on balance of payments; (iii) lack of diversified products for export, weak linkages to global supply chain; (iv) poor business environment; (v) inequality; (vi) environment sustainability, climate change, and disaster risk.

17. The CPS also mentions on supporting Sri Lanka's transition to a UMIC by focusing on two strategic objectives: (i) pillar 1: strengthen the drivers of growth by promoting diversification of economic activities and productivity enhancement; and (ii) pillar 2: improve the quality of growth by promoting inclusiveness and thematic priorities.⁶

IV. PROJECT FINANCIAL MANAGEMENT SYSTEM

18. The two executing agencies i.e., MMWD and MPCLGS, implementing the strategic cities and secondary towns components are independent ministries functioning under the government. Both of the ministries are headed by the Minister of government of Sri Lanka and the secretaries

³ ADB. 2017. *Country Partnership Strategy: Sri Lanka, 2018–2022—Transition to Upper Middle-Income Country Status*. Manila.

⁴ The World Bank defines a UMIC as a country with per capita income of \$3,956 and above.

⁵ GDP shares are calculated with factor cost. The GDP share of agriculture is as low as that of the UMIC average, while the share of industry or manufacturing is equivalent to the lower middle-income country average.

⁶ The strategic objectives under the CPS are in line with ADB. 2015. *Clients–Contributors–Collaborators: A New Partnership with Upper Middle-Income Countries*. Manila.

of ministries are the executive heads. The secretaries are supported by administrative, finance, audit, procurement, and legal staff for managing the activities.

A. Ministry of Megapolis and Western Development

19. **Overview.** The MMWD is a government ministry mandated for overall development of Colombo and its region in Western Province as a megapolis and also develops strategic cities⁷ identified by the National Planning Department as countermagnets to Colombo and thereby reducing the pressure of urbanization in Colombo. Presently, MMWD is implementing several development projects in the Colombo metro region using the government funds. The MMWD has also taken up projects on improvement of strategic cities. Jaffna, Galle and Kandy are being developed under Strategic Cities Development Project (SCDP) funded by World Bank and Anuradhapura being developed under Anuradhapura Urban Infrastructure Development Project (AUIDP) through funding of Agence Française de Développement (AFD). The strategic cities component under UPPF will support project preparedness for development of four strategic cities – Trincomalee, Dambulla, Kurunagela and Ratnapura. The first three cities fall under the Colombo Economic Corridor and the fourth city is an important agro-commercial center of the country. The UPPF complements the efforts of ongoing ADB TA on preparation of the Colombo-Trincomalee Economic Corridor Development Plan.

20. The existing PMU for the ongoing SCDP will also function as PMU of the strategic cities component under the UPPF. The PMU has adequate administrative, technical, and accounting staff to implement the component. The project director is supported by engineering, safeguard, administrative, procurement, and accounts sections each headed by deputy project director (DPD) of the discipline. The accounts section is headed by DPD (finance) and has enough staff to support (2 senior finance officer, accountant, 2 accountants officers, and accounts assistant) and is sufficient to handle the disbursements under the UPPF.

21. **Experience of managing externally financed projects.** The MMWD has experience in implementing a couple of externally funded projects funded by World Bank and AFD⁸ but does not have the experience in implementing ADB funded projects.

22. **Funds flow arrangements.** The MMWD obtains project funds through the budgetary allocation from MOFMM. Even the amounts to be spent under the external funding projects also are included in national budgets. The funds from donor agencies will flow to the advance account (USD account) opened for the PMU at Central Bank of Sri Lanka. The counterpart funds of the government will flow to another account in approved bank (LKR account). In regard to the UPPF, the payments will be made only to consultants and incremental administration expenditure. Funds will flow from both the accounts for each payment based on the percentage contribution for ADB and the government for the respective category of payment.

23. **Staffing.** The MMWD is staffed with engineers, skilled staff, assistants, and computer operators, among others, at its various divisions. PMU for the ongoing SCDP has well qualified staff sufficient to handle the strategic cities component under the UPPF. The finance section of PMU is headed by DPD (finance) who is a chartered accountant with relevant experience. He is

⁷ The National Planning Department has identified 13 major and/or important cities across the country with economic and growth potential to be developed as counter magnets to Colombo by absorbing the pressure of urbanization in the country.

⁸ World Bank. 2014. *Strategic Cities Development Project: Project Appraisal Document*. Washington D.C.; World Bank. 2016. *Strategic Cities Development Project - Additional Financing: Project Appraisal Document*. Washington D.C.; and AFD. 2016. *Anuradhapura Integrated Urban Development Project: Credit Facility Agreement*. Paris.

supported by senior accounts officers and accountants. However, these officers do not have experience of implementing the ADB funded projects and need to be trained on ADB procedures for smooth handling of financial matters as per ADB procedures.

24. **Accounting policy and procedures.** Both MMWD and its PMU follow financial regulations of the government including Administrative Rules and Financial Rules (ARFR) and accepted national accounting standards. There were no issues found in accounting in the MMWD and PMU.

25. **Segregation of duties.** The delegation of authorities and/or responsibilities is defined clearly in both MMWD and PMU. The organizational system of both MMWD and PMU ensures adequate segregation of duties where procurement and engineering sections are respectively responsible for ordering and receiving. The secretary (MMWD) and/or project director (PMU) authorize and approve the payments for MMWD and PMU respectively. All other important activities like authorization, recording, payments and reconciliations are segregated and carried out by different officers in accounts departments.

26. **Budgeting system.** The MMWD obtains information from other divisions of ministry and prepares the budget. Responsibility of budget preparation lies with the secretary of MMWD supported by chief of accounts of the ministry. The PDs of PMU is responsible for budgeting required for implementing UFFP. The Project Director is assisted by engineering, administrative and accounts staff in budgeting. The works and activities to be executed in the ensuring year will be considered and the fund requirements compiled in preparing the budget requirements.

27. To obtain national budget allocation, the MMWD needs to provide the details to the Department of National Budgets (NBD) of the MOFMM. The MMWD collects the requirements of PMU also while doing so. The NBD is responsible for preparation of the national budget. After the approval by the parliament, the budget becomes the National Budget of Sri Lanka where allocations are available to MMWD including UPPF. Poor budgeting was observed in PMU of MMWD with disbursements of 30% in 2016 and 70% in 2017. The PMU of MMWD has attributed to the initial teething problems of project implementation and has assured that proper budgeting would be done in future based on the lessons learnt.

28. **Payments.** In both MMWD and PMU, payments are made against invoices and other supporting documents. After receiving the invoices, copies of purchase orders and/or agreements with consultants and/or contractors are taken and compared in terms of quantities, prices, and terms and conditions of contract and/or purchase order. The quantity surveyors and the engineers of MMWD and PMU are involved in certifying the quantity and quality of the works and/or items. The invoice is then scrutinized by accounts department for the compliance with the terms and conditions and calculations. The chief of finance of MMWD and PMU then clear the payment for the approval of the Secretary and/or Project Director respectively. All invoices are stamped as PAID, dated and recorded in the system correctly in both MMWD and PMU.

29. **Cash and bank.** In MMWD, the operation of the bank accountant is done by the chief of accounts section of the ministry with the approval of secretary. The accounts division is responsible to ensure reconciliation with accounting records and bank statement on a daily and monthly basis. At PMU, operation of bank accounts are the joint responsibility of project director and chief of accounts section (DPD [finance] for PMU). The accounts of both USD and LKR are managed properly and reconciled regularly. Most of the transactions are made through cheques and bank instructions and there are very minimal cash transactions. The PMU informed that the accounting of the facility would follow the same system.

30. **Safeguard of assets.** The records of fixed assets are maintained in MMWD. The government procedures require annual verification of assets through officials of other departments and/or ministries as ordered by the head of MMWD. This exercise is like peer review and called as Board of Survey. Also, adequate asset registers are maintained in PMU and annual verification procedures are same as explained above.

31. **Contract management and accounting.** Both the MMWD and PMU maintain contract-wise accounting records on agreed amounts, interim payments, final payments, variation to contracts, and undisbursed balances. All records are consistent with physical outputs and/or deliverables of the contract. The contractor records are maintained and reconciled regularly in both MMWD and PMU. There is delegation of powers and/or responsibilities in MMWD and PMU in approving variations to contract depending on the quantum of variation.

32. **Internal audit.** The MMWD has an internal audit section within the ministry, which is responsible for internal audit of the departments of MMWD and PMU under their jurisdiction. The internal audit section of MMWD reports to the secretary of the ministry directly and is independent of departments and project staff. All financial transactions of the departments and projects of the ministry including the quality audits fall in the scope of internal audit.

33. The latest internal audit report of PMU for accounts and/or transactions from March to December 2016 has been submitted as late as August 2017. The internal audit of the 2017 accounts have not yet commenced due to the overlap in timings with the external audit as reported by PMU.

34. It has been observed in MMWD, the frequency and timing of internal audit is inconsistent and quality of internal auditing is also poor. The technical observations of the audit like quality of construction, and designs are also given by auditors with financial and/or accounting background, who do not have adequate knowledge on technical issues and this often has led to wastage of project time, on observations, and clarifications. Hence, there is a requirement of (i) training for internal auditors on improved auditing, and (ii) inclusion of qualified technical officers in internal audits.

35. **External audit (entity).** The Auditor General of Sri Lanka is the external auditor of MMWD. The Auditor General conducts annual review and provide its observations on lapses in accounting and procedural issues. The audit reports of previous years have mentioned some lapses in the expenditure and accounting. It is found that the there are no delays in external audit of MMWD.

36. **External audit (project).** External audit of accounts of PMU is also carried out by Auditor General office of Sri Lanka. The externally funded projects require the submission of independent audit reports to the funding agencies within 6 months of next year. The external audit reports of project for 2015 and 2016 mention on procedural and accounting lapses. The external audit report for 2016 of PMU was submitted on time to external funding agencies.

37. **Reporting and monitoring.** The reporting of progress of MMWD is normally done once in a year including the progress of all the departments and projects of the year. But the monitoring of projects is done regularly by MMWD. The annual accounts of MMWD are prepared in accordance with financial regulations in accordance with the Sri Lanka Accounting Standards.

38. Same procedures are followed by PMU in submitting the annual accounts. Excel based sheets are used in reporting of accounts. The financial reports compare actual expenditure with

budgeted and programmed allocations. The reasons for shortfall in progress is analyzed. The progress reports at PMU are prepared on a monthly quarterly and yearly basis.

39. **Information systems.** The accounting of MMWD is based on excel based spread sheets. PMU of MMWD uses a customized software for its accounting requirements. It is a standalone system. Regular backups are taken in PMU and confidential information is stored in passwords.

B. Ministry of Provincial Councils, Local Government and Sports

40. **Overview.** The MPCLGS is a government ministry mandated with responsibilities such as (i) formulation of policies and legislations to develop provincial and local government system; (ii) capacity enhancement of provincial and local governments to exercise their powers and provide services; and (iii) assurance of public interests reflected in local governance activities. Presently, MPCLGS has successfully implemented and is currently implementing several development projects across the country through external and state funding. The secondary towns component under UPPF will support project preparedness for development of 25 model towns,⁹ one each in 25 districts of the country. MPCLGS' project and planning wing will take a lead role in the activities of proposed UPPF and is equipped with staff with specialization in administration, procurement and finance.

41. The existing PMU for the ongoing ADB-funded Additional Financing for Local Government Enhance Sector Project (LGESP-AF) will support the activities of UPPF.¹⁰ The existing PMU has adequate administrative, technical, and accounting staff to support implementation of the secondary towns component of UPPF. The project director is supported by engineering, accounts, safeguards, procurement and administrative officers. The accounts section is headed by financial analyst and supported by senior accountant and accountant and is sufficient to handle the disbursements under the UPPF.

42. **Experience of managing externally financed projects.** The MPCLGS has experience in implementing many externally funded projects funded by ADB,¹¹ WB, JICA and other external funded project. Hence, MPCLGS has enough experience to handle the activities under the facility. However, the implementation of the LGESP-AF has been delayed in procurement works due to the handling of major procurement activities by the ministry procurement committee. Extending capacity building to senior officers of the ministry on procurement procedures of ADB is required to avoid delays in procurement process.

43. **Funds flow arrangements.** The MPCLGS obtains project funds through the budgetary allocation from MOFMM. Even the amounts to be spent under the external funding projects also are included in national budgets. The funds from donor agencies will flow to the advance account (USD account) opened for the PMU at Central Bank of Sri Lanka. The counterpart funds of the government will flow to another account in approved bank (LKR account). In regard to the UPPF, the payments will be made only to consultants and incremental administration expenditure. Funds

⁹ One local authority (town) with potential for growth has been selected based on agreed selection criterion for each district in the country for being developed as model town which could be later on replicated in other towns of the district.

¹⁰ ADB. 2016. *Local Government Enhancement Sector Project (Additional Financing): Report and Recommendation of the President*. Manila.

¹¹ ADB has contributed to local government sector since more than last 10 years with support to Local Government Infrastructure Improvement Project (Loan 2209 SRI - 2007 -2013); Local Government Enhancement Sector Project (Loan 2790 SRI: 2012 - 2017)) an its additional financing component which is in progress (Loan No. 3431) is on the basis of scaling up activities of a well performing project.

will flow from both the accounts for each payment based on the percentage contribution for ADB and the government for the respective category of payment.

44. **Staffing.** The MPCLGS is staffed with engineers, skilled staff, assistants, and computer operators, among others, at its various divisions. PMU for the ongoing LGESP-AF has well qualified staff sufficient to handle the secondary towns component under the UPPF. The accounts section is headed by financial analyst and supported by senior accountant and accountant and is sufficient to handle the disbursements under the UPPF.

45. **Accounting policy and procedures.** Both MPCLGS and its PMU follow financial regulations of the government including Administrative Rules and Financial Rules (ARFR) and accepted national accounting standards. No issues found in accounting in MPCLGS and PMU.

46. **Segregation of duties.** The delegation of authorities/responsibilities is defined clearly in both MPCLGS and PMU. The organizational system of both MPCLGS and PMU ensures adequate segregation of duties where procurement and engineering sections are respectively responsible for ordering and receiving. The secretary (MPCLGS) / project director (PMU) authorize and approve the payments for MPCLGS and PMU respectively. All other important activities like authorization, recording, payments and reconciliations are segregated and carried out by different officers in accounts departments.

47. **Budgeting System.** The MPCLGS obtains information from other divisions of ministry and prepares the budget. Responsibility of budget preparation lies with the secretary of MPCLGS supported by chief of accounts of the ministry. Project Directors (PDs) of PMU is responsible for providing budgets required for implementing UFFP. The PD is assisted by engineering, administrative and accounts staff in budgeting. The works and activities to be executed in the ensuring year will be considered and the fund requirements will be compiled in preparing the budget requirements.

48. To obtain national budget allocation, MPCLGS needs to provide the details to NBD of MOFMM. The MPCLGS collects the requirements of PMU also while doing so. The NBD is responsible for preparation of the national budget. After the approval by the parliament, the budget becomes the National Budget of Sri Lanka where allocations are available to MPCLG including UPPF. The disbursements of PMU, and MPCLGS are normally consistent with budgetary allocation.

49. **Payments.** In both MPCLGS and PMU, payments are made against invoices and other supporting documents. After receiving the invoices, copies of purchase orders / agreements with consultants / contractors are taken and compared in terms of quantities, prices, and terms and conditions of contract / purchase order. The quantity surveyors / engineers of MPCLGS and PMU are involved in certifying the quantity and quality of the works / items. The invoice is then scrutinized by accounts department for the compliance with the terms and conditions and calculations. The chief of finance of MPCLGS and PMU then clear the payment for the approval of the Secretary / Project Director respectively. All invoices are stamped as PAID, dated and recorded in the system correctly in both MPCLGS and PMU.

50. **Cash and bank.** In MPCLGS, the operation of the bank accountant is done by the chief financial officer of the ministry with the approval of secretary. The accounts division is responsible to ensure reconciliation with accounting records and bank statement on a daily and monthly basis. At PMU, operation of bank accounts are the joint responsibility of project director and chief of accounts section (financial analyst) for PMU. The accounts of both USD and LKR have been

managed properly and reconciled regularly by PMU. Most of the transactions are made through cheques and bank instructions and there are very minimal cash transactions. The PMU informed that the accounting of the facility would follow the same system.

51. **Safeguard of assets.** The records of fixed assets are maintained in MPCLGS. The government procedures require annual verification of assets through officials of other departments and/or ministries as ordered by the head of MPCLGS. This exercise is like peer review and called as Board of Survey. Also, adequate asset registers are maintained in PMU and annual verification procedures are same as explained above.

52. **Contract management and accounting.** Both MPCLGS and PMU maintain contract-wise accounting records on agreed amounts, interim payments, final payments, variation to contracts, and undisbursed balances. All records are consistent with physical outputs and/or deliverables of the contract. The contractor records are maintained and reconciled regularly in both MPCLGS and PMU. There is delegation of powers and/or responsibilities in MPCLGS and PMU in approving variations to contract depending on the quantum of variation.

53. **Internal audit.** The MPCLGS has an internal audit section within the ministry, which is responsible for internal audit of the departments of MPCLGS and PMU under their jurisdiction. The internal audit section of MPCLGS reports to the secretary of the ministry directly and is independent of departments and project staff. All financial transactions of the departments and projects of the ministry including the quality audits fall in the scope of internal audit. In addition to this, the PMU of MPCLGS has a position of internal auditor in the staff cadre approved. But this position has remained vacant for a long period and hence for most of the period, the internal audit is carried out by the internal auditors of the ministry.

54. The latest internal audit of PMU for accounts / transactions of 2017 was carried out in February 2018 and no report was submitted to the PMU on this.

55. It has been observed in MPCLGS, the frequency and timing of internal audit is inconsistent and quality of internal auditing is also poor. The technical observations of the audit like quality of construction, designs etc. are also given by auditors with financial / accounting background without adequate knowledge on technical issues and this often has led to wastage of project time, on observations, clarifications etc. Hence, there is a requirement of (i) training for internal auditors on improved auditing; (ii) inclusion of qualified technical officers in internal audits.

56. **External audit (Ministry of Provincial Councils, Local Government and Sports).** Auditor General of Sri Lanka is the external auditor of MPCLGS. The Auditor General conducts annual review and provide observations on lapses in accounting and procedural issues. The audit reports of previous years have mentioned some lapses in the expenditure and accounting. It is found that there are no delays in external audit of MPCLGS.

57. **External audit (project).** External Audit of accounts of PMU is also carried out by Auditor General office of Sri Lanka. The externally funded projects require the submission of independent audit reports to the funding agencies within 6 months of next year. The external audit report for 2016 of LGESP-AF was submitted on time to ADB.

58. **Reporting and monitoring.** The reporting of progress of MPCLGS is normally done once in a year including the progress of all the departments and projects of the year. But the monitoring of projects is done regularly by MPCLGS. The annual accounts of MPCLGS are prepared in accordance with financial regulations in accordance with the Sri Lanka Accounting Standards.

59. Same procedures are followed by PMU in submitting the annual accounts. Excel based sheets are used in reporting of accounts. The financial reports compare actual expenditure with budgeted and programmed allocations. The reasons for shortfall in progress is analyzed. The progress reports at PMU are prepared on a monthly quarterly and yearly basis

60. **Information systems.** The accounting of MPCLGS is based on excel based spread sheets. The PMU also uses excel based spread sheets for its accounting requirements and has good experience on working for ADB funded projects. Regular backups are taken in PMU and confidential information is stored in passwords.

C. Risk Assessments

61. The FMA has considered two types of risks: (i) inherent risks, i.e., risks outside the direct control of the entity financial management; and (ii) control risks, i.e., risks concerning the internal functioning and control of the entity's accounts division. The following key risks have been identified.

Table 2: Financial Management Inherent and Control Risk Assessment

Risk Type	Risk Assessment	Proposed Mitigation Measures
A. Inherent Risk		
1. Country-Specific Risks (Sri Lanka)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> Institutional capacity is not sufficient for the effective financial management of externally funded projects. 	<ul style="list-style-type: none"> Ongoing efforts are underway by GOSL and ADB. Provision of support (by loans and TAs) has focused on capacity development at all levels.
2. Entity-Specific Risks (MMWD, MPCLGS)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> There is an institutional mechanism and legislative framework for budgeting, accounting, and audit in a time-bound manner. However, information system is not in place for accurate budgeting. 	<ul style="list-style-type: none"> Provision of loan support for IT systems and capacity building support ensure that the systems are updated regularly and running smoothly.
3. Project-Specific Risks	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> Occasional delays in the release of GOSL's counterpart funds have been observed in the previous and ongoing projects. 	<ul style="list-style-type: none"> Commitment of MOFMM, MMWD, and MPCLGS for timely allocation and disbursement of the government's counterpart funds is required.
Overall Inherent Risk	<p style="text-align: center;">Moderate</p> <p>While entity and project specific risks exist, these risks might be mitigated through efforts of the MMWD, MPCLGS, and related government entities with the support of ADB. However, MOFMM, MMWD and MPCLG need to commit the timely allocation and disbursement of its counterpart funds for the efficient implementation of UPPF.</p>	
B. Control Risk (MMWD and PMU)		
1. Implementing Entity	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> MMWD has sufficient experience in implementing externally financed projects. And, PMU for the ongoing SCDP will implement the UPPF. 	

Risk Type	Risk Assessment	Proposed Mitigation Measures
	<ul style="list-style-type: none"> • But, MMWD does not have the experience in implementing ADB funded projects. 	<ul style="list-style-type: none"> • Training on implementing ADB financed projects needs to be provided to PPU of MMWD.
2. Flow of Funds and Budget Allocation	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> • MMWD will receive the project funds from MOFMM through the budgetary allocation. • Occasional delays in the release of the government's counterpart funds have been observed in the previous projects. 	<ul style="list-style-type: none"> • Commitment of MMWD is required for timely allocation and disbursement of the government's counterpart funds.
3. Staffing	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Both MMWD and PMU have well qualified staff to implement UPPF. 	<ul style="list-style-type: none"> • Not applicable
4. Accounting Policies & Procedures	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Both MMWD and PMU follow financial regulations of the government including ARFR and accepted national accounting standards. 	<ul style="list-style-type: none"> • Not applicable
5. Internal Audit	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> • Although MMWD has its internal audit section, the frequency and timing are inconsistent. • Internal audit of the ongoing project was done up to the year of 2016. 	<ul style="list-style-type: none"> • MMWD needs to strengthen its internal audit process by appointing qualified staff or outsourcing to experienced audit firms.
6. External Audit (Entity)	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Audit General of GOSL conducts the external audits for MMWD. • There are no delays in conducting external audits of MMWD. 	<ul style="list-style-type: none"> • Not applicable
7. External Audit (Project)	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Audit General of GOSL also conducts the external audits for externally funded projects of MMWD. • There are no delays in conducting external audits of externally funded projects. 	<ul style="list-style-type: none"> • Not applicable
8. Reporting and Monitoring	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • MMWD publishes its annual reports which contain physical and financial progress reports. • PMU produces monthly, quarterly and annual progress reports. 	<ul style="list-style-type: none"> • Not applicable
9. Information Systems	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Excel spread sheets are used in MMWD. And, customized accounting software used in PMU. 	<ul style="list-style-type: none"> • Not applicable
Overall Control Risk	<p style="text-align: center;">Moderate</p> <p>Some financial management risks are recognized, but not all of them are substantial. However, non-experience in ADB funded projects and delays in the release of government's counterpart funds may hamper the effective</p>	

Risk Type	Risk Assessment	Proposed Mitigation Measures
	implementation of UPPF. The initial support and capacity development for MMWD and PMU staff on ADB procedures will be implemented with the support of qualified and experienced PDPCs.	
C. Control Risk (MPCLGS and PMU)		
1. Implementing Entity	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> • MPCLGS has sufficient experience in implementing externally financed projects. And, PMU for the ongoing LGESP-AF funded by ADB will implement the UPPF. 	<ul style="list-style-type: none"> • Not applicable
2. Flow of Funds and Budget Allocation	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> • MPCLGS will receive the project funds from MOFMM through the budgetary allocation. • Occasional delays in the release of the government's counterpart funds have been observed in the previous and ongoing projects. 	<ul style="list-style-type: none"> • Commitment of MPCLGS is required for timely allocation and disbursement of the government's counterpart funds.
3. Staffing	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Qualified and experienced staff are in place to take up the UPPF. 	<ul style="list-style-type: none"> • Not applicable
4. Accounting Policies & Procedures	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • MPLCGS and PMU follow the national financial regulations. No issues observed 	<ul style="list-style-type: none"> • Not applicable
5. Internal Audit	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> • Although MPLCGS has its internal audit section, the frequency and timing are inconsistent. • Internal audit of the ongoing project was done up to the year of 2017. 	<ul style="list-style-type: none"> • MPCLGS needs to strengthen its internal audit process by appointing qualified staff or outsourcing to experienced audit firms.
6. External Audit (Entity)	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Audit General of GOSL conducts the external audits for MPLCGS. • There are no delays in conducting external audits of MPLCGS. 	<ul style="list-style-type: none"> • Not applicable
7. External Audit (Project)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> • Audit General of GOSL also conducts the external audits for externally funded projects of MPCLGS. • There are no delays in conducting external audits of externally funded projects. 	<ul style="list-style-type: none"> • Not applicable
8. Reporting and Monitoring	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • MPCLGS publishes its annual reports which contain physical and financial progress reports. • PMU produces monthly, quarterly and annual progress reports. 	<ul style="list-style-type: none"> • Not applicable
9. Information Systems	<p style="text-align: center;">Low</p>	<ul style="list-style-type: none"> • Not applicable

Risk Type	Risk Assessment	Proposed Mitigation Measures
	<ul style="list-style-type: none"> Excel spread sheets are used in MPCLGS. And, customized accounting software used in PMU. 	
Overall Control Risk	Moderate	
	Some financial management risks are recognized, but not all of them are substantial. However, delays in the release of government's counterpart funds may hamper the effective implementation of UPPF. MPCLGS needs to commit the timely allocation and disbursement of the government's counterpart funds.	

ADB = Asian Development Bank, GOSL = Government of Sri Lanka, IT = information technology, LGESP-AF = Additional Financing for Local Government Enhance Sector Project, MMWD = Ministry of Megapolis and Western Development, MOFMM = Ministry of Finance and Mass Media, MPCLGS = Ministry of Provincial Councils, Local Government and Sports, PDPC = project design and procurement consultant, PMU = project management unit, SCDP = Strategic Cities Development Project TA = technical assistance, UPPF = Urban Project Preparatory Facility.

D. Strengths and Weaknesses

62. **Strengths.** A significant strength of the financial management systems of MMWD and MPCLGS is that they have sufficient experience in handling large-scale projects with substantial values. In addition, MMWD and MPCLGS have an established legal, institutional, and monitoring framework available for budgeting, accounting, and auditing.

63. **Weaknesses.** The following weaknesses in the financial management system have been identified and need to be addressed:

- (i) lack of MMWD's experience in implementing and managing ADB funded projects may hamper the timely preparation and implementation of UPPF;
- (ii) occasional delays in the release of the government's counterpart funds may cause delays in the timely and efficient implementation of UPPF;
- (iii) inadequate procurement capacity of PMUs may hamper the timely implementation of UPPF: and
- (iv) weak internal audit system in PMUs may cause delays in the timely identification of issues.

E. Proposed Time-Bound Action Plan

64. The following actions agreed are noted as an action plan to address issues that the financial management assessment identified in the PMU.

Table3: Time-Bound Action Plan

Area	Current Scenario	Risk	Mitigation measures	Responsibility	Target date
Externally assisted projects	Lack of MMWD's experience in implementing ADB funded projects	This may hamper the timely preparation and implementation of UPPF.	Extending full training and capacity building support for enhancing the financial management capacity of PMU of MMWD.	MMWD	before loan effectiveness
Government's counterpart fund	Occasional delays in the release of the government's counterpart funds	This may cause delays in the timely and efficient implementation of UPPF.	Commitment of MOFMM, MMWD and MPCLGS for timely allocation and disbursement of the	MOFMM, MMWD, MPCLGS	before loan signing

Area	Current Scenario	Risk	Mitigation measures	Responsibility	Target date
			government's counterpart funds.		
Procurement capacity	Inadequate procurement capacity of PMUs	This may hamper the timely implementation of UPPF	Providing adequate support through hiring PDPCs for enhancing the procurement capacity of PMUs.	MMWD, MPCLGS	before loan signing
Internal audit	Weak internal audit system in PMUs	This may cause delays in the timely identification of issues.	Commitment of PMUs to ensure that internal audits are done on annual basis.	MMWD, MPCLGS	before loan effectiveness

ADB = Asian Development Bank, MMWD = Ministry of Megapolis and Western Development, MOFMM = Ministry of Finance and Mass Media, MPCLGS = Ministry of Provincial Councils, Local Government and Sports, PDPC = project design and procurement consultant, PMU = project management unit, UPPF = Urban Project Preparatory Facility.