Session 4.2
Financial Sustainability, Financial Due Diligence, and Institutional Sustainability

Introductory Course on Economic Analysis of Investment Projects
5-9 July 2010
PFM and FM

- The broad objectives of PFM are to achieve overall fiscal discipline, allocation of resources to priority needs, and efficient and effective allocation of public services.

- FM arrangements include, budgeting, accounting, internal control, funds flow, financial reporting, and auditing arrangements of the entity. FM focus is on a single reporting entity.
Current PFM/ FM Focus

- The Accra Agenda for Action (AAA)
- Paris Declaration
- Donor harmonization
- Commitment to strengthen and use country systems
Charter Obligations

- “In making or guaranteeing a loan, the Bank shall pay due regard to the prospects that the borrower and its guarantor, if any, will be in a position to meet their obligations under the loan agreement.” Article 14(vi)

- "The Bank shall take the necessary measures to ensure that the proceeds of any loan made, guaranteed or participated in by the Bank are used only for the purposes for which the loan was granted and with due attention to considerations of economy and efficiency.” Article 14(xi)

- “The Bank shall be guided by sound banking principles in its operations.” Article 14(xiv)
ADB FM Services

- Developing country FM systems
- Managing fiduciary risks
Country Strategy and Fiduciary Risk

Country strategy should describe:

- Extent of fiduciary risks in the portfolio
- Underlying systemic weaknesses
- How problems in portfolio performance will be addressed
Fiduciary Risks in the Loan Portfolio

- Policy based lending – risks depend on the overall performance of the country’s PFM systems

- Investment operations – risks depend on effectiveness of controls over financial transactions, accurate financial reporting, audit and disbursement at the entity level
Risk Mitigation

- Strengthening country systems and/or
- Additional fiduciary safeguards at portfolio and project level

Strengthening country systems is likely to have greater impact than protection of funds through ring-fencing
Planning Fiduciary Activities

- FM Specialist should understand both the risk environment and also the business and financial systems of the EA/IA
- The results of country assessments should help shape the planning of ADB fiduciary activity
- FM specialists should be qualified accountants with relevant experience
The Fiduciary FM Process

- Financial Management Assessment (FMA)
- Project cost estimates
- Project financing plans
- Financial evaluation (FIRR v WACC)
- Financial analysis (projections)
- Project financial management arrangements including:
  - Disbursement arrangements
  - Financial reporting and auditing arrangements
Financial Management Assessment (FMA)

Objective – to assess whether or not financial management arrangements are suitable for purposes of recording transactions, preparing reliable financial statements and for safeguarding assets

Issues or weaknesses identified need to be taken into consideration either through project design or implementation arrangements
FMA – How?

- Review of country and/or previous EA/IA financial management diagnostics
- Complete tailored FMAQ and/or update FMA previously completed for the EA/IA
- Identify risks and/or issues associated with EA/IA financial management arrangements
- Develop appropriate mitigation measures
FMA - When and Who?

- The FMA should be undertaken as early as possible, preferably during early stages of the PPTA
  - Provides sufficient time to develop mitigating measures
  - Domestic consultants can assist EA
Cost Estimate 1

- Base Costs
- Taxes and Duties
- Physical Contingency
- Price Contingency
- Interest and other charges during construction (IDC)
Cost Estimate 2

- Confirm adequacy of cost structure
- Reasonableness of targeted units, outputs and unit cost assumptions
- Estimation of taxes and duties, physical and price contingencies and IDC
Financing Plan 1

- Prepared in the same currency units as the cost estimates
- Drawdown schedule should be consistent with cost estimates
- Sufficient to cover base costs, taxes and duties, contingencies and IDC
- RRP presentation should be in USD, with percentage of funds provided by each source presented
Financing Plan 2

- Assess existing capital structure of EA
- Assess availability of government counterpart financing
- Ensure that counterpart financing requirements are clearly identified in either the government budget and/or Medium Term Expenditure Framework
- Assess the availability of commercial and official co-financing
- Assess reasonability of EA self-financing
FIRR

- Net present value – present value of future cash flow stream
- FIRR: The discount rate at which the present value of a stream of cash flows is equal to zero (in financial terms)
- Needs a hurdle
FIRR

- Cash basis
- Incremental – with versus without the project
- Real versus nominal – remove impacts of inflation and foreign exchange fluctuation
- After tax – remove tax impact
WACC

- Real terms on an after tax basis
- Each component of the financing plan is costed individually
- Weighting based on proportionate contribution by each source to the total financing plan
WACC

- Need a project specific hurdle rate (ADB’s analysis is from the perspective of the project)
- WACC represents the costs associated with financing the investment
- FIRR > WACC = Financial Viability
ADB Project Financial Projections

- Financial projections include income statement, balance sheet and cash flow statement
- Presentation format should follow the enterprise’s chart of accounts
- Projections should be prepared in domestic current terms and should take into account the potential impact of inflation and foreign exchange rate fluctuations
- Essentially forecasts of financial performance and financial position
- Projections should be completed for a minimum of 5 years, but not usually longer than 10 years.
- 2-3 years of historical financial information should be presented
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- Non revenue projects - Assess EA capacity to absorb the recurrent costs
Financial Reporting

- EAs should submit audited financial statements for both the project and the EA
- This requirement remains in force until the loan is closed
- A number of issues exist in terms of receiving annual financial statements
- Relatively easy to implement good quality accounting software
## Audited Financial Statements Required

<table>
<thead>
<tr>
<th>Report</th>
<th>Reporting Basis Used In Practice</th>
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</thead>
<tbody>
<tr>
<td>Project ‘Accounts’</td>
<td>Cash Basis</td>
</tr>
<tr>
<td>EA financial statements</td>
<td>Variety of basis used e.g., cash basis, national standards, IPSAS, IFRS</td>
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*ADB*
Financial Risk and Covenants

- A written and signed “pledge”
- Two parties sign and are legally bound to certain actions, conditions, etc.
- Covenants documented in the Loan agreement
Examples of Common Financial Covenants

- Audit requirements
- Financial ratios (e.g., Debt:equity ratio; self-financing ratio; current ratio)
- Operating ratios (e.g., reduced transmission losses, unaccounted for water, improved accounts receivable performance)
- Provision of counterpart funds and agreement to meet incremental recurrent costs
Hints

- Covenants should:
  - be realistic and achievable
  - address risks
  - clearly stated
  - measurable
Three Funding Mechanism Examples

1. Traditional investment project
2. Common pool account
3. Use of treasury model

Design of funds flow should be influenced by perceived level of fiduciary risk.
Traditional Investment Project

Withdrawal application

Direct payment request

Payment request

Payment request

MOIC

Treasury at MoF

PESO Account in Commercial Bank

Local suppliers and PIU staff

Foreign suppliers

MDM Bank

US$ Designated Account

PESO funds

PESO transit Account

$ funds

Payment request

PESO funds

PESO funds

$ funds

Key:

Flow of funds

Flow of documents

Invoices from suppliers

$ funds

$ funds

$ funds

$ funds

or

$ funds

PESO funds automatic conversion

$ funds
Common Pool Account

PEDP II dual payment system
Treasury Model

Treasury model for fund management
Thank you

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