ADB

Financial Management Technical Guidance Note

May 2015

Financial Management Assessment

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
CPS	–	country partnership strategy
FMA	–	financial management assessment
FMAQ	–	financial management assessment questionnaire
FMICRA	–	financial management, internal control and risk assessment
GACAP II	–	Second Governance and Anticorruption Action Plan
GGSU	–	general government sector unit
OSFM	–	Financial Management Unit
PFM	–	public financial management
PIU	–	project implementation unit
RRP	–	report and recommendation of the President

GLOSSARY

Control risk – the risk arising from the failure of the project's financial management and internal control arrangements to ensure that project funds are used economically and efficiently and for the intended purpose.

Financial management – the overall arrangement for planning, directing, monitoring, organizing, and controlling of the monetary resources of an organization, with a view to efficient accomplishment of the enterprise objectives.

Inherent risk – risks posed by the overall environment in which the executing or implementing agency operates, before considering the impact of the agency's financial management systems and controls.

Internal audit – an independent, objective assurance activity designed to add value and improve an organization's operations.

Internal control – a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies.

Risk – the probability or threat of damage, injury, liability, loss or other negative occurrence that is caused by external or internal vulnerabilities that may be avoided through preemptive action.

CONTENTS

I. PURPOSE, INTRODUCTION AND SCOPE

A. Purpose

1. The purpose of this technical guidance note (TGN) is to provide guidance to Asian Development Bank (ADB) staff, consultants and executing agencies on the ADB requirements and considerations for financial management assessment. This TGN consolidates ADB's approach to project level financial management assessment (FMA), and replaces Section 4.2 of the *Financial Management and Analysis of Projects*[1] (the Guidelines). The approach and methodology in this TGN is based on international good practice, and is intended to explain the underlying principles for FMA. However, it is neither a substitute for sound professional judgment, nor a rule-book covering all possible situations. In non-typical or exceptional situations, staff are encouraged to seek further advice from the Financial Management Unit (OSFM) of the Operations Services and Financial Management Department (OSFMD).

B. Introduction

2. ADB's requirements for financial due diligence are summarized in the Operations Manual, section G2.[2] They comprise 4 major activities: (i) financial management assessment (FMA); (ii) preparation of cost estimates and financing plans; (iii) financial cost-benefit analysis of the proposed investment projects, or an assessment of the capacity of the executing or implementing agency to fund incremental recurrent costs; and (iv) financial analysis and projections of the executing and / or implementing agencies.

3. Article 14(xi) of the *Agreement Establishing the Asian Development Bank* (the Charter) requires the Asian Development Bank (ADB) to take necessary measures to ensure that the proceeds of any loan made, guaranteed, or participated in by ADB are used only for the purposes for which the loan was granted, and with due attention to considerations of economy and efficiency. Article 14(xiv) of the Charter also requires ADB to be guided by sound banking principles in its operations. ADB's financial due diligence requirements stem from these Charter obligations.

4. During the processing stage, project teams should assess the financial management capacity of the executing agency and the implementing agency, if any, to effectively manage the finances of the project. ADB's Governance Framework, as described in the Second Governance and Anticorruption Action Plan (GACAP II),[3] requires that that the public financial management (PFM) risks are assessed during the preparation of Country Partnership Strategies (CPS) at both the country and sector levels, and assessed and mitigated at the project level as part of project preparation.

5. Effective financial management is a critical success factor for efficient project implementation and project sustainability. Irrespective of how well a particular project or program is designed, if the executing or implementing agency does not have the capacity to

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[1] ADB. 2005. Financial Management and Analysis of Projects. Manila.

[2] ADB. 2014. Financial Management, Cost Estimates, Financial Analysis, and Financial Performance Indicators. *Operations Manual, G2*.

[3] ADB. 2006. *Second Governance and Anticorruption Action Plan*. Manila - http://www.adb.org/documents/second-governance-and-anticorruption-action-plan-gacap-ii; ADB. 2011. *Revised Guidelines for Implementing Second Governance and Anticorruption Plan.* Manila; and ADB. 2014. Revised Staff Guidelines http://www.adb.org/documents/revised-guidelines-implementing-adbs-second-governance-and-anticorruption-action-plan

effectively manage its financial resources,[4] implementation may not be as efficient as desired,[5] and the benefits of the project are less likely to be sustainable.[6] FMA is a risk-based assessment intended to (i) identify risks that country, sector or project financial management systems and/or practices may lead to non-achievement, or sub-optimal achievement, of the project outcomes and/or outputs; (ii) identify risks that ADB resources may be used other than for the intended purposes, whether due to leakage or inefficiency; (iii) assess the severity of the risk; and (iv) develop a practical risk management plan to address, at a minimum, high or substantial financial management risks at the project level that may, otherwise, adversely affect the achievement of the development outcomes. FMA should identify pre-mitigation risks and mitigation actions. It is intended to help improve project design either by implementing institutional strengthening for better financial management, or (at the very least) designing project-specific financial management arrangements to ring-fence project finances from larger institutional risks during the implementation stage.

6. The FMA assesses the capacity of executing and implementing agencies and their systems in the areas of planning and budgeting, management and financial accounting, reporting, auditing, and internal controls. The FMA also includes a review of proposed disbursement and funds-flow arrangements, and identifies measures for addressing identified deficiencies.

C. Scope and Coverage

7. This note covers all loans, grants, the investment component of sector development programs, and high value TAs delegated (wholly or in part) to executing or implementing agencies. Even if administered by ADB, FMA would be required[7] for high value TAs where an advance payment facility is extended to an executing or implementing agency. This note does not cover FMA of financial intermediary loans, or policy-based lending including the policy component of sector development programs.[8]

8. In the case of policy-based lending (including the policy component of sector development programs), the focus of ADB support is on implementation of the policy reform, and the ADB loan is provided for defraying a part of the adjustment costs. ADB funds flow through the country PFM system which needs to be assessed, and the project level FMA techniques described in this guidance note will have limited relevance.

9. For results-based lending, many of the techniques described in this guidance note may be adopted, particularly where the executing or implementing agency is a special purpose

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[4] For instance, poor budgeting practices may mean inadequate allocation of resources for project implementation, leading to inadequate financing and implementation delays.

[5] For instance, weak internal controls may mean that quantities and quality of work executed may not be thoroughly verified.

[6] For instance, weak financial management may lead to non-maintenance of fixed assets registers and/or periodic physical verifications, providing an opportunity for project assets to be pilfered, thereby jeopardizing project completion, reducing expected service levels and/or economic life. They may also impose higher operations and maintenance costs.

[7] Not all requirements of loans and grants apply to high value TAs. Project teams should discuss the extent of financial due diligence required with Financial Management Unit (OSFM) and Loan Administration Division (CTLA).

[8] While many of the principles in this note will apply to financial intermediary loans as well as policy-based lending, there are other considerations and requirements that are beyond the scope of this note. Specific guidance on financial intermediation loans will be provided in a separate guidance note. Policy-based lending requires a country- and sector-level public financial management assessment approach that is beyond the scope of this guidance note.

vehicle, or a state-owned enterprise. ADB‘s assessment of the financial management system will determine the degree to which it manages fiduciary risks and provides a reasonable assurance that program funds will be used appropriately. The assessment will be guided by commonly accepted good practice principles. It needs to be noted that in result-based lending (RBL), ADB loan disbursements occur on achievement of disbursement linked indicators as confirmed by verification protocols, instead of contract award, physical progress, and disbursement. ADB does not monitor procurement in RBLs unlike in the case of project loans. The fiduciary assessment for results-based lending requires an assessment of country or sector PFM aspects, as ADB loan proceeds are commingled with the country’s own resources and flow through the PFM system. The link between use of ADB loan proceeds and program outputs is not as direct as it is in the case of conventional project lending.

D. Definition of Key Concepts

10. Financial management can be defined as the overall arrangement for planning, directing, monitoring, organizing, and controlling of the monetary resources of an organization, with a view to efficient accomplishment of the enterprise objectives. It comprises multiple processes, including financial accounting, management (and cost) accounting, asset management, cash and treasury management, financial reporting, internal controls, and internal and external audit. Each of these processes should incorporate sub-processes and techniques including management, forecasting, strategic planning, planning and budgeting, procurement, disbursement, control, and communications and reporting.

11. Internal control is a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. Internal control has both active and passive components, which are intended to function continuously and provide appropriate checks and balances.[9] Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. While it is a component of internal control, internal control is much more than internal audit.

12. Risk can be defined as a probability or threat of damage, injury, liability, loss or other negative occurrence that is caused by external or internal vulnerabilities that may be avoided through preemptive action. Risks can be divided into (i) inherent,[10] arising from the overall environment in which the executing or implementing agency operates before considering the impact of the agency’s financial management systems and controls; and (ii) control risks, the risk that the project’s financial management and internal control arrangements are inadequate to ensure that project funds are used economically and efficiently and for the intended purpose.

[9] For instance, a basic internal control step is to ensure that one person is not responsible for receiving goods, verifying invoices, and making payments for any procurement. Another example would be that bank reconciliations are performed and exceptions reviewed by those who do not write the checks.

[10] External environment may be a high risk situation, for example, because the audit of the public accounts of the country are in arrears for over a year, and the audit reports are not reviewed by the public accounts committee of the Parliament. Nevertheless, it is possible that the executing agency may be better administered, with audited entity accounts being reviewed by those charged with governance within 6 months of the end of each financial year, and actions initiated promptly to address weaknesses.

II. APPROACH AND METHODOLOGY

A. Dealing with Integrity, Fraud, and Corruption Risks

13. The ownership structure of the executing or implementing agency should be ascertained. For entities with less than 100% government ownership, integrity due diligence may be required on the ultimate beneficial owners other than the government. In such instances, the project team should seek the advice of the Office of Anticorruption and Integrity.

14. While performing the FMA, the reviewer should take into consideration the risk of corruption and fraud. Financial management arrangements are usually designed to prevent, or minimize, the risk of misstatement, fraud and corruption. **Box 1** provides a typical hierarchy of PFM arrangements. The International Standards on Auditing (or their equivalent, International Standards for Supreme Audit Institutions) require that an external auditor carry out an assessment of the accounting and internal control systems and plan the audit such that the audit risk (that the audit opinion is inappropriate due to the accounts being materially misstated) is at an acceptably low level. Reviewers are usually not able to perform the in-depth assessments that an external auditor would, and consequently, the external audit reports and management letters would provide a good source of information on material issues affecting the entity financial statements.

Box 1: Typical Public Financial Management Arrangements

- **Public Accounts Committee** - review of external audit reports in public hearings
- **Audit Committee of the Board of Directors** - review internal and external audit reports and management letters
- Internal control systems (e.g.), segregation of duties, physical verifications and reconciliations, compulsory staff rotation of duties.
- Internal audit
- Independent external audit - performed by the supreme audit institution of the country, or by professional accounting firms.

15. The country PFM assessments focus on the national laws, rules and regulations governing financial management. In some cases, sub-national assessments (or sector level assessments) may also be available. The project level assessment should focus on the specific risks that could impact effective project implementation.

16. The project FMA should be informed by the country and sector PFM environment, and the proposed arrangements in the executing or implementing agency of the project. For instance, the country may have sound budgeting and financial reporting arrangements and adequate legislative oversight, and the sector in general also may have many well-managed entities, but the particular executing or implementing agency chosen for the proposed project may not have appropriately qualified finance personnel, leading to a weakness in the organizational structure jeopardizing overall financial management arrangements. Conversely, despite a somewhat weak PFM at the country level, the executing or implementing agency may have sound internal financial management arrangements.

B. Use of Country PFM or Entity Financial Management Systems

17. The FMA exercise is aimed at assessing the suitability and acceptability of the existing country systems for financial management – be it the PFM systems for general government sector units (GGSU) or the standalone financial management arrangements, of all other entities. In many cases, the existing financial management arrangements may be found adequate for implementing ADB-supported projects as they are, or with some modification and strengthening. An ad hoc financial management system for the ADB-supported project should be the last resort, to be adopted only when existing systems are found completely unreliable and unacceptable.[11] Such exceptional cases may even require that ADB defer the approval of the loan, and support the executing or implementing agency with TA resources to establish and staff the project implementation unit (PIU), develop various management systems (including financial) and thereafter proceed with loan approval. **Box 2** summarizes the considerations for GGSU.

Box 2: Use of Country Public Financial Management System for General Government Sector Unit

- REVIEW ANALYSIS OF PFM SYSTEM IN THE COUNTRY PROGRAM AND STRATEGY
- APPLY GUIDANCE FROM STAFF INSTRUCTIONS OF SECOND GOVERNANCE AND ANTI-CORRUPTION PLAN

Issues to be considered

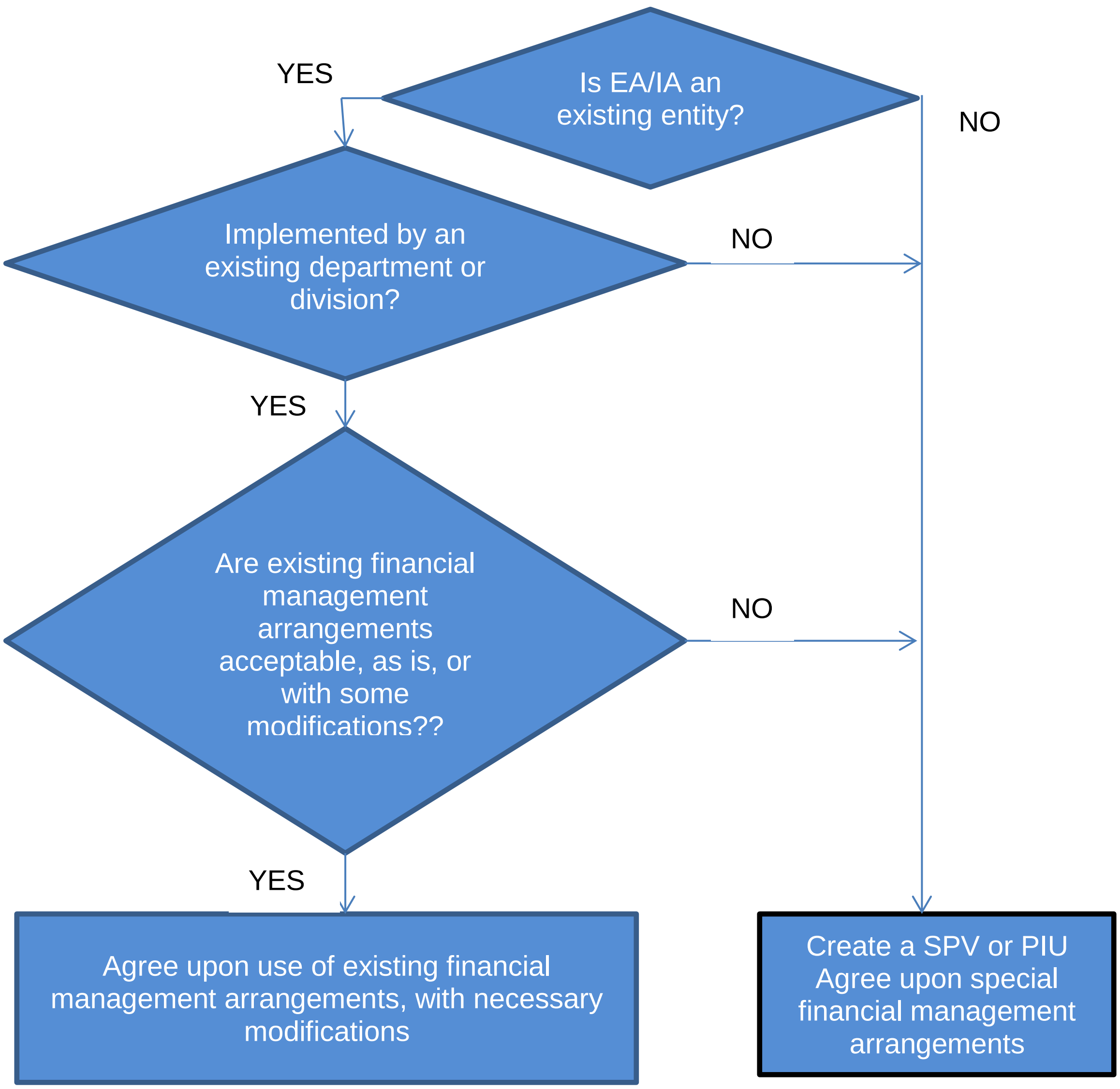
- **Budget:** Is external financing, whether program or project, and its intended use, included and reported in the country's budget documentation?
- **Treasury:** Are external financing funds received into the general government revenue account, and thereafter disbursed following the general financial rules of the country?
- **Accounting:** Is external financing recorded and accounted using the country's own accounting system, following the country's classification and reporting arrangements?
- **Auditing:** Are externally financed projects audited by the governments' conventional auditing systems (e.g., by the Supreme Audit Institution, without the imposition of additional or special accounts (other than providing an assurance on use of funds for intended purposes, or an opinion on compliance with financial covenants)?

Source: ADB. 2014. *Revised Staff Guidance for Implementing the Second Governance and Anticorruption Action Plan (GACAP II).*Manila.

[11] Sometimes, the project design includes the recruitment of consultants who would provide full financial management support. This is an undesirable (but sometimes unavoidable) arrangement, as consultants will demobilize at project completion, and take away the financial management expertise. The design should invariably include recruitment (if necessary) and training of executing or implementing agency staff, to mitigate the high risk that the consultant capacity provided during project construction will disappear at completion. This would ensure effective financial management support during operation and maintenance of the completed project facilities.

Figure 1: Use of Entity Financial Management Systems

For State-owned Enterprises, Non-governmental Organizations, Private Sector Units



EA=executing agency, IA=implementing agency, PIU=project implementation unit, SPV=special purpose vehicle

18. Project executing and implementing agencies may be either GGSU, or state-owned autonomous or semi-autonomous entities (companies, societies, or similar), or non-governmental organizations. For GGSUs, the proposed financial management arrangements would tend to adopt the country's PFM arrangements, while all other entities would tend to have their own financial management arrangements that may be different from the country PFM arrangements. **Figure 1** illustrates the assessment of financial management arrangements for all entities other than GGSU.

19. It has been noted that modifications and enhancements are more common in the case of GGSUs, where special purpose PIUs are established, sometimes requiring ring-fencing. Other project entities may also need to establish PIUs. In all such cases, the FMA will need to be based on proposed organization structure, its interaction with (and independence from) the parent executing or implementing agency, and proposed internal controls. It is likely that an existing executing or implementing agency would extend its current financial management system to the PIU, in which case the current system should be assessed. The reviewer, in consultation with the executing or implementing agency, should agree upon the appropriate organizational structure, procedures manual, accounting manual, internal control and reporting arrangements, arrangements for internal and external audit, etc. Implementation of such recommendations would need to be documented in the Action Plan for financial management with specific milestones, and perhaps covenanted in the legal agreements.

20. The framework guiding financial management assessment at the country, sector and project level is based on the cascading approach adopted under ADB's Governance framework and indicated in **Table 1**.

Table 1: Financial Management Assessment - Framework

When	Output	What, How and Who
CPS	Country (and priority sector) Governance and Risk Assessment	As part of the Governance Risk Assessment, the CPS team reviews the PFM environment at the country and priority sector levels, supplemented by primary assessments of specific issues, and review of existing diagnostic studies such as ADB's own prior assessments, Public Expenditure and Financial Accountability, [a] Report on the Observance of Standards and Codes, [b] etc. This will also take into consideration prevailing legal and institutional context.
Project Concept	Financial due diligence requirements, and potential risk areas	The concept paper should outline the extent of due diligence required for the executing or implementing agency based on the Country PFM Assessment, an existing FMA or other diagnostic studies.
Processing	FMA Report, inputs to PAM, RAMP, RRP	The FMA to be performed by the project team, with support from the regional financial management specialist. In appropriate cases, the support of the Financial Management Unit of Operations Services and Financial Management Department may be sought. This will take into consideration the CPS assessment for the country and sector, recommendations from project procurement related review of ADB, procurement risk assessments, and update any existing FMA and assessments by other development partners.

When	Output	What, How and Who
Implementation	Updated Action Plan (and FMA report, if required)	The FMA is a dynamic assessment, and should be reviewed regularly during implementation, particularly with reference to implementation of the Action Plan for risk mitigation and capacity development, and updated as necessary.

CPS=country partnership strategy, FMA=financial management assessment, PFM=public financial management, PAM=project administration manual, RAMP=risk assessment and risk management plan, RRP= report and recommendation of the President.

[a] The Public Expenditure and Financial Accountability (PEFA) Program was founded in 2001 as a multi-donor partnership between seven donor agencies and international financial institutions to assess the condition of country public expenditure, procurement and financial accountability systems and develop a practical sequence for reform and capacity-building actions. This is country-led, with support from multi-lateral and bilateral development organizations. National and sub-national assessments can be found at this link: www.pefa.org.

[b] In this exercise, the International Monetary Fund and the World Bank are undertaking a large number of summary assessments of the observance of selected standards relevant to private and financial sector development and stability. Of particular interest for ADB FMA are assessments relating to corporate governance, and accounting and audit. National assessments can be found at this link: Reports on the Observance of Standards and Codes http://www.worldbank.org/ifa/rosc.html.

III. FINANCIAL MANAGEMENT ASSESSMENT - PROCESS

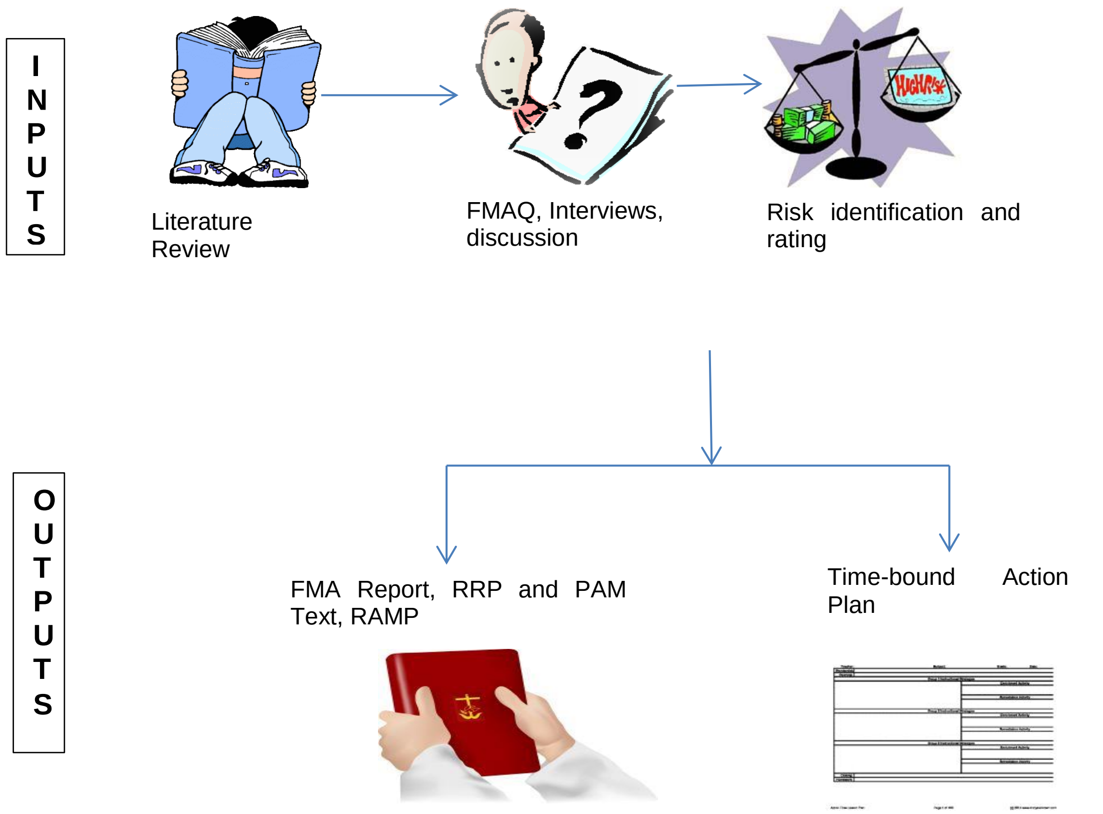
A. Planning the Assessment

21. The project team is responsible for the FMA. Being a skilled, but subjective, exercise, FMAs should be performed by persons possessing an advanced qualification in a financial discipline (preferably a chartered accountancy or equivalent designation), and prior experience in performing such assessments.[12] Control and supervision of the FMA exercise should rest with qualified and experienced ADB staff[13] even though some of the work may be out-sourced to the project preparatory technical assistance (PPTA) consulting firm, individual or staff consultant. In planning the assessment, consideration should be given to the country and sector governance risk assessments and PFM assessments. It is recommended that the project team should include staff with adequate skills in financial due diligence, to either perform the FMA, or guide the consultants. **Figure 2** illustrates the FMA process.

[12] The practice of recruiting a single consultant to perform both economic and financial due diligence is not recommended, as it is often not successful due to the limited supply of consultants who are equally skilled in both disciplines. Consultants with experience in similar assignments with other development partners may be engaged.

[13] It is envisaged that staff from a regional department, resident mission or OSFMD, with financial management expertise, could conduct and/or supervise the review. Where available, the Financial Management Specialist of Regional Departments should support such reviews. It is recommended that this work should not be “out-sourced” to project executing or implementing agencies, i.e., a self-assessment is not recommended.

Figure 2: Financial Management Assessment Process



FMA=financial management assessment, PAM=project administration manual, RAMP=risk assessment and risk management plan, RRP=report and recommendation of the President.

22. Project teams may rely upon the country and sector PFM assessments prepared during the CPS. If the assessments are not available (perhaps because this is a new country / sector), or are outdated, it may be necessary to complete (or update) the country or sector PFM assessment[14] to better understand the systemic issues that could impact project performance. The Staff Instructions for GACAP II also recommend that, in the event of ADB interventions in new sectors, a governance risk assessment should be prepared for the sector.

23. The FMA will usually involve, but is not limited to (i) the review of country PFM assessments; (ii) an assessment of financial management systems and capacity of the executing and implementing agencies, including potential strengths / weaknesses of project-specific financial management arrangements; (iii) risk assessment and preparation of a risk management plan; (iv) initial draft of the project's financial management, funds flow, accounting and auditing arrangements; and (v) the development of appropriate covenants to address these

[14] Updating a country or sector level governance risk assessment or PFM assessment is both resource- and skills-intensive task. Project teams should adopt this approach only under exceptional circumstances, and seek specialist staff and/or consultant resources at the concept paper stage. They should also discuss this with the team responsible to prepare CPS.

issues. An indicative terms of reference (TOR) is provided in **Appendix 1**. While PPTA or staff consultants may be assigned to deliver the whole or part of the TOR, the project team remains responsible to supervise the consultants for quality control purposes.

24. In the case of the second or subsequent tranches in a multi-tranche financing facility, or for second or subsequent loans to the same executing or implementing agency, project teams should update the FMA conducted earlier. Even in the case of first-time executing or implementing agencies, diagnostic work performed by other development partners, if it is recent,[15] may be updated. Special attention should be paid to risks earlier identified, and the assessment should verify if the mitigation / avoidance actions proposed were fully implemented, and their impact on the risks. The current situation should be assessed, and any new risks that may be identified should also be rated and addressed suitably.

25. It is essential that the risk assessment in the project FMA is realistic, as this is the only way for appropriate risk mitigations to be identified and built into the project design. If the risks are understated, the absence of appropriate risk mitigations may lead to financial accountability issues and potential reputational risks. It is also important that the assessment is conducted more rigorously on those units, facilities and staff within the executing and implementing agencies that will directly contribute to project implementation. The assessment of higher level entities, under whom the units would function, should focus more narrowly on the interaction between the financial management systems.

B. Conducting the Assessment

26. **Box 3** provides an illustrative list of secondary literature that should be reviewed before the project team (or consultants) embarks on a field visit. It may be emphasized that there may be other sources of information that are available for a particular project, sector, or country, beyond those listed here. The primary source of fresh information will be interviews conducted with counterpart staff,[16] development partners and other stakeholders. The reviewer may perform verifications of key or material issues, through test-checks, walk-throughs,[17] etc.

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[15] Prepared within the last 3 years.

[16] Should it be required, project teams may need to enter into a confidentiality and nondisclosure agreements. They should consult with OSFM and OGC for each such transaction.

[17] An external auditor would normally perform actual walk-throughs and tests of internal control and systems to form an assessment of the financial management systems and arrangements, to establish their reliability. However, the FMA exercise of ADB does not necessarily require such an approach, due to considerations of budget, time, and also ADB’s status as a lender rather than an auditor.

Box 3: Literature Review for FMA

ADB Internal Sources

- Country Partnership Strategy – Governance Risk Assessments, including for priority sectors.
- Project Procurement Related Reviews.
- Existing FMA for the executing or implementing agency.
- Findings and recommendations of project completion reports for the executing or implementing agency.
- Experience in past or ongoing projects with the same agencies.
- Special reviews or reports by the Office of the Auditor General.
- Procurement capacity assessments.
- Assessments by the Independent Evaluation Department such as Sector or Country Assistance Program Evaluations.

External Sources

- Public Expenditure and Financial Accountability reports
- Report on Observance of Standards and Codes – Accounting and Audit
- Financial management capacity assessments by the World Bank or other multilateral or bilateral development partners
- Country Procurement Assessment Reports
- Reports on websites, such as Bloomberg, Standard and Poor, Bankscope, etc.

Note: This is an illustrative, and not exhaustive list.

27. To elicit information in a structured and comprehensive manner, the Financial Management Assessment Questionnaire (FMAQ, **Appendix 2**), should be administered by the reviewer. It needs to be emphasized that the FMAQ is a useful, but not mandatory,[18] tool for structured information gathering, but it is not a substitute for the FMA report. The FMAQ may be filled in jointly by the reviewer and the counterpart staff, to ensure acceptability and a common understanding.[19] More information may be required than envisaged in the FMAQ, and should be obtained by the reviewer through supplementary questions, interviews, or research (e.g., from the internet or other published or unpublished sources). This would be supplemented by a critical review of the external audit reports of the executing agency / implementing agency, the auditors' management letters, internal audit reports.[20,21] Copies of these key documents should be obtained, apart from others such as budgets, organization charts, accounting manuals, charts of accounts, etc. Such reviews should take into consideration the actions taken by the executing or implementing agency to address the external audit qualifications, and observations and recommendations in the management letter and internal audit reports.

28. The results are analyzed and form the basis for completing the assessment of the project financial management arrangements. An outline for the Financial Management Assessment Report is provided in **Box 4** below, and an annotated outline is available in **Appendix 3**.

[18] For second or subsequent loans (or tranches), it may not be necessary to administer the full FMAQ; instead, it may be administered selectively, or the FMA updated based on past experience.

[19] The FMAQ is not intended to be a self-assessment by the executing or implementing agency. Because of its critical nature as a source of information, the responses should be elicited by the reviewer.

[20] A qualification in an external audit report should be carefully considered, as it would have been reported by the external auditor only because it is material in the entity context. However, the impact at the project level needs to be measured or evaluated.

[21] Preferably, at least the reports for the preceding 3 years should be reviewed.

Box 4: Financial Management Assessment Report Outline

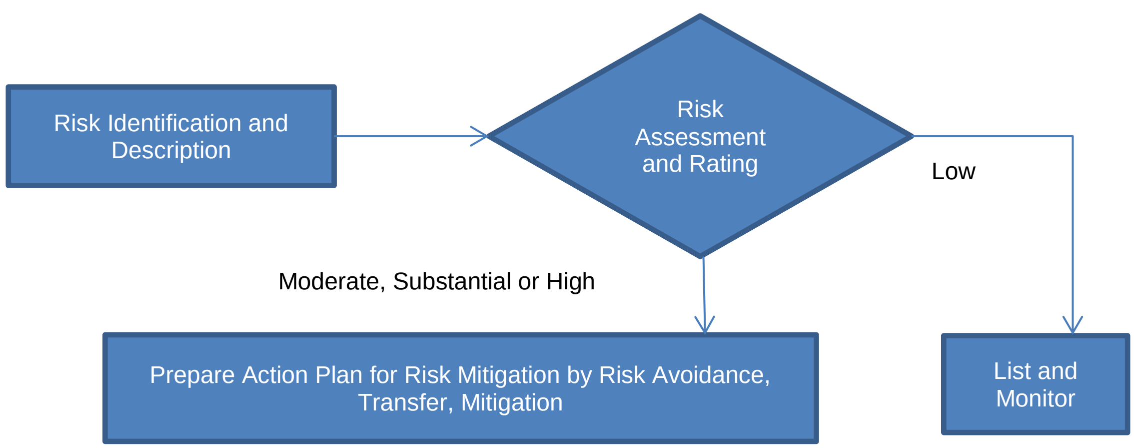
Executive Summary

I. Introduction
II. Project Description
III. Country and Sector Financial Management Issues (from CPS assessments)
IV. Project Financial Management System
  A. Overview of the executing agency/implementing agency, Financial Management System and Institutional Context
  B. Strengths
  C. Weaknesses
  D. Personnel, Accounting Policies and Procedures, Internal and External Audit
  E. Financial Reporting Systems, including Use of Information Technology
  F. Disbursement Arrangements, Funds Flow Mechanism
V. Risk description and rating
VI. Proposed Action Plan
VII. Suggested Covenants
VIII. Conclusion
Appendixes

C. Financial Management Risk Assessment

29. **Risk Identification:** The risk assessment process is illustrated in **Figure 3**. If a weakness is identified, it may be necessary to gather additional information to determine the root cause of the weakness and how it may result in a risk. See **Box 5** for an example.

Figure 3: The Risk Assessment Process



Box 5: Risk Identification - Example	
Weakness:	Executing agency has weak control over its fixed assets – it does not maintain a fixed assets register, conduct periodic physical verification and perform a reconciliation of the books with physical assets.
Risk:	Risk of loss or abuse of its assets, leading to misappropriation, inability to complete the project or efficiently operate project facilities, and financial losses. Risk of incorrect or incomplete annual financial statements.

30. **Risk Assessment:** Once risks have been identified, it is necessary to determine whether or not the risk is likely to occur and, if it were to occur, the impact it could have on the project. Likelihood of occurrence is to be assessed in terms of probability of occurrence. Impact if a risk were to materialize is to be assessed by the assessor based on experience, and should take into consideration potential damages (in terms of loss to the project and/or the enterprise). **Box 6** illustrates an example of how a weakness is translated to a risk, and then rated.

Box 6: Risk Identification – Example	
Weaknesses:	External audit report for the last 3 years has noted that original supporting documents are not always available, and hence the audit trail is incomplete. The agency does not have a document retention policy as regards location, safe preservation, and retention period.
Risk:	Risk of errors, fraud or misappropriation remaining undetected due to non-availability of original supporting documents; lack of an audit trail to enforce accountability.
Likelihood of occurrence:	Likely
Impact:	High
Risk Rating:	High

31. Individual risks should be categorized and rated for their potential impact, and the combined impact of all risks should guide the FMA exercise in making a comprehensive assessment of project level financial management risk. The risks should be categorized as follows:

High	-	likely to occur, will have high impact if occurs
Substantial	-	unlikely to occur, will have high impact if occurs
Moderate	-	likely to occur, will have low impact if occurs
Low	-	not likely to occur, will have low impact if occurs

32. Risk assessment is a subjective exercise, and requires prior experience and an appropriately qualified and skilled practitioner. It requires not only knowledge of good financial management practices, but also country context and sector- and entity-specific conditions. The purpose of the risk assessment is to identify situations or events and the extent to which they could hamper the achievement of project outcomes and/or outputs, and hinder effective project

implementation. The categorization of risk also helps to guide the nature and extent of mitigating measures required. Mitigation measures will need to be tailored to fit each project, and a "one-size-fits-all" approach may fail. An example is provided in **Box 7**.

Box 7: Risk Assessment – Example			
Weakness	**Risk and Impact**	**Likelihood**	**Rating**
Executing Agency does not maintain a fixed assets register, conduct periodic physical verification and reconciliation with the books. Assets are portable and stored in scattered locations without fencing or access controls.	High – *Chances of misappropriation of assets.*	Likely	High
Executing Agency does not maintain original supporting documents, and does not have a document retention policy.	High – *Chances of error or fraud remaining undetected.*	Likely	High
Project accounts are proposed to be maintained on Excel, and re-entered into the accounting software of the enterprise on a quarterly basis.	High – *errors of data re-entry; Excel-based accounting is error-prone*	Likely	High

33. **Risk Mitigation and Management:** Risks are assessed and categorized based on the responses in the FMAQ and the supplementary information gathered, to help focus and prioritize remedial action. A variety of options exist for managing risks, these include:

- Avoidance / mitigation / transfer (for risks rated "High" or "Substantial") – specific measures to minimize or eliminate unacceptable risks. Avoidance may require re-design of part or whole of the project, or particular processes. Mitigation measures are directed at reducing the severity of the risk, reducing the probability of the risk materializing or reducing exposure to the risk. Risk transfer could occur, for instance, through insurance (against theft, damage, etc.).

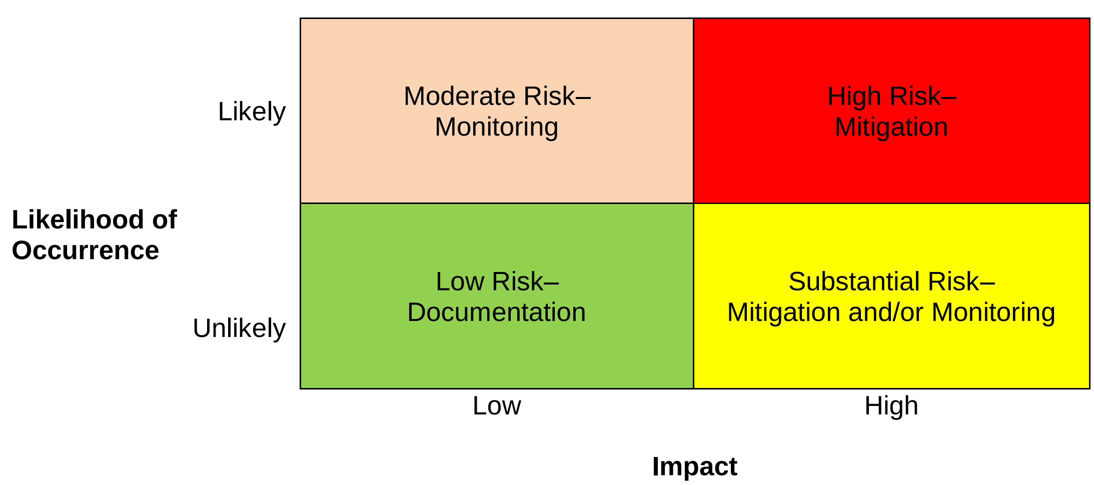
- Monitoring (for risks rated "Substantial" or "Moderate") – mechanisms to track and report on exposure to risks, particularly to ensure that neither the probability nor the impact associated with the risk is increasing.

- Identification and documentation (for risks rated "Low") – measures to document and draw attention to risks without needing to formally mitigate or monitor them.

Example of Time-bound Action Plans			
Weakness	**Mitigation Actions**	**Responsibility**	**Timeframe**
Weak control over inventory can lead to theft or misappropriation, inability to construct or operate the project.	Introduce inventory accounting, control over issue and utilization, physical verification and reconciliation. 3 staff to be recruited and trained.	Implementing agency	Staff recruitment within 3 months of loan effectiveness. First year – with 100% help of project implementation consultants. Second year, staff take over with supervision by consultants. Third year onwards by staff.
Executing agency does not maintain original supporting documents, and there is no document retention policy	At the project level, initiate procedure for safe custody of original supporting documents including safe storage, and retention period, access control, etc. Initiate policy dialogue to persuade the management to adopt a similar policy for the enterprise.	Implementing agency Implementing Agency and ADB	Policy to be adopted and implemented at project level as a condition for disbursement Enterprise level dialogue to be continued until satisfactory resolution is achieved.

34. Risks that are likely to impact the achievement of the project outcome or output need to be mitigated. Particular attention should be accorded to mitigating high and substantial risks. The purpose of risk mitigation is to strike a balance between the efficiency of the mitigation measure and the cost of implementing it. **Figure 4** provides a high level approach to determining how and when to mitigate risks.

Figure 4: Risk Categories



D. Documentation Requirements and Validation

35. The FMA exercise should be fully documented in the working files of the project team, and preferably saved electronically in eStar. In case some of the work was performed by consultants, the final report of the consultants should include all the details, including the FMAQ and all supplementary information. Copies of documents (e.g., audit reports, accounts manuals, organization charts, management letters, etc.) should also be submitted to ADB along with the final report. The final FMA should be reviewed and validated either by the financial specialist (ADB staff on the project team) or the regional financial management specialist for quality, consistency and acceptability.

36. The governance section of the report and recommendation of the President (RRP) should have a summary assessment along with the overall risk rating of the financial management arrangements. The FMA should be broadly described in the Project Administration Manual, and the time-bound Action Plan included for monitoring during implementation. The FMA description in the project administration manual should be analytical, and provide an assessment of the financial management arrangements, as illustrated in **Box 8**. Although not mandatory, the project team may consider including the full FMA as a supplementary linked document to the project documents.[22]

Box 8: Descriptive Vs. Analytical

Descriptive – The entity uses CSP accounting software. The project will use HVDC software, to be specially procured for project accounting.

Analytical – The entity uses CSP accounting software, but will procure a new software, HVDC, for project accounting. Project accounting staff will need to be specially trained in HVDC. Electronic transfer of project accounts cannot be accomplished from HVDC to CSP, and integration of the project accounts with the entity accounts will require use of Excel spreadsheets, and manual re-entry of data from the project accounts into the CSP software. This arrangement is considered to have substantial risk associated with it, and requires additional training, monitoring, audit checks and reconciliations to ensure acceptable quality of the entity financial statements.

37. **Financial Management, Internal Control and Risk Assessment (FMICRA) Table:** Once the risks have been identified and categorized[23] and mitigation measures identified, the FMICRA is prepared to include the risks and mitigations identified from the FMA exercise.[24] The template is provided as **Appendix 4**.

38. It is recommended that the mitigation Action Plan that is developed as part of the FMA should be time-bound, preferably with interim milestones. This would help monitoring the implementation of such plans during project implementation, and while updating the FMA for second or subsequent tranches or new loans to the same executing agency or implementing agency. This will also facilitate a constructive policy dialogue with the executing agency and

[22] Disclosure may be subject to any non-disclosure agreement that may have been entered into during processing.
[23] Financial management risks are identified on a four-point scale of Low, Moderate, Substantial or High. The current template of the RAMP envisages only a three-point scale of Low, Medium, or High. As a temporary workaround, it is suggested that financial management risks rated Low, Moderate and High be classified as Low, Medium or High in the RAMP. The reviewer should exercise judgment in classifying a risk rated Substantial as either Medium, or High, depending upon its significance. It is expected that the RAMP will be eventually modified to allow a four-point scale.
[24] Pre-mitigation risks are disclosed with their "as-is" rating. The implementation of mitigation measures, measurement of their impact, and re-assessment of the risk, is a time-consuming process.

implementing agency. Preferably, the risk assessment should be fully reviewed at least once every year, having regard to implementation of the mitigation actions. The time-bound Action Plan should be monitored regularly to ensure actions are implemented as agreed. A sample completed FMICRA is provided in **Appendix 5**.

39. The final step of the risk assessment is to determine the overall project financial management risk. The overall risk should be rated as high, substantial, moderate or low, and summarized in the main text of the RRP. In considering the overall risk rating, the reviewer considers the cumulative impact of the risks identified and the likelihood of that impact occurring. This requires professional judgment and is unlikely to be a straight average of individual risk ratings. Significant financial management risks (at least all those rated substantial or high) should be reported in the Risk Assessment and Risk Management Plan (link document to the RRP) as illustrated in **Box 9**.

Box 9: Risk Assessment and Management Plan - Example

Risk Description	Risk Assessment	Mitigation Measures or Risk Management Plan
Due to weak control over fixed assets, there is risk of loss of project assets, leading to risks for project completion and operation	High	• A fixed asset register for project assets will be introduced as a condition for contract award. • A Periodic physical verification plan will be developed prior to contract award, with provision for periodic counts including reconciliations. • Agency staff will be trained in fixed asset management (including reporting and monitoring) • Policy dialogue will continue to strengthen awareness of the importance of asset management and internal control over fixed assets across the executing agency.
Internal control weakness – risks of misappropriation of bank funds, due to long delays in performing bank reconciliations. Even when performed, the same person maintaining the bank book performs the reconciliation, and the reconciliation is not reviewed by any senior officer.	High	• At the project level, a standard operating procedure will be introduced whereby the reconciliation is to be performed by someone other than the person maintaining the bank book. Bank reconciliations will be performed at a minimum, on a monthly basis, perhaps more frequently should there be higher volume transactions. • The reconciliations must be reviewed and signed off by a senior officer, and every item carefully scrutinized for appropriate resolution. • Policy dialogue will continue to encourage management to adopt similar bank reconciliations procedures across the entire agency and covering all bank accounts.

IV. CONCLUSIONS

40. These guidelines and associated tools are provided to assist country, sector and project teams to better assess financial management risk at the project level, to ensure that this is effectively mitigated or managed through project implementation arrangements. However, guidelines cannot substitute for professional judgment. It is up to the ADB country, sector or project team to determine how best to obtain sufficient comfort that ADB funds will be used for intended purpose, with due regard to efficiency and effectiveness. In exceptional situations, OSFM’s advice should be sought.

PROJECT FINANCIAL MANAGEMENT ASSESSMENT
INDICATIVE TERMS OF REFERENCE

A. Background

This section should include details pertaining to the project, as well as a description of the country and sector financial management environment that could impact the project implementation.

B. Purpose and Scope of the Assessment

The purpose of the assessment is to (i) identify the capacity, procedural and organizational constraints that could hinder effective project implementation and agree on an action plan with the executing agency/implementing agency and the developing member country (DMC) concerned, to address these constraints; and (ii) determine the overall financial management risk, and establish appropriate review and supervision processes, to mitigate these risks.

Scope: The review team will:

(i) Review (and update if necessary) the Governance and Risk Assessments at the Country and Sector level from the current Country Partnership Strategy.

(ii) Assess strength and weaknesses in project financial management practices and capacity from the perspective of (a) organizational and staff capacity; (b) information management; (c) financial management practices; (d) effectiveness;

(iii) Identify and evaluate financial management and internal control risks at the project level.

(iv) Propose risk mitigation and management strategies and/or activities with appropriate timelines and suggested responsibilities.

C. Approach and Methodology

The review will include, but not be limited to:

(i) Identification of the organisation, entity or unit that is to be the prime focus of the assessment. This could be the executing agency, and/or the implementing agency, and/or the project implementation unit.

(i) Assess relevant previous experience with the executing and implementing agencies, assess how much reliance can be placed on PFM systems by reference to CPS, FMAs from similar prior projects by ADB or other development partners. Review the available secondary information sources, including internal audit reports, external audit reports, management letters, for the last 3 years; reports on Public Expenditure and Financial Accountability, [1] Report on Observance of Standards and Codes; Project Procurement Related Reports by ADB; etc.

[1] Public Expenditure and Financial Accountability (PEFA) http://www.pefa.org

(ii) Assessment of project financial management arrangements – based on interviews with government counterparts, executing and implementing agencies, development partners and relevant stakeholders supported by review of the internal control arrangements, internal and external auditor's reports, and sampling of specific transactions. The Financial Management Assessment Questionnaire should be completed by the reviewer, in consultation with the counterparties, for each of project's executing and implementing agencies.

a. The assessment should include a review of the tone at the top, budgetary framework, external and internal audit , staffing, fund flows mechanism, financial accounting and reporting, management information systems, and detailed internal control activities (over payments, payroll, maintenance of bank balances, imprest accounts, advances, fixed assets, completeness of liabilities, etc.)

b. Identify and recommend appropriate funds flow mechanism for all sources of project funding; recommend ring-fencing of ADB funded expenditure, if necessary

(iii) Prepare a narrative description of the project financial management systems, including identification of strengths and weaknesses.

(iv) Identify and assess financial management and internal control risks, on the basis of degree of impact and likelihood of occurrence using the following scale:

High:	likely to occur, high impact if occurs
Substantial:	unlikely to occur, high impact if occurs
Moderate:	likely to occur, low impact if occurs
Low:	unlikely to occur, low impact if occurs

(v) Propose risk mitigation/management strategies to address identified risks:

High:	risk avoidance / mitigation / transfer recommended
Substantial:	risk avoidance/ mitigation/ monitoring recommended
Moderate:	risk monitoring recommended
Low:	risk documentation/identification

(vi) Summarize findings in the Financial Management and Internal Control Assessment Report.

(vii) RRP and PAM inputs prepared

D. Key Deliverables

(i) Financial Management Assessment Report
(ii) RRP and PAM inputs

E. Consultants Terms of Reference

This TOR can be executed by ADB project teams. However, if they intend to use consultants to execute a part or the whole of this TOR, the following additional information would be required. Number of consultants, specific skills and expertise will depend upon the amount of field work required, the number of sectors to be assessed, and the specific financial management issues identified during the initial country, sector and agency financial management assessments. The consultants should preferably be qualified chartered accountants, certified public accountants (or equivalent) with relevant experience (to be defined). A combined Economics and Financial Expert position is not recommended, as it has not been found to be successful in delivering the full scope of work defined in the terms of reference, as there is a limited number of practitioners with sufficient skills and competence in both disciplines.

Financial Management Assessment Questionnaire[1]
(Note: This questionnaire should be used as a tool only to gather information relevant for assessing financial management capacity of executing and implementing agencies. It may be used selectively for second subsequent projects, or periodic financing reports. Additional questions may be required as deemed fit).

Topic		Response	Potential Risk Event
1. Executing / Implementing Agency			
1.1	What is the entity's legal status / registration?		
1.2	How much equity (shareholding) is owned by the Government?		
1.3	Obtain the list of beneficial owners of major blocks of shares (non-governmental portion), if any.[2]		
1.4	Has the entity implemented an externally-financed project in the past? If yes, please provide details.		
1.5	Briefly describe the statutory reporting requirements for the entity.		
1.6	Describe the regulatory or supervisory agency of the entity.		
1.7	What is the governing body for the project? Is the governing body for the project independent?		
1.8	Obtain current organizational structure and describe key management personnel. Is the organizational structure and governance appropriate for the needs of the project?		
1.9	Does the entity have a Code of Ethics in place?		
1.10	Describe (if any) any historical issues reports of ethics violations involving the entity and management. How were they addressed?		
2. Funds Flow Arrangements			
2.1	Describe the (proposed) project funds flow arrangements in detail, including a funds flow diagram and explanation of the flow of funds from ADB, government and other financiers, to the government, EA, IA, suppliers, contractors, ultimate beneficiaries, etc. as applicable.		
2.2	Are the (proposed) arrangements to transfer the proceeds of the loan (from the government / Finance Ministry) to the entity and to the end-recipients satisfactory?		
2.3	Are the disbursement methods appropriate?		

[1] This questionnaire should be administered by ADB staff or consultant (the Reviewer), and utilized only to obtain information, and to identify and describe potential risk events. Rating of risks should be carried out separately by assessing their likelihood and impact.
[2] In such cases, consult OAI on the need for integrity due diligence on non-governmental beneficial owners.

Topic	Response	Potential Risk Event
2.4 What have been the major problems in the past involving the receipt, accounting and/or administration of funds by the entity?		
2.5 In which bank will the Imprest Account (if applicable) be established?		
2.6 Is the bank in which the imprest account is established capable of − • Executing foreign and local currency transactions? • Issuing and administering letters of credit (LC)? • Handling a large volume of transaction? • Issuing detailed monthly bank statements promptly?		
2.7 Is the ceiling for disbursements from the imprest account and SOE appropriate/required?		
2.8 Does the (proposed) project implementing unit (PIU) have experience in the management of disbursements from ADB?		
2.9 Does the PIU have adequate administrative and accounting capacity to manage the imprest fund and statement of expenditure (SOE) procedures in accordance with ADB's Loan Disbursement Handbook (LDH)? Identify any concern or uncertainty about the PIU's administrative and accounting capability which would support the establishment of a ceiling on the use of the SOE procedure.		
2.10 Is the entity exposed to foreign exchange risk? If yes, describe the entity's policy and arrangements for managing foreign exchange risk.		
2.11 How are the counterpart funds accessed?		
2.12 How are payments made from the counterpart funds?		
2.13 If project funds will flow to communities or NGOs, does the PIU have the necessary reporting and monitoring arrangements and features built into its systems to track the use of project proceeds by such entities?		
2.14 Are the beneficiaries required to contribute to project costs? If beneficiaries have an option to contribute in kind (in the form of labor or material), are proper guidelines and arrangements formulated to record and value the labor or material contributions at appraisal and during implementation?		

Topic		Response	Potential Risk Event
3. Staffing			
3.1	What is the current and/or proposed organizational structure of the accounting department? Attach an organization chart.		
3.2	Will existing staff be assigned to the project, or will new staff be recruited?		
3.3	Describe the existing or proposed project accounting staff, including job title, responsibilities, educational background and professional experience. Attach job descriptions and CVs of key existing accounting staff.		
3.4	Is the project finance and accounting function staffed adequately?		
3.5	Are the project finance and accounting staff adequately qualified and experienced?		
3.6	Are the project finance and accounting staff trained in ADB procedures, including the disbursement guidelines (i.e., LDH)?		
3.7	What is the duration of the contract with the project finance and accounting staff?		
3.8	Identify any key positions of project finance and accounting staff not contracted or filled yet, and the estimated date of appointment.		
3.9	For new staff, describe the proposed project finance and accounting staff, including job title, responsibilities, educational background and professional experience. Attach job descriptions.		
3.10	Does the project have written position descriptions that clearly define duties, responsibilities, lines of supervision, and limits of authority for all of the officers, managers, and staff?		
3.11	What is the turnover rate for finance and accounting personnel (including terminations, resignations, transfers, etc.)?		
3.12	What is training policy for the finance and accounting staff?		
3.13	Describe the list of training programs attended by finance and accounting staff in the last 3 years.		
4. Accounting Policies and Procedures			
4.1	Does the entity have an accounting system that allows for the proper recording of project financial transactions, including the allocation of expenditures in accordance with the respective components, disbursement categories, and sources of funds (in particular, the legal agreements with ADB)? Will the project use the entity accounting system? If not, what accounting system will be used for the project?		

Topic		Response	Potential Risk Event
4.2	Are controls in place concerning the preparation and approval of transactions, ensuring that all transactions are correctly made and adequately explained?		
4.3	Is the chart of accounts adequate to properly account for and report on project activities and disbursement categories? Obtain a copy of the chart of accounts.		
4.4	Are cost allocations to the various funding sources made accurately and in accordance with established agreements?		
4.5	Are the General Ledger and subsidiary ledgers reconciled monthly? Are actions taken to resolve reconciliation differences?		
4.6	Describe the EA’s policy for retention of accounting records including supporting documents (e.g, ADB’s policy requires that all documents should be retained for at least 1 year after ADB receives the audited project financial statements for the final accounting period of implementation, or 2 years after the loan closing date, whichever is later). Are all accounting and supporting documents retained in a defined system that allows authorized users easy access?		
4.7	Describe any previous audit findings that have not been addressed.		
Segregation of Duties			
4.8	Are the following functional responsibilities performed by different units or persons: (i) authorization to execute a transaction; (ii) recording of the transaction; (iii) custody of assets involved in the transaction; (iv) reconciliation of bank accounts and subsidiary ledgers?		
4.9	Are the functions of ordering, receiving, accounting for, and paying for goods and services appropriately segregated?		
Budgeting System			
4.10	Do budgets include physical and financial targets?		
4.11	Are budgets prepared for all significant activities in sufficient detail to allow meaningful monitoring of subsequent performance?		
4.12	Are actual expenditures compared to the budget with reasonable frequency? Are explanations required for significant variations against the budget?		
4.13	Are approvals for variations from the budget required (i) in advance, or (ii) after the fact?		

Topic		Response	Potential Risk Event
4.14	Is there a ceiling, up to which variations from the budget may be incurred without obtaining prior approval?		
4.15	Who is responsible for preparation, approval and oversight/monitoring of budgets?		
4.16	Describe the budget process. Are procedures in place to plan project activities, collect information from the units in charge of the different components, and prepare the budgets?		
4.17	Are the project plans and budgets of project activities realistic, based on valid assumptions, and developed by knowledgeable individuals? Is there evidence of significant mid-year revisions, inadequate fund releases against allocations, or inability of the EA to absorb/spend released funds? Is there evidence that government counterpart funding is not made available adequately or on a timely basis in prior projects? What is the extent of over- or under-budgeting of major heads over the last 3 years? Is there a consistent trend either way?		
Payments			
4.18	Do invoice-processing procedures require: (i) Copies of purchase orders and receiving reports to be obtained directly from issuing departments? (ii) Comparison of invoice quantities, prices and terms, with those indicated on the purchase order and with records of goods actually received? (iii) Comparison of invoice quantities with those indicated on the receiving reports? (iv) Checking the accuracy of calculations? (v) Checking authenticity of invoices and supporting documents?		
4.19	Are all invoices stamped PAID, dated, reviewed and approved, recorded/entered into the system correctly, and clearly marked for account code assignment?		
4.20	Do controls exist for the preparation of the payroll? Are changes (additions/deductions/modifications) to the payroll properly authorized?		

Topic	Response	Potential Risk Event
Policies And Procedures		
4.21 What is the basis of accounting (e.g., cash, accrual) followed (i) by the entity? (ii) By the project?		
4.22 What accounting standards are followed (International Financial Reporting Standards, International Public Sector Accounting Standards – cash or accrual, or National Accounting Standards (specify) or other?		
4.23 Does the project have adequate policies and procedures manual(s) to guide activities and ensure staff accountability?		
4.24 Is the accounting policy and procedure manual updated regularly and for the project activities?		
4.25 Do procedures exist to ensure that only authorized persons can alter or establish a new accounting policy or procedure to be used by the entity?		
4.26 Are there written policies and procedures covering all routine financial management and related administrative activities?		
4.27 Do policies and procedures clearly define conflict of interest and related party transactions (real and apparent) and provide safeguards to protect the organization from them?		
4.28 Are manuals distributed to appropriate personnel?		
4.29 Describe how compliance with policies and procedures are verified and monitored.		
Cash and Bank		
4.30 Indicate names and positions of authorized signatories for bank accounts. Include those persons who have custody over bank passwords, USB keys, or equivalent for online transactions.		
4.31 Does the organization maintain an adequate and up-to-date cashbook recording receipts and payments?		
4.32 Describe the collection process and cash handling procedures. Do controls exist for the collection, timely deposit and recording of receipts at each collection location?		
4.33 Are bank accounts reconciled on a monthly basis? Or more often? Is cash on hand physically verified, and reconciled with the cash books? With what frequency is this done?		
4.34 Are all reconciling items approved and recorded?		
4.35 Are all unusual items on the bank reconciliation reviewed and approved by a responsible official?		
4.36 Are there any persistent/non-moving reconciling items?		

Topic	Response	Potential Risk Event
4.37 Are there appropriate controls in safekeeping of unused cheques, USB keys and passwords, official receipts and invoices?		
4.38 Are any large cash balances maintained at the head office or field offices? If so, for what purpose?		
4.39 For online transactions, how many persons possess USB keys (or equivalent), and passwords? Describe the security rules on password and access controls.		
Safeguard over Assets		
4.40 What policies and procedures are in place to adequately safeguard or protect assets from fraud, waste and abuse?		
4.41 Does the entity maintain a Fixed Assets Register? Is the register updated monthly? Does the register record ownership of assets, any assets under lien or encumbered, or have been pledged?		
4.42 Are subsidiary records of fixed assets, inventories and stocks kept up to date and reconciled with control accounts?		
4.43 Are there periodic physical inventories of fixed assets, inventories and stocks? Are fixed assets, inventories and stocks appropriately labeled?		
4.44 Are the physical inventory of fixed assets and stocks reconciled with the respective fixed assets and stock registers, and discrepancies analyzed and resolved?		
4.45 Describe the policies and procedures in disposal of assets. Is the disposal of each asset appropriately approved and recorded? Are steps immediately taken to locate lost, or repair broken assets?		
4.46 Are assets sufficiently covered by insurance policies?		
4.47 Describe the policies and procedures in identifying and maintaining fully depreciated assets from active assets.		
Other Offices and Implementing Entities		
4.48 Describe any other regional offices or executing entities participating in implementation.		
4.49 Describe the staff, their roles and responsibilities in performing accounting and financial management functions of such offices as they relate to the project.		
4.50 Has the project established segregation of duties, controls and procedures for flow of funds and financial information, accountability, and reporting and audits in relation to the other offices or entities?		
4.51 Does information among the different offices/ implementing agencies flow in an accurate and timely fashion? In particular, do the offices other		

Topic		Response	Potential Risk Event
	than the head office use the same accounting and reporting system?		
4.52	Are periodic reconciliations performed among the different offices/implementing agencies? Describe the project reporting and auditing arrangements between these offices and the main executing/implementing agencies.		
4.53	If any sub-accounts (under the Imprest Account) will be maintained, describe the results of the assessment of the financial management capacity of the administrator of such sub-accounts.		
Contract Management and Accounting			
4.54	Does the agency maintain contract-wise accounting records to indicate gross value of contract, and any amendments, variations and escalations, payments made, and undisbursed balances? Are the records consistent with physical outputs/deliverables of the contract?		
4.55	If contract records are maintained, does the agency reconcile them regularly with the contractor?		
Other			
4.56	Describe project arrangements for reporting fraud, corruption, waste and misuse of project resources. Has the project advised employees, beneficiaries and other recipients to whom to report if they suspect fraud, waste or misuse of project resources or property?		
5. Internal Audit			
5.1	Is there an internal audit (IA) department in the entity?		
5.2	What are the qualifications and experience of the IA staff?		
5.3	To whom does the head of the internal audit report?		
5.4	Will the internal audit department include the project in its annual work program?		
5.5	Are actions taken on the internal audit findings?		
5.6	What is the scope of the internal audit program? How was it developed?		
5.7	Is the IA department independent?		
5.8	Do they perform pre-audit of transactions?		
5.9	Who approves the internal audit program?		
5.10	What standards guide the internal audit program?		
5.11	How are audit deficiencies tracked?		
5.12	How long have the internal audit staff members been with the organization?		
5.13	Does any of the internal audit staff have an IT background?		
5.14	How frequently does the internal auditor meet with the audit committee without the presence of		

Topic		Response	Potential Risk Event
	management?		
5.15	Has the internal auditor identified / reported any issue with reference to availability and completeness of records?		
5.16	Does the internal auditor have sufficient knowledge and understanding of ADB's guidelines and procedures, including the disbursement guidelines and procedures (i.e., LDH)?		
6. External Audit – entity level			
6.1	Is the entity financial statement audited regularly by an independent auditor? Who is the auditor?		
6.2	Are there any delays in audit of the entity? When are the audit reports issued?		
6.3	Is the audit of the entity conducted in accordance with the International Standards on Auditing, or the International Standards for Supreme Audit Institutions, or national auditing standards?		
6.4	Were there any major accountability issues noted in the audit report for the past three years?		
6.5	Does the external auditor meet with the audit committee without the presence of management?		
6.6	Has the entity engaged the external audit firm for any non-audit engagements (e.g., consulting)? If yes, what is the total value of non-audit engagements, relative to the value of audit services?		
6.7	Has the external auditor expressed any issues on the availability of complete records and supporting documents?		
6.8	Does the external auditor have sufficient knowledge and understanding of ADB's guidelines and procedures, including the disbursement guidelines and procedures (i.e., LDH)?		
6.9	Are there any material issues noted during the review of the audited entity financial statements that were not reported in the external audit report?		
External Audit – project level			
6.10	Will the entity auditor audit the project accounts or will another auditor be appointed to audit the project financial statements?		
6.11	Are there any recommendations made by the auditors in prior project audit reports or management letters that have not yet been implemented?		
6.12	Is the project subject to any kind of audit from an independent governmental entity (e.g. the		

Topic		Response	Potential Risk Event
	supreme audit institution) in addition to the external audit?		
6.13	Has the project prepared acceptable terms of reference for an annual project audit? Have these been agreed and discussed with the EA and the auditor?		
6.14	Has the project auditor identified any issues with the availability and completeness of records and supporting documents?		
6.15	Does the external auditor have sufficient knowledge and understanding of ADB's guidelines and procedures, including the disbursement guidelines and procedures (i.e., LDH)?		
6.16	Are there any recommendations made by the auditors in prior audit reports or management letters that have not yet been implemented?		
6.17	[For second or subsequent projects] Were past audit reports complete, and did they fully address the obligations under the loan agreements? Were there any material issues noted during the review of the audited project financial statements and related audit report that have remained unaddressed?		
7. Reporting and Monitoring			
7.1	Are financial statements and reports prepared for the entity?		
7.2	Are financial statements and reports prepared for the implementing unit(s)?		
7.3	What is the frequency of preparation of financial statements and reports? Are the reports prepared in a timely fashion so as to be useful to management for decision making?		
7.4	Does the entity reporting system need to be adapted for project reporting?		
7.5	Has the project established financial management reporting responsibilities that specify the types of reports to be prepared, the report content, and purpose of the reports?		
7.6	Are financial management reports used by management?		
7.7	Do the financial reports compare actual expenditures with budgeted and programmed allocations?		
7.8	How are financial reports prepared? Are financial reports prepared directly by the automated accounting system or are they prepared by spreadsheets or some other means?		

Topic		Response	Potential Risk Event
7.9	Does the financial system have the capacity to link the financial information with the project's physical progress? If separate systems are used to gather and compile physical data, what controls are in place to reduce the risk that the physical data may not synchronize with the financial data?		
7.10	Does the entity have experience in implementing projects of any other donors, co-financiers, or development partners?		
8. Information Systems			
8.1	Is the financial accounting and reporting system computerized?		
8.2	If computerized, is the software off-the-shelf, or customized?		
8.3	Is the computerized software standalone, or integrated and used by all departments in the headquarters and field units using modules?		
8.4	How are the project financial data integrated with the entity financial data? Is it done through a module in the enterprise financial system with automatic data transfer, or does it entail manual entry?		
8.5	Is the computerized software used for directly generating periodic financial statements, or does it require manual intervention and use of Excel or similar spreadsheet software?		
8.6	Can the system automatically produce the necessary project financial reports?		
8.7	Is the staff adequately trained to maintain the computerized system?		
8.8	Do the management, organization and processes and systems safeguard the confidentiality, integrity and availability of the data?		
8.9	Are there back-up procedures in place?		
8.10	Describe the backup procedures – online storage, offsite storage, offshore storage, fire, earthquake and calamity protection for backups.		

PROJECT FINANCIAL MANAGEMENT ASSESSMENT
REPORT OUTLINE

EXECUTIVE SUMMARY

Overall Assessment of project financial management risk (High, Substantial, Moderate or Low)
Summary of weaknesses and risks identified
Summary of mitigation/management measures to be adopted

I. INTRODUCTION

The introduction should indicate that the assessment was prepared in accordance with the technical guidance note for financial management assessment. The assessment should indicate when and how the assessment was undertaken "The FMICRA was undertaken from <<< to >>> by (indicate names of ADB staff and consultants). Preparation activities included reviewing documents, ADB's ongoing experience, interviews with counterpart and discussions with stakeholders."

II. BRIEF PROJECT DESCRIPTION – *Summarize the project outcome and outputs, total cost estimates and financing plan, period of implementation, names of the executing and implementing agencies.*

III. COUNTRY AND SECTOR FINANCIAL MANAGEMENT ISSUES (EXTRACT FROM CPS ASSESSMENTS) – *With special attention to identified High or Substantial financial management risks.*

IV. PROJECT FINANCIAL MANAGEMENT SYSTEM

A. Overview

This section should provide a narrative description of the country public financial management systems covering:

(i) Organization and Staff Capacity
(ii) Information Management
(iii) Budgeting and Funds Flow Arrangements
(iv) Effectiveness
(v) Accountability Measures (e.g., public audits, legislative oversight)

B. Strengths

This section should identify strengths of project financial management arrangements, particularly those elements that ADB may wish to rely upon. This should include those elements considered fully capable or competent.

C. Weaknesses

This section should identify weaknesses of the project financial management arrangements. This should be include those elements considered to be weak or need of improvement

D. Personnel, accounting policies and procedures, internal control, internal and external audit

E. Financial reporting systems, including use of information technology

F. Disbursement arrangements, funds flow mechanism

V. RISK DESCRIPTION AND RATING – INCLUDING THE FINANCIAL MANAGEMENT AND INTERNAL CONTROL RISK ASSESSMENT

Based on the weaknesses identified, fiduciary risks should be identified, assessed on the basis of likelihood of occurrence and degree of impact, and mitigation measures identified. Risks should first be classified as inherent or project risk, and then an overall risk assessment combining both should be provided.

VI. PROPOSED TIME-BOUND ACTION PLAN

VII. SUGGESTED FINANCIAL MANAGEMENT COVENANTS

VIII. CONCLUSION

The overall conclusion including an opinion as to whether or not the project arrangements with appropriate mitigation measures, are considered satisfactory.

Appendixes:
(Illustrative list)

Completed financial management assessment questionnaires, funds flow arrangements, organization charts, audit reports, management letters, etc.

FINANCIAL MANAGEMENT, INTERNAL CONTROL AND RISK ASSESMENT AND RISK MANAGEMENT PLAN TEMPLATE

Risk Description	Risk Assessment	Mitigation Measures or Risk Management Plan
Inherent Risk		
1. Country Specific		
1. Entity-specific		
Overall Inherent Risk		
Project Risk		
1. Implementing entity		
2. Funds flow		
3. Staffing		
Accounting policies and Procedures		
3. Internal Audit		
4. External Audit		
5. Reporting and Monitoring		
6. Information Systems		
Overall Project Risk		
Overall (Combined) Risk		

Instructions:

1. **Risk Assessment** – Assign any one rating - High, Substantial, Moderate, or Low (no combinations)

2. **Mitigation Measures -** For risks that can be mitigated by the executing agency, implementing agencies, and ADB, specify major actions planned for mitigation, responsible agencies, and timelines for implementation. For risks that are mitigated by other agencies (e.g., government and other development agencies), outline the key mitigating measures.

SAMPLE COMPLETED FINANCIAL MANAGEMENT, INTERNAL CONTROL AND RISK ASSESSMENT WORKING TABLE

Risk Description	Impact	Likelihood	Risk Assessment	Mitigation Measures or Risk Management Plan
Inherent Risk				
1. Country Specific - Audit reports of supreme audit institution are submitted with a delay of over 2 years, and are not reviewed by the Public Accounts Committee of Parliament. Consequently, audit opinions are ignored, and tend to get repeated without satisfactory resolution. (From PEFA assessment of November 2013)	High	Likely	High	World Bank, ADB, USAID and other development partners are in dialogue with the government. Grants have been provided by the US Government and World Bank to strengthen the capacity of the SAI to provide timely audits. The government has been requested to request the Parliament to ensure that the Public Accounts Committee meets regularly, and reviews the SAI's audit reports.
1. Entity-specific - The roles of the Entity as a whole, the Project Implementation Unit for the ADB-assisted project, and the design and supervision consultants are not clearly delineated, leading to confusion and overlaps.	Low	Likely	Moderate	A clear organizational structure will be prepared; specific terms of reference will be developed for PMU staff and the design and supervision consultants.
Overall Inherent Risk			**Moderate**	
Control Risk				
1. Implementing Entity - The Finance function of the executing agency is headed by a Manager level officer, who is quite junior compared to General Managers who head all other functions. There is no Board-level representation for the finance function.	High	Likely	High	Appointment of a Director (Finance) to the Board, upgrading the staff head of the Finance function to the level of General Manager, and appointment of a suitably qualified and experienced person to both positions are conditions for loan disbursement.
2. Funds flow - Due to weak financial position, the executing agency is unable to provide sufficient liquidity to pay for ADB share of project expenditure in advance, and will need 100% of the counterpart resources to be provided by the government.	High	Likely	High	ADB's direct payment and commitment letters will be adopted to pay ADB's share of project costs. A covenant to be included in the loan agreement requiring the government to provide adequate and timely counterpart funding. An imprest fund is not recommended.
3. Staffing - While adequate book-keeping skills are available, there is a high staff turnover in the finance department. There is no procedure in place for regular rotation of staff on different duties; and there is no process for periodic performance evaluation and imposition of penalties for non-performance. Accounting staff have limited knowledge of ADB requirements.	Moderate	Likely	Moderate	Staff to be remunerated at market rates to mitigate high turnover. Rotation of staff to be implemented to the extent feasible. A performance management system to be put in place. Staff to be provided specific training in ADB requirements.
3. Accounting policies and Procedures - There are no written Accounting Policy or Procedure manuals. Bank reconciliations are in arrears by over 6 months at any point of time. Customer and supplier account reconciliations have never been carried out.	High	Likely	High	A consultant will be provided to assist the executing agency to prepare an Accounting Manual, and disseminate the manual among all staff including handholding for initial implementation. Strict policy will be put in place for carrying out bank reconciliations in a timely manner.
4. Internal Audit - there is no internal audit function.	High	Likely	High	An Audit Committee of the Board will be constituted, and a chartered accounting firm recruited to carry out internal audit functions, particularly focusing on effective operation of internal controls (including review of bank reconciliations). The internal audit reports, to be provided on a quarterly basis, will be reviewed by the Audit Committee and actions taken to address the findings.
5. External Audit - Audit is carried out by the Supreme Audit Institution. While competent, the SAI is short-staffed, leading to inordinate delays of up to 1 year in finalizing audits. This has knock-on effects on preparation of accounts for subsequent years as the opening balances are not finalized in a timely manner.	Moderate	Likely	Moderate	Audit of the project accounts will be out-sourced to a private firm of chartered accountants under the supervision of the SAI. This will be funded by the ADB loan proceeds, and audit will be required to be submitted within 5 months after the close of each financial year.
6. Reporting and Monitoring - No in-year reporting is provided, with annual financial reports being provided based on unreconciled accounts with a delay of up to 6 months (unaudited) and over 1 year for audited. There is no comparison of actual with budget.	High	Likely	High	Project financial reports will be generated on a quarterly basis with the help of the design and supervision consultants. Project budget figures will be compared with actual in each quarterly report. Annual unaudited repors will be provided within 45 days of the close of each financial year; and audited annual reports will be submitted within 5 months after the close of each financial year.
7. Information Systems - There is partial computerization, with heavy reliance on Excel spreadsheets to produce financial reports. The IT department is poorly staffed and resourced, and the Excel spreadsheets are inherently open to accidental (or intentional) errors..	High	Likely	High	A computerized accounting software will be procured for the project financial reporting, and implemented initially through consultants in the design and supervision consultancy. Staff will be trained to operate the software during the project implementation.
Overall Control Risk			**High**	
Overall (Combined) Risk			**Substantial**	