EXPOSURE DRAFT

PROJECT FINANCIAL MANAGEMENT MANUAL

LOAN DEPARTMENT, THE WORLD BANK

FEBRUARY 1999

PROJECT FINANCIAL MANAGEMENT MANUAL

FOREWORD

Purpose of the Manual

1. This Exposure Draft is to help people improve the financial management of projects funded by the World Bank. The fundamental aim is therefore to improve project management. It is also to promote improved compliance with Operational Policies and Bank Procedures (OP/BP) 10.02 on *Financial Management* and to facilitate the use of a new method of disbursement introduced by the World Bank, which uses periodic Project Management Reports (PMRs) as a basis for disbursement.[1] This manual elaborates on the procedures provided, and supersedes the PMR model presented in the LACI Implementation Handbook, Annex 6. Reference to the PMR models presented in the annexes to this manual is therefore strongly recommended.

2. The Bank has issued policies and procedures for the guidance of Bank and borrower staff on various aspects of financial management. The Bank's fundamental policies and procedures regarding financial management of Bank-financed projects are described in OP/BP 10.02 which was updated with effect from November 1, 1997. Further guidance is given in the *Financial Accounting, Reporting and Auditing Handbook* (FARAH), and also in two regional documents (the *Guide for Review and Design of Accounting and Reporting Systems for World Bank Financed Projects*, and the *Audit Manual for Bank Financed Projects,* both published by the East Asia and Pacific Region). This manual is not designed to replace these documents, but rather to be used with them. In due course existing project financial management manuals, guidelines and handbooks, including this manual, will be combined.

3. The Bank's Board of Executive Directors approved the Loan Administration Change Initiative (LACI) for implementation with effect from July 1, 1998. This changed loan and project administration procedures through:

- providing a methodology for more thorough compliance with OP/BP 10.02;
- preparing PMRs for Bank-financed projects; and
- introducing PMR-based disbursement as the benchmark which Bank-financed projects should either adopt immediately, or seriously aspire to, in the foreseeable future.

The Bank's emphasis on quality at entry is critical to understanding this manual. The financial management of each project is to be reviewed before the project is negotiated. The review is to establish whether the project has adequate financial management. If it does not, it cannot proceed to Board without remedial work. A plan is needed showing how the project's financial management and

[1] The procedures are explained in the *Implementation Handbook* (LIH) of the Loan Administration Change Initiative (LACI).

other systems will be improved in order to satisfy Bank requirements.

The review also establishes whether the project is capable of producing quarterly PMRs to meet Bank requirements. If it cannot, a short-term action plan is needed demonstrating how the project's financial management capacity will be strengthened in order to do this. In the interim, the project proceeds without delay, using existing disbursement procedures and transitional PMRs (Chapter 4 Section 4.6). When a project *is* capable of producing quarterly PMRs, disbursement is normally made on that basis. Exceptionally, the borrower may request to continue using traditional disbursement procedures for an agreed period. However, irrespective of the disbursement method, PMRs are to be produced each quarter. Given these features, the financial management system of the project, and its ability to produce quarterly PMRs are of central importance.

Structure of the Manual

4. The manual has five chapters and ten annexes. Chapter 1 is a brief introduction. Chapter 2 is an overview of project financial management procedures. It addresses issues arising at each stage of the project cycle.[2] These two chapters can be read separately for those wishing to understand the essentials, without getting immersed in detail. The other three chapters provide information of a more detailed nature:

- Design and Assessment of Project Financial Management Systems (Chapter 3);
- Project Management Reports (Chapter 4); and
- Annual Financial Statements (Chapter 5).

The annexes provide further information on various aspects of the three detailed chapters.

Feedback and Review

5. Since this is an exposure draft we strongly encourage you, the user, to provide us with the results of your experience in its practical application. <u>Your comments and suggestions should be sent to Randolph A. Andersen, Loan Department before July 31, 1999</u>, when we plan to review and update the manual.

[2] It deals specifically with the impact of LACI on project financial management.

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ACRONYMS USED

AG	=	Auditor-General
ARCS	=	Audit Reports Compliance System
CAS	=	Country Assistance Strategy
CFAA	=	Country Financial Accountability Assessment
CPFA	=	Country Profile of Financial Accountability
DO	=	Disbursement Officer
EAP	=	East Asia and Pacific Region (of the World Bank)
FARAH	=	Financial Accounting, Reporting and Auditing Handbook
FMS	=	Financial Management Specialist
GEF	=	Global Environment Facility
IAS	=	International Accounting Standards
IASC	=	International Accounting Standards Committee
IBRD	=	International Bank for Reconstruction and Development
IDA	=	International Development Association
IDF	=	Institutional Development Fund
IFAC	=	International Federation of Accountants
INTOSAI	=	International Organization of Supreme Audit Institutions
LACI	=	Loan Administration Change Initiative
LCU	=	Local Currency Unit
LIH	=	LACI Implementation Handbook
LIL	=	Learning and Innovation Loan
LOA	=	Loan Department
LOADR	=	Loan Department, Office of the Director
MOF	=	Ministry of Finance
OCS	=	Operational Core Services
OMR	=	Output Monitoring Report
OP/BP	=	Operational Policies/Bank Procedures
PAD	=	Project Appraisal Document
PCD	=	Project Concept Document
PHRD	=	Policy and Human Resources Development Fund
PIP	=	Project Implementation Plan
PIU	=	Project Implementation Unit
PMR	=	Project Management Report
PPF	=	Project Preparation Facility
PS	=	Procurement Specialist
SA	=	Special Account
SAI	=	Supreme Audit Institution
SOE	=	Statement of Expenditures
TL	=	Task Team Leader
TOR	=	Terms of Reference
TT	=	Task Team

Chapter 1: Introduction

1.1 FINANCIAL MANAGEMENT

1.1.1 Project Financial Management

Project financial management is a process which brings together planning, budgeting, accounting, financial reporting, internal control, auditing, procurement, disbursement and the physical performance of the project with the aim of managing project resources properly and achieving the project's development objectives.

1.1.2 The Need for Good Financial Management

Financial management, as broadly defined above, is essential for Bank-financed projects. It is more than an administrative and control process. Sound financial management is a critical ingredient of project success. Timely and relevant financial information provides a basis for better decisions, thus speeding the physical progress of the project and the availability of funds, and reducing delays and bottlenecks. This is why Bank policy and procedures require good financial management in Bank-funded projects. Sound project financial management provides:

- essential information needed by those who manage, implement and supervise projects, including government oversight agencies and financing institutions;
- the comfort needed by the borrower country, lenders and donor community that funds have been used efficiently and for the purposes intended; and
- a deterrent to fraud and corruption, since it provides internal controls and the ability to quickly identify unusual occurrences and deviations.

1.1.3 Applicability of the Manual

The manual aims to assist those involved in financial management aspects of Bank-funded projects. It concerns both design and implementation of financial management systems, including financial reporting. While the primary focus is on Bank-assisted projects, the contents may also be applicable to other projects. In particular, it is hoped that the model presented will satisfy the accountability requirements of government and of other donors, in cases where a Bank project is funded by several contributors.

1.1.4 Regional Flexibility

The manual contains core financial management procedures. Slight regional modifications and adaptations are permissible, but any major deviation from the standards set in this manual should first be cleared with the Head of the Financial Management Board of the Operational Core Services (OCS) Network.

1.2 BANK POLICY AND PROCEDURES

1.2.1 Operational Policy

OP/BP 10.02 requires the borrower and implementing entities of all projects financed by funds administered by the Bank[3] to maintain financial management systems to ensure accurate and timely information regarding project resources and expenditures. Financial management systems:

- include the planning, internal controls, accounting, financial reporting and audit arrangements relating to the project;
- are maintained by the unit, department, agency or entity designated by the borrower to implement and manage the project;
- should relate to the entire project as defined in the Project Appraisal Document (PAD), irrespective of the percentage financed by the Bank (they are not limited to the funds provided by and/or administered by the Bank); and
- should enable the reporting entity, where it is a commercial, industrial or other revenue-earning entity, to provide information which adheres to accounting standards acceptable to the Bank, and where it is not, to provide information in an appropriately designed format acceptable to the Bank.

When project implementation begins, the project implementing entity must have appropriate accounting and internal control systems in place that: (i) reliably record and report the financial transactions of the project (and where appropriate, the entity), including those transactions involving the use of Bank funds; and (ii) provide sufficient financial information for managing and monitoring project activities.

1.2.2 Annual Audited Financial Statements

OP 10.02 requires the submission of annual audited financial statements of the project acceptable to the Bank. Under certain circumstances, implementing entities may also be required to submit annual audited financial statements. In such cases, both project and entity financial statements must be submitted. Bank policy also provides for the submission of periodic unaudited financial reports where appropriate (Chapter 5 provides further details on audited financial statements).

1.2.3 Bank Procedures

[3] Funds administered by the Bank include IBRD loans and IDA credits, project preparation facility (PPF) advances, IDF grants, project-related trust funds and other funds administered by the Bank.

In accordance with BP 10.02, Bank staff inform the borrower and the project implementing entity of the Bank's requirements. For each project, they ensure that adequate financial management systems are in place by assessing the adequacy of the accounting and auditing practices and internal control arrangements. If the systems need improvement, Bank staff agree with the borrower and the project implementing entity on remedial actions and the timetable for their implementation. Where no system is yet in place (such as for a new project implementing entity), Bank staff advise on the design of the proposed financial management system, and agree to a timetable for its implementation. To ensure adequate financial management of project funds, the financial management risks should be carefully assessed and documented.

Chapter 2: Project Financial Management Procedures

INTRODUCTION

This chapter summarizes the entire subject matter of this manual. It discusses the key financial management issues likely to arise at each stage of the project cycle, both for new projects and for projects already under implementation. As explained in the Foreword, a perusal of this chapter should enable the reader to decide whether to delve deeper into any of the subjects in the detailed chapters in Part II.

2.1 ASSESSMENT OF THE PROJECT FINANCIAL MANAGEMENT SYSTEM

In accordance with Bank policy and procedures, all projects appraised from July 1, 1998 onwards are required to have a Financial Management Specialist (FMS) as a member of the project task team (TT) throughout the project cycle. The FMS is required to review the project financial management system, including the project's ability to produce a project management report (PMR).[4] Ideally, the assessment should begin during the early stages of project preparation and should take into account any Country Financial Accountability Assessment (CFAA) that may have been produced. Early action enables the timely identification and introduction of system changes and/or development where necessary.

2.1.1 Role of the Country Financial Accountability Assessment (CFAA)

CFAAs provide for a review of the private and public sector financial management systems of the country and the regulatory framework. Focus on the country helps identify those countries with specific financial management capacity building needs and serves as a mechanism for building appropriate technical assistance into the lending portfolio. CFAAs also provide a framework in which the requirements of project financial management can be better understood. Each CFAA is undertaken by agreement and in partnership with the borrower. It identifies major issues affecting financial management in the country and any departures from international standards. CFAAs are important because they provide the context, without which an assessment of the financial management system of a project lacks country-specific underpinning. Specifically, the CFAA can provide information on topics such as the strength of the local accounting profession, the nature of accounting and auditing standards, the capacity of the supreme audit institution, and the quality and reliability of government accounting. Such detail provides a good basis for assessing project financial management systems. It is therefore recommended that those who assess project financial management systems refer to the CFAA, (where it exists)[5], as well as to the Country Assistance Strategy (CAS) which may also raise relevant issues.

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[4] See Chapter 3 for details.

[5] In some countries a brief version of the CFAA is available. It is called a Country Profile of Financial Accountability (CPFA). The OCS/Financial Management website, which is available to Bank staff, contains examples of CFAAs and CPFAs. A checklist for preparing them is provided in Annex 1.

2.1.2 Scope of the Project Financial Management Assessment

Assessment of the project financial management system may comprise features of both review and design. The financial management system depends on the nature of the project and of its implementing entity, which could be a self-standing project implementing unit (PIU), a government ministry, department, or agency, or a commercial entity. This manual uses "PIU" to refer to all of the above. Where a project is implemented by a government department or agency, it is likely that the project will use the government's standard financial management system. A review of this system would be best carried out as part of a CFAA, so that the project review can be limited to those aspects which are project specific. However, where a CFAA does not exist, the review should cover interrelationships between the financial management systems of the project and of government.

Institutional strengthening can take several years to achieve. The best way to achieve this is to address not only the needs of the project but also those of the wider environment in which it is located. An enclave or ring fence approach, provides only for the financial management needs of the project while ignoring the needs of the larger environment. Treating the project and its accounting systems, procedures and controls as separate may help in the short term to achieve acceptable standards for the project. But in the longer term, ring fencing is likely to be ineffective. Therefore when planning technical assistance, attention should also be given to financial management development needs generally. Often the strengthening of government's financial management systems is a priority.

2.1.3 Assessing the Project Financial Management System

Before assessing the project financial management system, the FMS, working with the task team leader (TL), acquires a thorough understanding of the project concept including its objectives, components, costs, implementing agencies, cost-sharing arrangements, and procurement profile. Starting with the fundamental premise that sound financial management is essential for project success, the FMS looks for a system that is able to provide timely and reliable information, give early warning of problems in project implementation and allow borrower and Bank staff to monitor the project's progress toward its agreed objectives.

The following questions should be posed:

- does the PIU have available an adequate number and mix of skilled and experienced financial management staff;
- does the internal control system ensure the conduct of an orderly and efficient payment and procurement process, and proper recording and safeguarding of assets and resources;
- is the accounting system able to produce financial reports that show budgeted and actual expenditures for the quarter and for the year to date;
- are financial data linked to measures of output of the project; and
- is an independent, qualified auditor in place to review the project internal controls and reporting requirements.

Every effort should be made to harmonize the accounting classifications and headings in the project's chart of accounts (see Paragraph 3.5.5 below) with those used by government (or in the case of implementation by a revenue-earning entity, with its classifications and headings). Frequently, government internal control systems prove to be adequate, but the accounting system cannot provide the level of information required for project management. In some instances, it may be necessary to develop a completely new financial management system for the project, even though this may result in an accounting system running parallel to that required by the government. More detail on the design and assessment of a financial management system is given in Chapter 3 of this manual.

2.1.4 Assessment of Risks

An important aspect of the assessment is the evaluation of the risks associated with the project financial management system and/or identified in the larger government system. As most systems have some inadequacies, it is important that the FMS and other members of the Task Team together apply experienced and professional judgment to this aspect. The risks and their likely impact on the project should be evaluated from both fiduciary and management viewpoints. If the inadequacies are found to be minor, the system can be certified as ready for PMR-based disbursement using Annex 4A of the LIH; if major, Annex 4B or 4C applies. Assessing the risks involved and their materiality helps in choosing the appropriate course of action with respect to the project financial management system. The following are important for assessing the extent of risks:

- financial management risks identified in the CFAA or CPFA;
- track record of the implementing agency with other Bank projects;
- level of corruption as indicated by the *Corruption Perceptions Index* of *Transparency International* [6] or by other means;
- reports of the supreme audit institution;
- timeliness and reliability of government accounts;
- government's track record in the award and management of contracts;
- strength of internal control systems in the public sector; and
- overall level of accountability and transparency concerning the use of public funds.

It is important that controls and other initiatives be considered to mitigate the likely impact, if the risks identified are significant.

2.1.5 Monitoring of Risks and Action Plans

Remedial actions to address identified weaknesses and/or to enhance system development, including actions to enable the project to develop a PMR, should be agreed between the borrower and the Bank and listed in a time-bound action plan. This plan establishes the path for developing the financial management systems of the project. As the project progresses through preparation, appraisal and implementation the plan is updated reflecting problems encountered and progress made. To ensure its

[6] The website of Transparency International can be found at http://www.transparency.de

coherence and continuing relevance the plan should be:

- attached to the report on the assessment of the financial management system (LIH Annexes 4 A-C);
- included in the project implementation plan and in the project files;
- referred to in the loan agreement; and
- attached to the minutes of negotiations.

The above procedure should also be followed in the case of new PIUs for which a financial management system has yet to be developed.

2.1.6 Action Plan Monitoring Responsibilities

The Task Team (with the FMS playing a leading role) is responsible for monitoring financial management aspects of the action plan, ensuring that all actions affecting eligibility for PMR-based disbursement are addressed to their satisfaction before certifying the project for PMR-based disbursement (LIH Annex 4). The action plan must be treated as a living document: it is reviewed and discussed with the borrower periodically, and updated regularly. Staff associated with the project including operations and the Loan Department should be kept informed of material issues arising from the monitoring of the plan.

2.1.7 Project Financial Management Assessment Decisions

While the Bank requires an accredited FMS to sign off on the status of the financial management system (see LIH Annex 4), the initial review of the system may be carried out by staff not certified as an FMS or by consultants. In these instances, the suitability of the reviewer who carries out the assessment is important and therefore an accredited FMS should be consulted. The FMS must also review and approve the terms of reference (TOR) and the work carried out, so as to enable the FMS to issue the certification required. The certification takes the form of one of the following decisions (LIH Annexes 4A-C):

A. Eligible for PMR-based Disbursement	**B. Ineligible for PMR-based Disbursement (but Eligible for Traditional Disbursement)**	**C. Inadequate Financial and/or Procurement Management System**
FMS considers project financial management system adequate. FMS considers project management system adequate to produce a PMR (copy of agreed PMR format included in PIP/and project implementation file, confirmed at negotiations and agreed in the minutes thereof).	FMS considers financial management system adequate with respect to internal controls and basic accounting system but further strengthening is needed and/or the project is unable to provide a PMR. FMS considers financial reporting systems adequate to produce the transitional PMR (Chapter 4, Section 4.6).	FMS considers internal controls and/or basic accounting system inadequate to ensure the financial accountability of project funds. FMS works with borrower to develop an action plan to build capacity. FMS signs certificate as per Section 3.02 and Annex 4-C of LIH.

A. Eligible for PMR-based Disbursement (continued)	B. Ineligible for PMR-based Disbursement (but Eligible for Traditional Disbursement) (continued)	C. Inadequate Financial and/or Procurement Management System (continued)
FMS signs certificate attesting to readiness of project for PMR-based disbursement as per Section 3.01 and Annex 4-A of LIH. PMR disbursement mechanism reflected in PAD and loan agreement.	FMS signs certificate as per Section 3.02 and Annex 4-B of LIH. Loan proceeds without delay using traditional disbursement procedures. PAD and loan agreement include time bound action plan to build borrower capacity to produce a full PMR. This plan would not normally have a duration longer than 18 months.	Board presentation is delayed until a sound system is in place. In exceptional situations, the loan may go forward, but the issue is flagged to the Board, interim internal control measures are instituted and PAD and loan agreement include a time bound remedial action plan.[7]

2.2 PROJECT MANAGEMENT REPORT (PMR)

2.2.1 Project management and supervision are easier and more effective when a project is able to produce regular progress reports. Large entities typically report on, and consider their progress every week or month. Using annual reports for this purpose is quite unrealistic because by the time the information is available, its usefulness has long since expired. The typical period for reporting discussed in this manual is quarterly. For project managers to be able to consider project progress from quarter to quarter, would in most cases be a considerable improvement on the current status quo.

2.2.2 In response to borrowers' requests the Bank has developed a standard form of project management report (PMR). The PMR comprises financial reports, progress reports, and procurement reports. The design and main features of the PMR are discussed in Chapter 4 and are supported by the models included in Annexes 7 to 9. These annexes supersede the model PMR presented in LIH Annex 6. The models presented in this manual should be followed closely to facilitate comparison and to enable electronic submission, processing and disbursement. Normally, the PMR is the basis for the Bank's disbursement of its share of project financing. However it must be prepared within the framework of an acceptable financial management system and submitted in an acceptable format. The design of the PMR provides the flexibility to adapt to specific borrower, cofinancier and other project participants' needs. Ideally, the same set of PMRs should meet the needs of the borrower, the Bank, and other cofinanciers.

[7] See bottom of column B for duration of plan.

2.3 PROJECT DOCUMENTATION

2.3.1 Key Project Documents for the Financial Management Specialist (FMS)

The major project documents of concern to the FMS are the Project Concept Document (PCD), project cost tables, the Project Appraisal Document (PAD), and the legal documents.

2.3.2 Project Concept Document (PCD)

The PCD defines the rationale for a proposed investment operation, describes the framework for its preparation and flags issues of special concern to the Bank. As a result, the content of a PCD varies greatly from project to project. Bank staff can refer to guidelines for completing a PCD on the Operational Core Services (OCS) website. Given the overview nature of the PCD, its financial management content is usually brief. It is concerned with matters such as whether the implementing agency and the PIU have adequate financial management capacity; any special financial management needs which arise from the project concept and overall design; and a program of actions needed for the project to comply with OP/BP 10.02 and LIH. This program should be included in or attached to the project implementation plan.

2.3.3 Project Cost Tables

These must be included in the PAD. They are generated either by using COSTAB (software used by the Bank specifically for the preparation of project cost tables) or by other means such as a spreadsheet. The project cost tables show how project expenditures are to be allocated, in terms of a range of factors such as nature of expenditure, project component, project activity, source of funding and type of procurement. Project cost tables have to meet Bank requirements. At a minimum as far as financial management is concerned, they should provide a two-way matrix allocating the total costs of the project and showing on one axis the nature of project expenditures (e.g. goods, works, consultants' services, and other); and on the other, the project components. For this purpose the project components are the major divisions of the project each of which has a corresponding objective (for an example, see Report 1-B of annexes 7 and 8 which show an education project with five components).

2.3.4 Project Appraisal Document (PAD)

The PAD updates and elaborates on the PCD. It summarizes the assessments by the task team of various aspects of the proposed operation and identifies areas of special concern. It is therefore of great importance as a source of information in the design and review of financial management systems. Given that the PAD covers a wide range of issues, the level of detail on financial management issues needs to be balanced against the requirements of the document as a whole. Summary information on financial management should be included in the PAD with detail included in annexes and in a separate financial management report. The following should be included:

- a brief summary of the major points arising from the review of the project's financial management system (budgeting, accounting, internal control, auditing and reporting) including issues of staffing;

- a statement of opinion on whether the project's financial management system meets the minimum requirements for Board presentation. Where it is not adequate, the statement should enumerate steps to be taken for it to be considered adequate, distinguishing between actions to be taken before and after Board presentation, including any proposed legal covenants regarding necessary financial management actions;
- a statement of opinion on the extent to which the project's financial management system is able to produce a PMR. If it cannot produce a PMR, a summary should be prepared of the action plan necessary to improve the capacity of the system and a timetable for its achievement including necessary legal covenants;
- a statement with respect to the selection and appointment of auditors; and
- the title, date and location of the report arising from the review of the project financial management system.

2.3.5 Legal Documents

The loan agreement is prepared by the Bank's country lawyer assigned to the project. However, the FMS has the responsibility to ensure that covenants in the agreement, adequately reflect agreed upon financial management issues. These would include the submission of the quarterly PMR and of annual audited financial statements, and significant aspects of any action plan. If the financial management system for the project is not yet adequate by the time of negotiations, a covenant is included requiring that an adequate system (including adequate staffing) be in place before loan effectiveness.

2.3.6 Project Records

The project implementation file and the project files kept by Financial Management Specialists should include reference to significant financial management matters such as the monitoring of an action plan (where it exists), the agreed format of the PMR, and significant findings and decisions arising from the Bank's reviews of PMRs, annual audited financial statements and related matters.

2.4 PROJECT IMPLEMENTATION

2.4.1 PMR-Based Disbursement

The Bank will make disbursements against withdrawal applications and PMRs for projects eligible for PMR-based disbursement (Section 5 of LIH).

2.4.2 Submission of PMR

For most projects, PMRs will cover a three month period. However, they may be prepared for a period of four months, if this is necessary to fit the borrower's own reporting cycle. The legal agreement requires submission of the PMR within 45 days following the end of each quarter (or other agreed reporting interval). Section 6.03 of LIH states the procedures to be followed if the PMR is not received as agreed.

2.4.3 Review of PMR

The FMS working on the project (as well as the Procurement Specialist and the TL) is required to review the PMR and report on it in the format shown in the LIH Annex 5. A checklist for reviewing the PMR is in Annex 6. The checklist is designed for a project implemented by a non revenue-earning entity and may not be sufficient to cover the review of a revenue-earning entity. The checklist is for illustrative purpose and is not considered to be exhaustive. FMSs are therefore encouraged to add procedures that they consider necessary for a particular project. In modifying the checklist, the FMS should take into consideration the observations arising from the risk assessment (Paragraphs 2.1.4 - 2.1.5). In addition to the points in the checklist:

- the format of the PMR submitted should be in accordance with the model agreed at project appraisal and confirmed at negotiations;
- the PMR should be reviewed within the timetable shown in Section 5.06 of LIH so that the Bank maintains its service standard for processing borrower disbursement requests and;
- the review of the PMR should include the monitoring of any action plan arising from the review of previous PMRs.

2.4.4 Transitional PMR

All projects appraised on or after July 1, 1998, whether or not they qualify for PMR-based disbursement, are required to submit periodic (usually quarterly) PMRs. Projects which cannot produce a PMR from the outset are required to submit a transitional PMR (Section 4.6 below). The rationale for requiring this interim model is as follows:

- the preparation of the transitional PMR will assist in building the capacity and gaining the experience for moving to PMR-based disbursements at a later date;
- the transitional model provides information for managing and monitoring the project; and
- quarterly preparation will facilitate the preparation of the annual audited financial statements.

While task team (TT) review of the transitional PMR is not directly linked to Bank disbursement, it provides useful information to the TT for project monitoring (including monitoring of the Special Account).

2.4.5 Monitoring the Action Plan

There are two possible project financial management-related action plans. The first is developed and agreed before negotiations to build capacity including the ability to produce a PMR. It addresses issues when the project is not deemed ready for Board presentation because of financial management shortcomings. The second results from the review of each PMR to follow up on issues that may arise. Action plans should be updated at each review (see LIH Annex 5).

2.5 ANNUAL FINANCIAL STATEMENTS AND COMPLIANCE WITH AUDIT COVENANTS

2.5.1 The Bank requires borrowers and PIUs to submit annual audited financial statements to the Bank as soon as possible but normally no later than six months after the end of each fiscal year. In addition, there are stipulated actions to be taken in the event of non-compliance (see OP/BP 10.02) before the Bank can suspend disbursements. While the information in PMRs provides better monitoring capabilities for the Bank than traditional disbursement documentation, the Bank still relies on audited financial statements to validate the quarterly PMRs on which disbursements have been made. For projects using PMR-based disbursement, a financial covenant in the legal agreement requires that audit reports contain a separate opinion as to whether the PMRs submitted during the year, together with the procedures and internal controls involved in their preparation, can be relied upon to support the related withdrawals. This requirement is parallel to the separate audit opinion required for SOE expenditures under traditional disbursement procedures.

2.5.2 The date six months after the end of the fiscal year, when an audit report becomes overdue and sanctions are required, would normally coincide with the receipt of the PMR covering the second quarter of that fiscal year. To ensure uninterrupted disbursement, FMSs should follow up on the status of audit reports, well before they become overdue. If it is likely that the audit report will become overdue, FMSs and TLs should immediately alert their managers both in operations and in LOA to try and resolve the matter before the second quarter PMR-based disbursement request is submitted. A more detailed discussion of annual financial statements and auditing is in Chapter 5. Annex 10 also refers.

2.6 CONVERSION OF EXISTING PROJECTS TO PMR-BASED DISBURSEMENT

2.6.1 While the primary focus is on new projects, all projects approved from July 1, 1995 and any other projects requested by the borrower are considered for conversion to PMR-based disbursement. The assessment and certification procedures to be followed for conversion are identical to those for new projects (LIH Section 3.04). In addition, the borrower prepares a reconciliation of project expenditures, disbursements received, and Special Account movements up to the proposed date of the conversion. The amount of Bank funds disbursed (Special Account advances, replenishments direct payments etc.) should match the sum of Bank funds paid for eligible expenditures plus the Special Account balance. If eligible expenditures have been paid from the Special Account but the relevant documents have not yet been submitted to the Bank, the documents should be submitted promptly, together with a withdrawal application. This will enable PMR-based disbursement to commence.

2.6.2 When the project is converted to PMR-based disbursement, the legal agreement is amended and the “authorized allocation” to the Special Account is eliminated. Thereafter, the amount advanced to the Special Account will be equal to the borrower’s six-month forecast of eligible expenditures minus the balance remaining in the Special Account, subject to a maximum amount set in the legal agreement which is normally 20% of the loan amount (see Report 1-E of the PMRs given in Annexes 7 to 9 and LIH Section 4.04).

Chapter 3: Design and Assessment of Project Financial Management Systems

INTRODUCTION

This chapter deals with financial management issues arising early in the project cycle. Chapter 2 discussed the review and assessment of the financial management environment in which the project will be implemented. Now the discussion moves directly to the details of the project itself, covering such matters as internal controls, records, project planning, and accounting systems and software. While an assessment of the project's ability to produce PMRs is an essential part of the financial management assessment, a detailed discussion on PMRs appears in the next chapter.

3.1 UNDERSTANDING THE PROJECT AND ITS CONTEXT

As explained in Chapter 2, the financial management review should start with a review of the latest Country Financial Accountability Assessment (CFAA) to obtain an understanding of the general financial management environment prevailing in the country. Financial management systems are designed to facilitate project implementation. A clear understanding of the nature and features of the project is therefore of primary importance. This involves understanding the objectives and components of the project. Project objectives are outlined in the PAD. For example the objective may be to "improve secondary education" or "to improve agricultural production via irrigation".

3.1.1 Project Components

The PAD outlines the components of the project under which costs will be incurred to achieve the objectives. These components may be divided into sub-components reflecting the activities and outputs expected from the project. For example, for the objective *to improve secondary education*, project components may be as follows:

- to improve pre-service and in-service teacher education;
- to strengthen linkages between secondary education and teacher training; and
- to raise the qualifications of teacher educators.

These components may be further divided into sub-components, e.g. the project component *to improve pre-service and in-service teacher education,* may have sub-components as follows:

- upgrade science laboratory facilities;
- provide secondary school textbooks and educational materials; and
- make available offices and conference rooms.

3.1.2 Understanding the Project

To understand the project the following should be considered:

- the Project objectives and components as outlined in the PAD;
- implementing agencies, including the relationship between the main agency and other participating agencies;
- the amount and type of expenditure under each component, summarized under works, goods, consultants' services, etc.;
- component costs by locations, e.g. by provinces or districts;
- physical or other measurable indicators of project progress that relate to the cost of each component or sub-component, e.g. training of 1,000 teachers, or the construction of one kilometer of drains;
- sources of project financing (Bank, government, cofinanciers, donors, project beneficiaries, etc.);
- cost-sharing arrangements as they relate to specific expenditure categories, e.g. where the Bank finances 60% of works;
- flow of funds arrangements such as the use and management of Special Accounts, other project bank accounts, direct payments, organizations which will be making payments or receiving funding, currency of payments, etc.;
- the procurement profile of project expenditures e.g. the size, number and nature of contracts; the requirements for international or local bidding, and the use of consultants;
- the information the PIU will need to manage the project; and which government oversight agencies, other financiers and the Bank will also need to monitor the project, (including the type, format and frequency of such information); and
- the laws, rules and regulations of the borrower that may have an impact on the project.

3.2 RECORDS MANAGEMENT

3.2.1 Importance of Record Keeping

The creation and maintenance of records is integral to the operation of the management system, and there is an implicit assumption that records are being created and are available to support each stage of the management cycle.

3.2.2 Maintaining Financial Records

A record is created for each financial transaction. Some are created by the project (e.g. orders for payment or for goods); others are created by entities with which the project deals (e.g. suppliers' invoices, bank statements). Records must be preserved and classified for easy access because they provide the paper trail on which the accounting system is based. A good record-keeping system facilitates financial accounting and reporting, internal control, project management and subsequent auditing. Records represent a particularly valuable type of information because they can provide verification and are therefore suitable as legal evidence. When project financial management systems are being designed, the maintenance of records, and their computerization are also considered. Finance and audit laws generally require ministries to ensure that financial and accounting records are adequately kept. This helps those involved with the project (in particular the auditor) by providing supporting documentation for transactions. Financial regulations may set down further detailed requirements for keeping financial records, including the creation, filing, storage, production and disposal of prescribed forms and records. In addition, legislation relating broadly to the management of government records may also cover financial records even though they may not be referred to explicitly.

3.2.3 Scope of Review of Records Management System

The review should check that:

- there are clearly defined procedures for creating, maintaining and safeguarding records;
- the records management procedures address the location and maintenance of records relating to project participating agencies, particularly for projects which have decentralized project implementation;
- records, including computerized records, are properly secured from fire, water, other environmental risks, and from unauthorized access;
- there are adequate back-up procedures, particularly with respect to computerized records; and
- there is easy access by authorized persons including auditors.

3.3 INTERNAL CONTROLS

3.3.1 Introduction

Internal control is a process, effected by an agency's management and other personnel, designed to provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial and operational reporting; and
- compliance with applicable laws, and regulations.

Internal control consists of specific policies and procedures which are often called "controls". These controls fall into the following five categories:

- control environment;
- risk assessment;
- control activity;
- information and communication; and
- monitoring.

The control environment is the foundation for the other four main components of internal control. Where the control environment is weak, the other components of internal control are not likely to be effective. In reviewing the internal controls of a project, it is necessary to examine each of the five components. The purpose is to identify strengths and weaknesses to judge whether: (i) an agency's existing policies and procedures can be used and relied upon for the project financial management functions; (ii) supplementary systems and procedures are required for the project; and (iii) shortfalls in existing systems need to be addressed.

3.3.2 Scope of Review of Internal Control System

The PIU should be reviewed to ascertain the strength of the management and staff functions, management philosophy and style, relationship between management and staff, the process for delegating power and responsibility, procedures for ensuring internal check and adherence to ethical values, and programs to develop staff skills, when needed. Specific attention should be given to:

- clearly written administrative, accounting and operational procedures to define the levels of authority and responsibility required of management and staff responsible for project funds and activities (including the segregation of duties);
- accountability to an outside implementation agency or committee which should maintain appropriate minutes recording significant decisions and actions authorized;
- qualified and trained staff and supervisors commensurate with the complexity and volume of project transactions and activities; and
- management and staff with a high level of professional behavior, performance and accountability.

3.3.2.1 PIU Responsibilities

The PIU management should establish procedures to identify, analyze and manage the risks that may arise from internal and external sources that may affect the project. These procedures would cover defining, identifying, analyzing and managing risk. The PIU management should develop policies and procedures to ensure that its directives are followed. This would require:

- appropriate documentation of the policies and procedures, covering management of finances, accounting, procurement and financial reporting;
- suitable authorization procedures, e.g. for the award of contracts by authorized personnel;
- appropriate segregation of duties and responsibilities (for instance certain responsibilities such as authorization, custody, record keeping and accounting duties should be segregated);
- adequate measures for safeguarding project assets, including cash and bank balances;
- arrangements for carrying out accounting reconciliation and independent verification of assets and records; and
- arrangements for storing project documents and restricting access to authorized personnel.

3.3.2.2 Monitoring of Plans Against Actuals

The information system should be reviewed to ensure that it can generate reports that will satisfy the Bank's PMR requirements and facilitate managing project operations. This includes suitable arrangements for communicating information to officials and responsible staff so they can do their jobs properly; arrangements for maintaining effective communication with government, supervisory agencies, suppliers, project beneficiaries, the Bank and other donors; and clear procedures for preparing, signing and dispatching the financial information required by the Bank.

The arrangements for periodic comparison of actual project activities against plan, and regular evaluation of systems should be reviewed. They should enable management and staff to assess the quality and performance of the internal control system. These arrangements would include:

- inventory taking and verification, and report preparation and distribution;
- internal and external audits; and
- clear procedures for timely reporting of important deficiencies and audit findings to management, and for taking appropriate actions.

Annex 2 provides a checklist to help the FMS in reviewing the control environment.

3.3.2.3 Procurement Controls

The Financial Management Specialist should work in close collaboration with the Procurement Specialist to ensure that there is a proper internal control system for ensuring that:

- contracts and all other significant aspects of procurement are properly approved and monitored (this is to ensure that goods and services have been provided in accordance with the terms of procurement, and properly managed and reported);
- contract amounts are recorded from the agreed contracts and that subsequent changes are both in accordance with the contract provisions and properly approved and adjusted to the amounts in the contract records (where there are several contracts, a contract register noting important information such as retentions withheld etc. for each contract will be needed);
- amounts invoiced and approved are noted showing date of approval including amounts payable, paid and deferred for future payment; and
- payments against contracts are noted beside the relative contract showing date of payment (explanations should be made where payments have been delayed).

More detailed information on the assessment of a project's procurement capacity is shown in LIH Annex 3.

3.4 PROJECT PLANNING

3.4.1 Objective of Project Planning

Project goals include completing the project on time and within the estimated cost. Project planning is a tool that is crucial in achieving these objectives. It helps PIU management to set realistic goals for each year and quarter of the project's life. Without planning, PIU management lacks direction. A project plan is a quantitative expression of a set of actions prepared in advance. Ideally the planning process starts early in project preparation. As the definition of the project is developed, the plan becomes more specific, and is expressed in the form of a project implementation plan (PIP) which guides project implementation. It is reflected in the PAD and project cost tables, and would include physical output and cost information. A project plan helps PIU management and staff to work toward achieving specific goals, and serves as a medium for communicating information to government oversight agencies, the Bank and any other interested parties.

Since a project plan provides information about project activities and their estimated costs, it provides a basis for monitoring and identifying areas that require corrective action. Through project planning, PIU management thinks through the coordination of the components and activities of the project. Project planning includes:

- linking the plan to the activities and processes associated with the project, e.g. the need to secure the services of contractors;
- linking cost to the physical activities and other monitorable indicators; and
- establishing a methodology for control, including tracking variances between actual and planned cost and activities.

3.4.2 Scope of Review of the Project Plan

A review should consider whether PIU management has established adequate procedures for planning and monitoring project activities, including procurement. The PIU management should prepare a realistic plan which, ideally, should:

- identify all the activities required to complete the project and their cost of completion (It is important that there is harmonization between the plan and reporting information, to ensure comparison between them. The timing of project cash inflows, particularly amounts to be contributed by the government and donors, should be properly projected); and
- include staffing issues, such as availability of qualified staff and any issues associated with the adequacy of staff salaries.

The PIU should establish a linkage between the plan and other relevant processes associated with the project. For instance, the plan should be linked to contract management and annual budgets.

3.5 ACCOUNTING SYSTEM

3.5.1 Purpose of the Accounting System

The accounting system gathers, processes and organizes accounting data in order to produce useful financial information. It should reflect project needs and be designed to provide the financial information required by all interested parties (PIU, borrower oversight agencies, cofinanciers, the Bank, etc.) and fulfill all the legal and regulatory requirements of the borrower country. The accounting system is a critical part of the project's financial management system and its design and operation are therefore of great importance. It should:

- provide information compatible with the agreed accounting standards;
- be simple and user friendly;
- be capable of installation and maintenance by PIU staff, and be easily understandable by users;
- provide adequate documentation and audit trails;
- provide reliable and timely information, including financial management and other reports; and
- maintain integrity.

3.5.2 Bases of Accounting

There are four generally recognized accounting bases used by governments:[8]

- cash accounting;
- modified cash accounting;
- accrual accounting; and
- modified accrual accounting.

The basic difference between these accounting bases is the timing of recognition (or recording and reporting) of a transaction:

- under the cash basis, income (or expenditure) is recognized when cash is received (or paid) irrespective of when goods or services are received;
- under the accrual basis, income (or expenditure) is recognized when earned (or incurred), regardless of when cash is received (or paid); and
- under the modified accrual version, there are differences in the accounting treatment of fixed assets.

In addition to the above four bases, there is also commitment accounting. This basis recognizes transactions when they are committed, e.g. when an order is issued. It is used mainly by governments, and its main function is budgetary control. In practice, different levels of government in the same country may use different bases of accounting. However, to ensure consistency, it is necessary that only one basis is applied for project accounting.

The following stages of a transaction can be used to illustrate the differences in accounting for each basis:

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[8] For further discussion, see *Guideline For Governmental Financial Reporting* (exposure draft), IFAC, 1998.

Stage 1	Stage 2	Stage 3
Placing an order	Receiving goods	Making payment

Under the cash basis, the transaction would be recognized in Stage 3, under the accrual basis at Stage 2 and under the commitment basis at Stage 1. Under the modified cash basis, the transaction would be recognized at Stage 2 if an invoice is received and payment occurs soon after (e.g. one month). Under the modified accrual basis, the transaction would be accounted for in the same way as under the accrual basis, except where the goods represent long term assets, which are written off in the year of acquisition (i.e. not capitalized).

Following from the difference in the timing of recognition of transactions (or events), asset reporting varies depending on the accounting basis used:

- under the cash and modified cash basis, only cash balances are reported;
- under the modified accrual basis, the assets reported include cash balances, investments, receivables, inventories for sale and liabilities; and
- under the full accrual basis, in addition to the assets reported on the modified accruals basis, physical assets, such as plant, equipment and infrastructure assets are also reported.

3.5.3 Cash Accounting

The cash basis is easier, simpler and less costly to maintain than the accrual basis. Compared to the accrual basis, fewer entries are made for goods purchased or sold on credit, and little judgment is involved in deciding when to record and report a transaction. However, unlike the accrual basis, the cash basis does not give a full picture of the income, expenditure, assets and liabilities of an entity. For instance, pure cash accounting does not report accounts receivable, accounts payable, interest earned but not yet received, and outstanding staff salaries. Also, the cash basis does not provide vital information for decision making and planning.

Despite the shortcomings of cash accounting, it is used by many governments and their agencies (excluding public sector enterprises and other revenue-earning entities which use the accrual accounting basis) because it:

- is relatively simple, easy to use and inexpensive to operate; and
- follows the government budgetary practice where parliament authorizes spending in cash and the government demonstrates compliance via appropriation accounts which are also prepared on a cash basis.

For projects of a non revenue-earning nature that are funded/supported by the Bank, the cash basis of accounting is normally acceptable. However, adoption of the accruals basis is encouraged where this is feasible.

3.5.4 Accrual Accounting

The accrual basis is useful where the management of advances and payables requires specific attention and as a means of deriving cost figures. It is essential for revenue-earning entities. The full accrual basis is therefore required of all commercial/revenue-earning entities in receipt of World Bank funds.

3.5.5 Chart of Accounts

To make sense of financial data it is essential to be able to classify it. A chart of accounts is a means of classifying an entity's accounting data in a way that will promote its use, lead to better management and achieve more meaningful accountability. Major classifications of accounting data are income, expenditure, assets, liabilities and capital. Within each major classification, further classification occurs (e.g. expenditure may be sub-divided into accounts for salaries and wages, other operating expenditure, interest payable, etc.). The necessary level of detailed classification depends on the nature of the accounting entity and the needs of users of accounting information. A chart of accounts provides a logical structure according to which accounting transactions will be sorted. It determines the limits for reporting financial information (because data cannot easily be reported unless the relevant category has been created in the chart of accounts). For Bank-funded projects, a minimum requirement is to report by major disbursement category: works, goods, consultants' services and other. It is also necessary to be able to present expenditure by project component. The chart of accounts reflects these and other information gathering and reporting considerations.

The chart of accounts for a Bank-assisted project should be designed to capture sources and uses of funds, assets and liabilities[9] in sufficient detail to satisfy reporting requirements. For each transaction, balancing debit and credit entries are required:

- sources of funds will include e.g. IBRD, government, cofinanciers; and
- uses of funds will cover total expenditures, further broken down into useful categories (such as by project components, activities, and location). They may also be broken down to reflect expenditures by source of funds.

The above categories provide a structure within which the individual project accounts are developed. The chart of accounts provides a logical means of aggregation of each set of related transactions. Once the account structure has been defined, the actual codes to be used may be established. For most projects, the chart of accounts and related accounting procedures will be formalized in an accounting manual.

3.5.6 Coding Schemes

Coding schemes are needed to implement charts of accounts and are essential in a computer environment. They are usually in numeric form: 99-999-999-999… with each set of digits

[9] Depending on the accounting basis used. See Paragraph 3.5.2-3.5.4 above

representing a different type of account. For example, the first two digits might represent the budget unit (e.g. a line ministry), the next set of digits, the source of funds (e.g. the IDA credit number), the next three, the objects of expenditure (in case of expenditure accounts), and so on. Computerization vastly reduces staff costs and skill requirements while reducing the possibility of human error. Examples of charts of accounts can be found in Annexes 3 and 4.

3.5.7 Scope of Review of the Accounting System

The review should ensure that:

- the accounting systems fulfill the requirements explained in this chapter;
- the basis of accounting is appropriate for the controls and reporting requirements of the project;
- the chart of accounts is prepared logically and makes it possible to aggregate sources of financing and expenditures under the main groups and sub groups, taking into consideration the requirements of the borrower, cofinanciers, the Bank and other interested parties;
- groups and sub-groups of cost can be identified to allow comparison with physical and other monitorable achievements;
- expenditures can be shown under disbursable cost categories works, goods, consultants' services and other, which may be further subdivided as required;
- sources of funds and expenditures can be shown by main locations where this information is required;
- individual expenditure categories are reduced to the minimum required; and
- there are appropriate groupings for assets, liabilities, and the accumulated project fund (where applicable).

3.6 ACCOUNTING SOFTWARE

3.6.1 Utilization of Accounting Software

Computerization facilitates timely and reliable financial reporting. The Bank is in the process of updating its data bank which lists selected software packages used by borrowers for project accounting. Some were designed for specific projects while others are off the shelf software, customized for particular projects. The data bank includes data on commercial packages which can be easily adapted to project needs and for which support is available.

The law of natural selection and the evolution of systems favors long standing, mainstream products with large market shares, and thousands of installed sites and users. The Bank's financial reporting formats are mainstream except for those additional reports relating to "cash withdrawal" and "forecasts." However, these reports rely on information provided in the main accounting system/reports and are only required on a quarterly basis.

Important considerations in the selection of accounting software are:

- the need for the software to accommodate the chart of accounts: enough fields, character positions and reporting capacity, given the need for flexibility as the project develops;
- the need to train staff in the use of software and the ways in which this can be achieved;
- the capacity of the supplier of the software to provide technical support for the product (proven mainstream products normally have strong technical support);
- the internal controls, security systems, drill-down features and audit trails provided by the software; and
- the capacity of the installed software to provide the timely and reliable information needed for project decision taking and reporting.

3.6.2 Scope of Review of Accounting Software

To achieve the above, the FMS should ensure that the software:

- has good internal controls, is auditable and will provide transparency;
- has a good track record for reliability, will be installed on time, will be within budget, and is well supported technically;
- can provide data: for periodic reporting (monthly, quarterly, annual etc.); by unit or activity; by funding source and expenditure categories; by actual and budget for the period and accumulated to date; to show variance between actual and budget/plan for period, accumulated for year, and to date;
- has the capability to work in the language of the borrower, in addition to English; and
- has the ability to work in the currency of the borrower, in addition to that of the Special Account (SA).

A checklist for evaluating accounting software is in Annex 5.

Chapter 4: Periodic Reporting using the Project Management Report (PMR)

INTRODUCTION

The PMR is designed to assist borrowers in managing their projects and also to facilitate project monitoring. It comprises project financial reports, project progress reports and project procurement management reports. Three models of the PMR have been developed and included in this manual–the cash accounting model, the accrual accounting model, and the simplified model for small projects. This chapter provides guidelines on the preparation and review of these PMRs, as well as on transitional reporting to be used by projects while building capacity to produce a full PMR. Sample PMRs are shown in Annexes 7 to 9. These annexes supersede the material presented in Annex 6 of LIH.

4.1 STANDARD FEATURES OF THE PMR

4.1.1 Content of the PMR

The project management report (PMR) comprises the following:

Section 1: Financial Report
- 1-A Project Sources and Uses of Funds
- 1-B Uses of Funds by Project Activity
- 1-C Project Balance Sheet (where appropriate)
- 1-D Project Cash Withdrawals (Disbursement)
- 1-E Special Account Statement
- 1-F Project Cash Forecast

Section 2: Project Progress Report
- 2-A Output Monitoring Report (Contract Management)
- 2-B Output Monitoring Report (Unit of Output by project activity)

Section 3: Procurement Management Report
- 3-A Procurement Process Monitoring (Goods and Works)
- 3-B Procurement Process Monitoring (Consultants' Services)
- 3-C Contract Expenditure Report (Goods and Works)
- 3-D Contract Expenditure Report (Consultants' Services)

4.1.2 Designing the PMR for a Project

The PMR provides information to the borrower for project management and to the Bank and other financiers for project monitoring. The design of the PMR provides the flexibility to adapt to the unique objectives and activities of each individual project. The column formats should be followed as closely as possible to facilitate comparison and aggregation and to enable electronic submission, processing and disbursement. Any major modification of standard procedure or format should be cleared with the Head of the Financial Management Board of the OCS Network. The PMR will form the basis for the Bank's disbursement of its share of project financing provided it is prepared within the framework of an acceptable financial management system, is submitted in the standard format and fulfills all other requirements. Clearly, more detailed reporting may be required for management purposes than is covered by the PMR.

4.1.3 Scope of the PMR

The PMR encompasses the total project as described in the PAD, and not merely the use of Bank funds. This is irrespective of whether the PIU controls the funds for a particular aspect of the project or not. PMRs are special purpose statements prepared in the format agreed at appraisal and do not always follow International Accounting Standards. The PMR reflects all project financing and expenditures, including those expenditures that may be financed outside the PIU and those provided in kind. In some projects, the borrower or a donor/cofinancier may provide goods and services which it finances directly. These should be quantified, costed and reported by the financier and incorporated in the accounts. Also, some borrowers and/or project beneficiaries may provide other contributions in kind such as accommodation, staff, etc. The criterion for inclusion in the PMR, is inclusion in the total project cost given in the PAD, as subsequently amended.

4.1.4 Currency of the PMR

Project accounts are normally kept in the national currency of the borrower (referred to in this manual as local currency units or LCUs). PMRs are therefore prepared in LCUs. However, if the borrower prefers, project accounts may be maintained in a foreign currency and the PMR prepared in that currency. Since the Special Account is normally maintained in a foreign currency, adjustments to certain parts of the PMR are needed so that the Special Account can be reconciled with other financial statements. Consequently, certain PMR financial reports are expressed in the currency of the Special Account, i.e. the Special Account Statement (Report 1-E) and certain columns in the project cash withdrawals (Report 1-D) and the cash forecast (Report 1-F). In addition, to establish the exact relationship between the project accounts (in LCUs) and the Special Account (in foreign currency), currency conversion is necessary. The principles applied are:

- the opening and closing balances of the Special Account are converted at the prevailing rates of exchange at the opening and closing dates;
- payments of funds from the Special Account for eligible project expenditures are converted at the actual rates of exchange when the payments are made; and
- because of the use of different rates of exchange, accounting differences occur and are reflected as shown in Report 1-A.

4.1.5 Expenditure Reporting in the PMR

Expenditures reported in the PMR are as follows:

- actual expenditures for the quarter (or other agreed reporting period), for the year to date, and cumulative to date (from the beginning of the project);
- planned (or budgeted) expenditures for the quarter, for the year to date, and cumulative to date;
- variances between actual and planned expenditures for the quarter, for the year to date, and cumulative to date; and
- the expenditure figures appearing in the PAD for the life of the project, updated to reflect project changes including agreed revisions, and loan agreement amendments. The figures to be presented will be in local currency units (i.e in the national currency of the country concerned).

4.2 PMR FINANCIAL REPORT

4.2.1 Project Sources and Uses of Funds (Report 1-A)

This report summarizes the sources of project financing, with uses of funds summarized under the disbursement categories in the loan agreement. These disbursement categories would normally be limited to the standard four categories into which all expenditures are reported in the Bank's Annual Report: goods, works, consultants' services and other. The "other" category may be further subdivided, depending on the requirements as recorded in the loan agreement. If the project is financed by several Bank-administered sources (such as, IBRD, IDA, PHRD, GEF, etc.), the sources of funds should show a separate line item for each financier.

4.2.2 Uses of Funds by Project Activity (Report 1-B)

This report summarizes project expenditures by components and sub-components (activities) consistent with those in the PAD. Sub-components are necessary only for those items considered significant for monitoring the project, with smaller components aggregated as appropriate. The total actual, planned and cumulative expenditures in this report match those shown as uses of funds in Report 1-A.

4.2.3 Project Balance Sheet (Report 1-C)

The balance sheet is optional where the cash or simplified model is adopted. Fixed assets of the project may be included as a part of uses of funds or shown separately. The treatment of fixed assets is further discussed in Paragraph 5.1.4 of this manual.

4.2.4 Project Cash Withdrawals (Disbursement) (Report 1-D)

This report summarizes by disbursement categories, the current quarter's project expenditures, showing the amount of eligible expenditures paid from Bank funds and the amount paid from government funds. If the project is financed by several Bank-administered sources (such as, IBRD, IDA, PHRD, GEF, etc.), a separate Report 1-D (Report 1D-1, 1D-2, etc.) is prepared for each financier.

4.2.5 Special Account Statement (Report 1-E)

This report summarizes the movements in the Special Account. Any discrepancy between the outstanding amount advanced to the Special Account and the total advance accounted for is explained in the report. If the project has more than one Special Account, a separate Report 1-E (Report 1E-1, 1E-2, etc.) is prepared for each Special Account. Should the borrower choose to pre-finance the Bank's share of project expenditures from its own resources instead of opening a Special Account, Report 1-E will not be required (LIH Section 4.09).

4.2.6 Cash Forecast (Report 1-F)

This report summarizes forecasted total project expenditures and IBRD eligible expenditures by disbursement category for the two quarters subsequent to the latest PMR received. Taking into account any balance remaining in the Special Account and any amount to be paid by other disbursement procedures (direct payment and special commitment), it establishes the amount requested to be advanced to the Special Account. If the project is financed by several Bank-administered sources (such as, IBRD, IDA, PHRD, GEF, etc.), and/or has more than one Special Account, a separate Report 1-F (Report 1F-1, 1F-2, etc.) is prepared for each cofinancier/Special Account. The maximum amount to be advanced is the amount required for the subsequent two quarters but may not exceed the maximum amount set out in the loan agreement (LIH Section 4.04). This allows the project sufficient funds (a) to finance the first quarter which will then be reported as actual expenditures in the next PMR; and (b) for the second quarter while the next PMR is being prepared and submitted to the Bank. If the borrower prefers to limit the advance, a lower amount may be requested

4.3 PMR PROJECT PROGRESS REPORT

The PMR project progress report comprises an output monitoring report and a brief summary of project progress.

4.3.1 Output Monitoring

Output monitoring is stressed because too much emphasis on cost, and not enough on what is achieved, may lead to wrong perceptions and wrong decisions. In reality, cost (the input used to obtain goods and services) and output (the results achieved as a result of using the input) are two sides of the same coin. Output monitoring assumes the existence of data on outputs. However, some PIUs do not normally accumulate such data, and others need assistance to strengthen their current systems for doing so. For this reason, the job of identifying the outputs of Bank-funded projects needs to be given serious consideration during project preparation. To do this job well the following are needed:

- a project design that identifies the project components and activities to which outputs would relate;
- a reliable means of recording and reporting outputs; and
- a link between outputs and the costs incurred to produce them.

Given the lack of the above in many environments, output monitoring needs to be approached realistically in relation to what is feasible and meaningful. It is not recommended that all project components and activities necessarily be covered by output measures. Rather, those who plan and manage projects are encouraged to give attention to output measurement at least for certain key activities and to provide an information system to measure outputs that will expand in coverage over time given the type of project and its environment. Therefore, in some cases, at the outset a project may begin monitoring only the two or three most critical project outputs, with additional monitoring indicators added later as capacity for such monitoring increases. Given the difficulty of output management and relative unfamiliarity with its use in project management, this manual does not deal with measuring outcomes[10] which is an even greater challenge. Nevertheless, the move to measuring project outputs is seen as a step in the direction of measuring outcomes.

4.3.2 PMR Output Monitoring (Reports 2-A and 2-B)

There are two formats for the output monitoring report: one which requires units of output related to the costs of project components or activities, and the other which requires information on the status of contracts. A decision on which form to use rests with the TL and the borrower. Clearly the first method is suitable where recognizable outputs are delivered or supplied. Where a flow of reasonably homogenous outputs occurs (e.g. people trained, items supplied, cases assessed, treatments carried out, permits issued) and this flow can be counted with some precision, the first method will be suitable. Generally this method is preferred because it directly links the outputs to the identified project components or activities. However, where the major project objective is construction, there may be no flow of outputs until the construction is complete. In this case the contract method may be used as the basis for output monitoring of the project.

For some projects, only one of the suggested formats (Reports 2-A or 2-B) will be suitable; and for others both formats may be used (e.g. an education project with one component for training teachers (units of output format) and another for building a university (contract management format). If the same project had yet another component to build 200 schools, either format might be used, but the units of output format would be preferable.

4.3.3 Summary of Project Progress

The PMR should include a summary of physical progress which:

- analyses and comments on the reasons for significant variances between planned and actual costs as reflected in the PMR financial report;
- analyses and comments on reasons for significant variances between planned and actual outputs as reflected in the PMR output monitoring report;
- analyses and comments on reasons for significant variances between planned and actual procurement as reflected in the PMR procurement management report;

[10] Outcome measures would indicate the project's success in achieving its development effectiveness goals, such as reducing poverty, improving life expectancy and increasing agricultural output.

- seeks to assess the impact of identified trends and variances on the final outcomes of the project; and
- seeks to identify remedial actions that may be necessary.

The level of variance which needs to be addressed in the project progress report should be agreed during project preparation, either by setting a percentage level of variance and/or agreeing on those activities to be addressed. For example, the cost of a particular activity may vary by a large percentage, but its impact on the project as a whole may be relatively insignificant. Therefore, the level of variance which needs to be addressed could differ from one activity to another within the project.

4.4 PMR PROCUREMENT MANAGEMENT REPORT

4.4.1 Procurement Process Monitoring (Reports 3-A and 3-B)

These reports (Report 3-A for goods and works and Report 3-B for consultants' services) provide details on the status of procurement for the major steps in the bidding/proposal process for contracts above the prior review threshold.

4.4.2 Contract Expenditure Report (Reports 3-C and 3-D)

These reports (Report 3-C for goods and works and Report 3-D for consultants' services) provide details on amounts invoiced and paid for contracts above the prior review threshold or above USD 100,000 equivalent. In addition to use as project management/monitoring information, this data is also used to report expenditure by source of supply in the Bank's Annual Report.

4.5 SIMPLIFIED PMR FOR SMALL PROJECTS

Projects that have few components or activities and whose project costs are below an agreed threshold can be treated as small for financial management and accountability purposes. PPF advances, IDF or GEF Grants and LILs are examples of projects which may fall under this definition, depending on the design of the particular project and its total cost. If the total cost is $5 million or less and is expected to remain so, the simplified PMR format given in Annex 9 may be used. For projects of this type, special efforts are needed to tailor the financial management requirements to the particular needs of the situation, the aim being to maintain accountability, but in a way that is appropriate to the size of the project. The financial information required for this type of project is less extensive than that required for large projects.

4.6 TRANSITIONAL REPORTING

As indicated in Chapter 2, the review of project financial management during project preparation establishes whether the project is capable of producing quarterly project management reports (PMRs) according to Bank requirements. If it cannot, a short-term action plan is needed[11] showing how the project's financial management capacity will be strengthened to produce PMRs. In the interim, the project proceeds without delay using existing disbursement procedures and the transitional PMR. It should be noted that if the borrower does not intend to move to PMR-based disbursement, eventual quarterly submission of the full PMR is nonetheless required.

The transitional reporting requirements during this interim period are:

- Sources and Uses of Funds (Report 1-A); and
- Procurement Management Report (Reports 3-A, 3-B, 3-C and 3-D).

In addition, the PIU should comment on the progress of important aspects of the project. Additional PMR reports should be added as the PIU is able to produce them.

[11] The action plan would not normally have a duration in excess of 18 months.

Chapter 5: Annual Financial Statements

INTRODUCTION

This chapter discusses annual financial statements and their audit. It describes the changes in audit requirements brought about by PMR-based disbursement. For projects still disbursing on Statements of Expenditure (SOEs), guidance should be sought from the Financial Accounting, Reporting and Auditing Handbook (FARAH). For such projects an audit opinion is required on the reliability of SOEs and the eligibility of expenditure subject to this method of disbursement. Also a summary statement concerning the year's SOEs should be provided and linked with the project's financial statements.

5.1 FINANCIAL STATEMENTS

5.1.1 Bank Policy

Bank Policy requires each project to submit annual audited financial statements. Under certain circumstances, implementing entities may also be required to submit annual audited financial statements.

5.1.2 Project Financial Statements

These are special purpose financial statements, whose format is agreed upon during project appraisal. The purpose of these statements is to fulfill the fiduciary requirements of the borrower, cofinanciers/donors and the Bank, and to provide financial management information including that required under PMR-based disbursements. Project implementing units (PIUs) are usually fully financed by the project concerned. In these instances, all the expenses of the PIU are part of the project and will normally be shown separately as PIU expenditures in the sources and uses of funds statement. When the PIU administers several projects, the accounts of the PIU differ from those of the project. It should be noted that the financial statements of the project cover not only Bank funds, but all other funds as reflected in the PAD. Where significant funding is provided in kind, appropriate adjustments should be made to the accounts and reflected in the financial statements.

One project financial statement is required for each project even though it may be financed by a blend of a loan, credit, trust fund etc. The same also applies where the vehicle of financing may change, such as a change to single currency loan. Where a project is implemented by several PIUs, the main PIU should consolidate the various financial statements. In certain circumstances, where there are several auditors involved and a consolidation is not convenient, a tabulation of the audit reports may be made, supported by the necessary individual audit reports. Where one loan finances a multi-state project and the Bank intends to apply its covenants separately to each participating State, a project financial statement is required from each State.

As the project is defined as covering all sources of funds (both Bank-provided and otherwise), the annual financial statements of the project should also include all sources of funds. Similarly the audit should relate to the whole project, not just to the Bank-financed portion.

In a project which supports capacity building in several institutions, the Bank may require each to provide annual audited financial statements as evidence of progress. While the individual financial statements will need to be shown in the listing of compliance with covenants (included in the project implementation file) and considered when judging compliance with legal covenants, they will not normally be reported individually via the Audit Reports Compliance System (ARCS). The PIU is required to monitor the receipt of these reports, review them and prepare a periodic report to the Bank summarizing the status of compliance with the relevant covenants. In addition the project financial statement would include the amounts disbursed to the participating institutions, summarizing the institutions' use of funds to the extent that this may be required under the project.

Special Accounts and expenditures disbursed on the basis of PMRs should be integrated with project financial statements. The financial statements should include summary statements for Special Account (SA) transactions and for PMRs submitted during the year.[12] The audit opinion should also include a specific reference to the SA activities and PMR–based disbursements. It is important that all details of the SA, including bank statements, be made available to the project's auditors to enable the auditors to reconcile project with bank records.

5.1.3 Entity Financial Statements

A separate financial statement for the entity as a whole is often required for projects implemented by commercial, industrial and business entities. Entity financial statements are only required for those projects which (a) are implemented by revenue-earning entities (b) the financial viability of the implementing organization is vital to the success of the project or (c) one of the objectives of the project is to improve the institutional capability of the implementing organization. These situations usually arise where the project is implemented by a commercial, industrial or business enterprise. Where a commercial-type entity wishes the project financial statement to be integrated as a part of the entity's financial statements, the project must be identifiable (through an accompanying table or annex summarizing the sources and uses of funds of the project, or through the notes to the financial statements). In addition to the auditor's opinion on the financial statements of the entity, there must also be an auditor's opinion on those of the project.

5.1.4 Fixed Assets

Much of this manual is about quarterly accounting, as this is the normal basis for quarterly disbursement using PMRs. As a result, accounting for fixed assets has not been given the attention which it normally receives in financial reporting. Whatever the basis of accounting used, accounting for fixed assets requires serious consideration. Even though the main financial statements may not feature fixed assets (e.g. under cash accounting), there is a clear need to account for and report fixed assets. Without this

[12] When the Special Account is not be maintained by the PIU, the summary of Special Account transactions should be obtained from the party which operates this account and submitted with the financial statements.

information, an element of the accountability chain is broken because information needed for management and fiduciary purposes cannot be supplied.

It is therefore important that projects maintain complete fixed asset registers specifying details such as the type of asset, its cost, the number of units (where appropriate), the date of acquisition and the beneficiary institution to which the assets have been transferred. For projects involving large engineering works, a full cost ledger is needed so that costs can be accumulated for each component of the project during the planning, construction and commissioning phases of the project. To summarize, accounting for fixed assets is an important aspect of due diligence, even though it does not figure prominently for the purpose of the PMR. Fixed assets should be recorded in asset registers or ledgers, and periodic management reports should report summary data on their status.

Projects normally finance fixed assets for beneficiary entities including the relevant PIU. These assets are used for the production or supply of goods and services, for rental, or for the administrative purposes of the beneficiary entities. Project fixed assets as reported in the financial statements of the project are usually limited to those used in the administration of the project such as vehicles and equipment used by project managers and staff.

Even under the accrual basis of accounting, fixed assets should be shown at cost without depreciation. Amortizing their cost over the life of the project would normally serve no useful purpose due to their immateriality to total project costs and because typically there is no project income against which the depreciation could be charged.

5.1.5 Cash Accounting

Where the project is implemented by a non revenue-earning entity, the cash basis of accounting is normally used. The project's annual financial statements are presented in a format agreed with the Bank. No balance sheet is required on the assumption that cash balances would be reflected in the project sources and uses of funds statement.

5.1.6 Accrual Accounting

Where the project is implemented by a revenue-earning entity, the accrual accounting basis is applied and the entity's financial statements presented in accordance with an agreed national accounting standard (International Accounting Standards are the benchmark). Where possible, non revenue-earning projects are also encouraged to use the accrual accounting basis as this leads to better accounting, and provides more relevant information for comparison with output and other indicators.

Under the accrual accounting basis:

- a balance sheet is always required;
- assets may be shown gross under project expenditures with project financing shown under funds. This reflects the idea that the project represents work in progress until it is completed;

- project sources and uses of funds include all accruals and advances. For example, where the borrower has pre-financed 100% of project costs over a period, and the Bank will finance 50% thereof, the report will show the borrower as having advanced the Bank 50%, showing the Bank as a receivable for the same amount; and
- a cash flow statement is required summarizing receipts and payments. The Special Account and PMR disbursement statements and notes to the financial statements are also included.

5.1.7 Financial Statements of Revenue-Earning Entities [13]

The reporting principles applicable to revenue-earning entities are fully covered by International Accounting Standards and are therefore omitted from this manual. However, the Bank provides two options for meeting its reporting requirements for revenue-earning entities:

Option 1**:** Provide separate project financial statement, with a separate audit opinion on the Special Account and on disbursements made on the basis of PMRs. This option is usually the most suitable.

Option 2**:** Attach the project sources and uses of funds, and summary of PMR disbursements and the Special Account as appendices of the entity's financial statements, with (a) the note to the entity's financial statements covering any aspects requiring disclosure; and (b) the audit opinion specifically covering such appendices.

5.2 AUDITING

5.2.1 Bank Policy

Bank Policy (OP/BP 10.02) requires the borrower and the project implementing entities to have the required financial statements for each year audited. Audits are to be in accordance with standards that are acceptable to the Bank. Examples of such standards are the International Standards on Auditing (ISA) published by the International Federation of Accountants (IFAC) and Auditing Standards issued by the International Organizational of Supreme Audit Institutions (INTOSAI). Audits are discussed further in FARAH, Chapter 5 and Annexes 9 and 10. In addition, guidance can be obtained from the *Audit Manual for World Bank Financed Projects* issued by East Asia and Pacific Region of the Bank. The above-mentioned documents provide guidance on other matters, e.g. standard working papers that may be necessary, audit programs and internal control reviews. In the final analysis, however, there is no substitute for the professional judgment of qualified financial staff and a qualified auditor.

5.2.2 Auditing Requirements

The project financial statements of all investment projects are audited annually. The audit covers the

[13] For identification of the cases where entity financial statements are required in addition to project financial statements, see the first paragraph of Paragraph 5.1.3 above.

entire project, not only the Bank-funded portion. Where a Special Account and PMR-based disbursement are used, they are addressed separately in the auditor's opinion.[14] Audit of an implementing entity's financial statements may also be required under certain conditions (see OP/BP 10.02 and Paragraph 5.1.3 above). Audit of adjustment operations is not usually required. However, if needed, the Bank has the right to request an audit of the bank account into which the proceeds of the adjustment loan have been deposited.

5.2.3 Scope of Audit

Audits of financial statements for Bank funded projects include:

- an assessment of the adequacy of accounting and internal control systems to monitor expenditures and other financial transactions and ensure safe custody of project-financed assets;
- a determination as to whether the borrower and project implementing entities have maintained adequate documentation of all relevant transactions;
- verification that the expenditures submitted to the Bank, including those submitted in PMRs, are eligible for Bank financing, and identification of any ineligible expenditures; and
- verification that the annual financial statements can be reconciled with the relevant year to date amounts appearing in the PMR for the fourth quarter of the year.

5.2.4 Auditor

Audits of commercial, industrial and business entities are normally carried out by private auditors. Private auditors are members of professional bodies which are usually themselves members of the International Federation of Accountants (IFAC). Audits of entities other than commercial, industrial and business entities are frequently carried out by Supreme Audit Institutions (SAIs). The title of the SAI may vary from country to country. Office of the Auditor General or Court of Accounts are common titles. These are independent government auditors established by a country's constitution or laws. They are normally members of the International Organization of Supreme Audit Institutions (INTOSAI). Some audits of this type are carried out by private auditing firms.

5.2.5 Bank Procedures

The borrower and the project implementing entity select an auditor by the commencement of project activities. Auditors should be appointed in sufficient time to carry out their responsibilities, including a review of the financial management systems at the beginning of project implementation, and to enable the timely issue of annual audited financial statements. Auditors are selected by the borrower. Regional staff review the auditor's independence, experience, and terms of reference and inform the borrower and project implementing entities whether the auditor is acceptable. The borrower and the project implementing entity submit the audited financial statements to the Bank by their due dates as indicated in the loan agreement. The Bank normally requires audited financial statements to be received no later than

[14] For guidance on the audit of projects using PMR-based disbursement, see Annex 10.

six months after the end of the project fiscal year. Regional staff acknowledge receipt and review the financial statements. Where there are differences between the last quarter PMR, and the annual financial statements, these should be communicated to the borrower and reviewed with the relevant FMS/DO in the Loan Department (LOA). In this way outstanding issues are followed up. Once audited financial statements are received, regional staff maintain up to date information on the status of audited financial statements in the Audit Reports Compliance System (ARCS).

5.2.6 Monitoring Audit Compliance

If the statements are not received by the due date, regional staff take actions to resolve the situation as detailed in BP10.02. If the audited financial statements indicate financial accountability problems the FMS ensures that regional staff consult with the legal department and LOA in order to identify necessary remedial actions, and communicate with the borrower and the implementing entity. For example:

- *inadequate financial management*: provide technical assistance to the borrower and/or the implementing entity;
- *unacceptable quality of financial statement*: request submission of acceptable audited financial statements; and
- *ineligible expenditures disbursed by the Bank*: require additional evidence of eligibility of the expenditures, submission of documentation for other eligible expenditures, or a refund of the amount disbursed.

5.2.7 Audit Reports Compliance System (ARCS)

The Audit Reports Compliance System (ARCS) records audit reports submitted and tracks audit compliance through the life of the project. Details of the system, its outputs and processes are covered in the *ARCS User Guide*. The ARCS database is updated and maintained by staff responsible for each project, with LOADR providing a monitoring and policy role. Once a Bank-financed project becomes effective, it is automatically entered into the ARCS system. The TL is required to enter the basic audit report requirements, showing the financial statements required, the first and subsequent due dates, name of auditors, etc.