

## 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:<sup>1</sup>

- 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.

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<sup>1</sup> For further discussion, see *Guideline For Governmental Financial Reporting* (exposure draft), IFAC, 1998.

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:

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<sup>2</sup> 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 representing a different type of account. For example, the first two digits

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<sup>2</sup> Depending on the accounting basis used. See Paragraph 3.5.2-3.5.4 above

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 disburseable 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.