FINANCIAL MANAGEMENT ASSESSMENT

EXECUTIVE SUMMARY

1. An updated financial management assessment (FMA) has been conducted for the four Implementing Agencies (IAs) in accordance with Asian Development Bank (ADB)'s *Guidelines for the Financial Management and Analysis of Projects*[1] (the Guidelines) and ADB's Financial Due Diligence a Methodology Note[2] for the purpose of Nepal Earthquake Emergency Assistance Project. The FMA was conducted for the four IAs; (i) Department of Education (DOE), (ii) Department of Local Infrastructure Development and Agriculture Roads (DOLIDAR), (iii) Department of Roads (DOR), and (iv) Department of Urban Development and Building Construction (DUDBC). The FMA focuses on fund flows, staffing, accounting policies and procedures, internal controls, financial reporting and monitoring and internal and external audit. The purpose of this updated FMA is to ensure that adequate financial management arrangements are in place for the proposed Nepal Earthquake Emergency Assistance Project. The IAs are responsible for the implementation of the project. Project assets, once constructed will be handed over to the IAs for operation and maintenance.

2. The FMA draws on lessons learnt during the implementation of past and existing projects, various sector level governance assessments, and interviews with the Implementing Agency Project Management Units and other relevant government staff.

3. The overall financial management risk is considered Substantial, due to the overall fiduciary risk for Nepal noted in the country partnership strategy (CPS) and the weakened government institutional capacity post disaster. At the government departments, (i) the fund release remains unreliable, (ii) the internal audit function is weak, (iii) project financial records are maintained manually, and (iv) human resource capacity requires to be supplemented by external consultants.

4. Risk mitigating measures to partially manage the weaknesses in the financial management process include:

- (i) Dedicated and competent accounting staff are appointed to each of the PIUs within 2 months of project inception;
- (ii) TA support for overall ongoing financial and accounting hand holding support, for at least the first two years of project implementation;
- (iii) Loan assurance on timely release of counterpart funds;
- (iv) Training of project implementation unit staff on government's and ADB's financial and procurement rules and guidelines by October 2015;
- (v) TA support for establishing adequate internal control systems of proposed SPV, including (a) development of an appropriate organogram with adequate segregation of duties and financial accounting manual (within four months of establishment), and (b) establishment of an independent and effective internal audit function and computerized financial accounting within a year of operations;
- (vi) Provision of a Statement of Audit Needs and capacity building of the project accounting staff to ensure that reporting and external audit of the project is more closely aligned to the international reporting and audit standards;

[1] ADB, 2015, *Financial Management Assessment-Technical Guidance Note*
[2] ADB, 2009, *Financial Due Diligence, A Methodology Note*, Mania

(vii) Ensuring more rigorous follow up of resolution of audit issues on an ongoing basis;

(viii) A unified web-based project monitoring and Management Information System (MIS) will be established by the EA in the PMU-PIUs-DIUs to monitor implementation, fund flows, accounting, audit and reporting functions within a year of project commencement. The attached TA will also provide support for operationalizing an electronic tracking system of expenditures and outputs of the recovery and reconstruction (R&R) program to promote transparency and reduce administrative burden; and

(ix) Assurance of PIU that the annual work plan process complies with MOF and NPC's timeline for the annual budgeting cycle. This is to identify all counterpart funding and budget allocation requirements for the project on an annual basis.

5. On the positive side, despite the issues noted above, all four IAs of the Project are successfully implementing ongoing ADB funded projects. Audited project financial statements are submitted on time, auditor has issued a clean unqualified audit opinion and the IAs have established accounting, reporting and budgeting procedures in place in line with government regulations. DOR and DUDBC have adequate accounting staff and DOE/DOLIDAR PIUs will be supplemented by additional full time qualified accountants. Accordingly, adequate capacity exists for the purpose of removing the SOE ceilings.

A. Country Level Issues

6. The 2014 Public Expenditure and Financial Accountability Survey (PEFA) Assessment results indicate that Nepal has made positive strides in establishing the Public Financial Management (PFM) systems. However, gaps remain in their implementation. Strengthening PFM is a key element of the government's strategy for improving governance, optimizing outputs from public resources and for ensuring inclusive and broad-based development. A number of development partners, including ADB are investing in improving the PFM systems, including increasing accountability in public expenditure, financial management, and addressing fiduciary and governance weaknesses in utilization of public resources. Country issues that potentially impact project financial management include (i) overall weaknesses in capital expenditure reported under budgeted levels due to PFM implementation weaknesses in preparing annual work plans and procurement plans and large fiscal activities outside of the budget, (ii) delays in the release of counterpart funding, (iii) historical weak absorptive capacity of government line departments and ministries, and (iv) lack of oversight of the Auditor General over expenditure incurred at Municipalities and VDCs.

7. Identified country-level PFM issues center around the gaps in implementation of PFM rules and procedures, compliance with the financial acts, weak internal control, and enforcement due to insufficient human resources, capacities and enforcement.

B. Risk Mitigation

8. The project will be implemented by IAs that already have ADB projects under implementation, thus are knowledgeable of ADB policies and procedures.

9. The PIUs will maintain separate books of account for the project finances under its management.

10. Annual external audit will be conducted by OAG for each project component under respective implementing agency. Detailed Statements of Audit Needs will be provided to OAG to ensure that AFSs comply more strictly with Government of Nepal Accounting and Auditing Standards.

11. PIU will ensure that the annual work plan process complies with MOF and NPC's time line for the annual budget planning cycle, which is currently April/May for the following fiscal year budget. This is to identify and ensure all counterpart funding and budget allocation requirements for the project on an annual basis.

12. IAs will ensure adequate level of human resources, specially accounting staff, at the PIUs including their orientation and training in government's and ADB's rules, procedures and reporting requirements.

13. Project funds will be disbursed in accordance with the Loan Disbursement Handbook (updated 2015)

C. Project Description

14. A catastrophic 7.8 magnitude earthquake struck on 25 April 2015 with epicenter in Gorkha District, 77 km northwest of Kathmandu and followed by hundreds of aftershocks. Only 17 days later, as people were beginning to recover, a second earthquake of 7.3 magnitude struck with epicenter near Mount Everest. There were over 8,600 deaths and the United Nations estimates that 8 million people – almost one-third of Nepal's population– is affected. Hill districts in the central, western and eastern regions have been particularly devastated and further isolated due to road damages and obstructions. Entire villages have been destroyed and even buried by landslides and avalanches. Already vulnerable areas are now even more susceptible to landslides and flooding. The government started working with the international community, civil society and other stakeholders to meet humanitarian response needs immediately following the first earthquake. Various organizations such as foreign governments, bilateral aid agencies, United Nations agencies, and nongovernment organizations continue to provide relief. ADB also approved a $3 million grant for relief on 27 April 2015.

15. The Government has already established a National Recovery and Reconstruction Fund to raise $2 billion, and has contributed $200 million of its own resources. However, the damages to assets and livelihoods are likely in the order of $5 billion, or about a quarter of Nepal's gross domestic product.

16. The government has requested the emergency assistance project to focus on schools, roads and urban reconstruction due to (i) extensive damages and financing needs; (ii) their importance for economic recovery and social development; and (iii) ADB's comparative advantage and experience in these sectors in Nepal. The Country Partnership Strategy (2013-2017) includes education, transport, and urban and rural development as focus areas. The project meets all six of the characteristics of an emergency assistance loan as defined in the Staff Instruction on Processing and Administration of Emergency Assistance Loans.

17. The government will take the lead in identifying, prioritizing, appraising, designing, and implementing subprojects. The approval of the subprojects will be based on satisfactory

technical, economic, and safeguards assessments in compliance with the eligibility criteria agreed between the government and ADB.[3]

D. Country Issues

18. The country level issues relating to financial management are summarized from the Nepal PEFA *An Assessment of the Public Financial Management Performance Measurement Framework February 2014 and 2008,* DFID *Fiduciary Risk Assessment for Nepal (2008)* and *Governance Risk Assessment and Risk Management Plan, ADB, CPS (2013-17).*

19. These reports conclude that the necessary architecture and procedures for effective public financial management are in place but there are significant gaps in implementation, compliance, internal control, and enforcement due to insufficient human resources, capacities, and enforcement. Uncertainly around the current political transformation process will continue impeding progress towards better public management and accountability.

20. The recent PEFA review found that although the government financial management is based on a robust legislative framework, there are a number of areas affecting implementation which require further strengthening at sectoral level. The budget is credible at the aggregate level for revenue and recurrent expenditures but is undermined by the capital budget which falls chronically short of estimates and large fiscal activities outside the budget. Additionally, low capital budget utilization reflects poor planning including poor procurement planning and weaknesses in implementing capital investment projects.

21. The government's cash-based accounting system does not allow for systematic recording of arrears in accounting records.

22. The government is implementing a PFM reform program with support from donors. The current focus for PFM reforms implementation includes improvements to the budgeting process since Platform 1 of the government's approach to PFM reform is to establish a credible budget delivering practical results. Currently the government has released the cash basis Nepal Public Sector Accounting Standards (NPSAS), broadly in line with international standards, and government accounts for FY2013 were to be prepared in accordance with NPSAS. Also good progress is being made on an Integrated Financial Management Information System (IFMIS). The Medium Term Expenditure Framework (MTEF) was utilized in budgeting for FY2013 and FY 2014.

23. Despite the existence of a credible public finance management reform program ongoing political instability may reduce the government's commitment to the reforms.

24. Internal and external audit functions in Nepal's public sectors exhibit system weaknesses. For internal audit the focus is primarily regulatory compliance and transaction audits with no emphasis on the efficient or effective use of public funds. The lack of internal audit function within sector ministries puts the internal control mechanisms at risk. In the case of external audit, OAG's staffing levels are inadequate, which is further accentuated by many vacancies in the agency.

---

[3] Subproject Selection and Approval Criteria (accessible from the list of linked documents available in Appendix 2).

E. Risk Analysis

25. Summary of the overall risks are given below

Table 2: Control Risk Summary

Risk Type	Risk Description	Risk Assessment	Proposed Mitigation Measures
1. Country Level	Absorption capacity of government departments for capital expenditure and adequacy of O&M budget for	Substantial	TA support to implement project and assessment of financial sustainability as a sub project selection criteria
2. Executing Entity	The proposed SPV will need significant support to set up its overall internal control and accounting environment	High	TA Support for Capacity Building
3. Funds Flow	Since MOF is the overall in charge and this is a high priority project with GON commitment, the usual delays in allocation and release of funds are not expected.	Moderate	Governments assurance to release the counterpart parts on timely basis SPV once set up, will manage overall project funds Direct Payment mechanism to be used as well
4. Staffing	PIUs to be set up will require dedicated accounting staff	Substantial	Government commitment for dedicated accounting staff at PMU and PIUs
5. Accounting Policies and Procedures	Policies and procedures are well documented and IAs use Government accounting standards.	Moderate	Policies and procedures would be established for SPV
6. Internal Audit	Internal Audit Function is generally weak	Substantial	Full time ongoing accounting support
7. External Audit (project level)	OAG has the constitutional mandate to conduct external audits of donor funded projects. Annual project audit reports are typically produced within 6 to 9 months of the end of the financial year. Compliance reports are prepared and submitted in response to audit findings (paras) for disposal of the same.	Low	Not applicable
8. External Audit (entity level)	OAG will carry out the audit of SPV	Low	
9. Reporting and Monitoring	At IAs, reporting systems are in place. Routine reports are produced from the Accounting System – others are prepared on spreadsheets with figures extracted from the accounting system.	Low	Not applicable
10. Informat	Mostly manual accounting	Substantial	Computerisation of SPV

Risk Type	Risk Description	Risk Assessment	Proposed Mitigation Measures
ion Systems			accounts to be supported. A unified web-based project monitoring and Management Information System (MIS) will be established by the executing agency in the PMU-PIUs-DIUs to monitor implementation, fund flows, accounting, audit and reporting functions. The attached TA will also provide support for operationalizing an electronic tracking system of expenditures and outputs of the R&R program to promote transparency and reduce administrative burden.
Overall Control Risk		**Substantial**	

DIU = District Implementation Unit, GON = Government of Nepal, MOF = Ministry of Finance, PIU = project implementation unit, PMU = project management unit, O&M = operation and maintenance, R&R = reconstruction and recovery, SPV = special purpose vehicle.

F. Project FM System: Strengths and Weaknesses

1. Strengths

26. The government of Nepal PFM system is based on robust legislative framework; the Financial Procedures Act (1999) and the Financial Procedures Rules (2007).

27. The four IAs for this project have significant experience in implementation of ADB financed projects and their staff is familiar with ADB financial management procedures. DUDBC is currently implementing the Integrated Urban Development Project (Loan 2651/Grant 0284); DOE is currently implementing some elements of the Skills Development Project (Grant 0345); DOR is currently implementing the Transport Project Preparatory Facility (Grant 0227); and DOLIDAR is currently implementing the Decentralized Rural Infrastructure and Livelihood Project (DRILP) (Loan 2796 and OFID loan 1442).

28. It is also important to note that the APFSs for all IAs have been submitted on time and with unqualified opinions.

2. Weaknesses

29. The dispersed implementation arrangements involving four government agencies (DOR, DOLIDAR, DOE and DUDBC) and their PIUs, the PMU at the SPV, and the Project management support consultants need to clearly establish the roles of each in the financial management of the projects. This would be essential to ensure counterpart contributions to the capital investments and training activities are included in the government budget.

30. The establishment of a separate PMU at the SPV requires the recruitment of a finance and administration officer for the PMU and ensure adequate Accounts Officers at each PIU. Currently, the project specific capacity and their knowledge of ADB financial procedures cannot be validated.

31. The current internal audit focus is on transaction level compliance rather than financial performance and internal control.

G. Implementing Entities

32. The executing agency will be Ministry of Finance (in the interim) and the proposed Special Purpose Vehicle which will be established (permanent), and the implementing agencies will be (i) Department of Roads, (ii) Department of Local Infrastructure Development and Agriculture Roads, (iii) Department of Education, and (iv) Department of Urban Development and Building Construction. The National Level Disaster Management Committee (NLDMC) will act as a policy-making body providing overall advice and guidance to the proposed SPV for reconstruction, which is being set up by the government.

33. A dedicated PMU will be established in the executing agency consisting managerial staff and technical experts assisted by project management consultants (PMC). A Program Steering Committee (PSC) will be constituted including the concerned ministry secretaries, and Project Approval Committee (PAC) in each implementing agency to review and approve subprojects. A dedicated Program Implementation Unit (PIU) will be established in the respective line departments headed by Project Implementation Director to implement the subprojects. The PIU will be supported through their District Implementation Units (DIUs) to supervise and implement the approved subproject activities.

34. At the district level, a District Implementation Monitoring Unit (DIMU) will be set up with mandate to coordinate and monitor program implementation. The DIMU will be headed by the Chief District Officer (CDO) and will be supported by technical, social and legal experts to oversee and report on the technical compliance during project implementation.

H. Fund Flow Mechanism

35. Fund Flow mechanisms are given in the PAM

I. Personnel

36. As discussed in Section E above, the government will ensure the appointment and retention of required staff at the PMU, PIU and DIMU. A dedicated staff in these units will be responsible for the financial management and procurement functions.

37. Ideally, personnel appointed will be experienced in ADB procedures. However, if this is not possible, then it is essential that arrangement are made between GON and ADB to ensure that required financial management training is provided to staff immediately upon appointment.

J. Accounting Policies and Procedures

38. The government, through the PIU will establish and maintain separate project accounts and records (by funding source) for all expenditures incurred on the project, and following the

accounting principles and practices prescribed by the Government of Nepal Financial Procedures Act (1999) and Financial Procedures Rules (2007).

K. Internal Audit

39. The internal audit function is weak across the Government of Nepal. The 2014 PEFA assessment (report not yet issued) identified that while there have been overall improvements in the PFM related policies and procedures, several weaknesses in the internal audit function exist, including the limitations arising from only performing audit of transactions rather than undertaking systems audits. Internal audit is centralized which does not support greater ownership or responsibility for PFM reforms among line ministries. The focus remains on audit of transactions rather than the identification of broader systemic issues including sufficiency of internal control, and recommendations for remedy.

L. External Audit

40. Government entities are audited annually by OAG. Reports are meant to be discussed by a parliamentary body, the Public Accounts Committee (PAC). The OAG prepares timely annual audit reports. The OAG has also recently concluded a 'Supreme Audit Institution Performance Management Framework' peer review, which will inform their strategic direction for capacity building. Amongst the first in the region to complete a SAI-PMF assessment, the OAG is committed to enhancing the quality of their audit function.[4]

41. The audit is performed in accordance with the Government Auditing Standards Part 3: Segment Audit Guidelines – Project Financial Statements issued by the OAG in October 2005. These guidelines were prepared specifically keeping in mind donor requirements, mostly ADB and World Bank.

42. The usual OAG's auditing process will be used to provide external audit of the project financial reports and records. The APFSs will be submitted in the English language to ADB within 9 months of the end of the fiscal year. The annual audit report should include a separate auditor's opinion on the use of the imprest account, statement of expenditures, compliance with loan covenants and use of loan proceeds in accordance with loan agreement for intended purposes. The government has been made aware of ADB's approach on delayed submission, and the requirements for satisfactory and acceptable quality of the audited APFSs. Three month extension is being given due to the need for consolidating financial data across multiple districts and cost centers spread-out in Nepal across departments, without full integrated computerized systems.

M. Financial Reporting and Monitoring

43. All government agencies currently prepare entity financial reports in accordance with Finance Procedures and Finance Procedure Rules (2007) generally consistent with International Accounting Standards and existing cash-based accounting practices are generally well-established and accounts are frequently reconciled. However, inadequate level of automation has weakened the timeliness and quality of accounting. Annual reporting and financial statements are of acceptable quality but there are some gaps in the content and some

---

[4] The report is available via the OAGN website: http://www.oagnep.gov.np/uploads/022-207172004_Peer%20Review%20by%20SAI-India%20SAI-PMF%202014(1).pdf (www.oagnep.gov.np).

delay in submission. Implementation of Nepal Public Sector Accounting Standard (NEPSAS) corresponding to the cash basis IPSAS has now been elevated on top of the government accounting reform agenda. Policy Decision was made by GON for adoption of Cash Basis NPSAS in 2009. However, necessary policy and guidelines for adoption are still in process. ICAN has a good working relationship with government bodies and there is good awareness about the IPSASs. It is planned that the government will implement NPSAS on phase wise basis.

44. There are many problems with unreconciled and undischarged advances as evidenced by audit reports. The PEFA also noted that in-year statements are produced but are incomplete, particularly with regards to transactions undertaken at local level. The appointment of regional monitors for the project may help mitigate potential reporting gaps for the project.

45. The compliance status of project loan covenants will be reported and assessed through the quarterly progress reports and verified by ADB review missions.

N. Information Systems

46. A unified web-based project monitoring and Management Information System (MIS) will be established by the EA in the PMU-PIUs-DIUs to monitor implementation, fund flows, accounting, audit and reporting functions within a year of project implementation. The attached TA will also provide support for operationalizing an electronic tracking system of expenditures and outputs of the R&R program to promote transparency and reduce administrative burden. In the interim, the manual accounting procedures shall be relied on for financial reporting, with qualified accountants' full-time support.

O. Procurement Arrangement

47. As a part of the project preparation due diligence for previous projects, procurement capacity assessments were carried out using the standard templates. The assessments identified risks from (i) absence of detailed guidelines or manual to implement the Public Procurement Act (PPA) 2007 and the Public Procurement Regulations (PPR) 2007; (ii) lack of human resources for procurement; (iii) low capacity in procuring consulting services. Mitigation measures include (i) use of ADB's guidelines for procurement and use of consultants, (ii) dedicated staff at PIUs to deal with procurement; (iii) training of PIU staff in government and ADB rules and procedures for procurement; (iv) inclusion of a procurement specialist in the implementation support consultant; and (v) annual fiduciary review including post procurement audit (spot checks).

P. Disbursement Arrangement

48. Disbursement arrangements are highlighted in the Project Administration Manual.

Q. Supervision Plan

49. ADB and the government will jointly undertake reviews of the project at least twice a year. These reviews will include a review of the financial management and procurement arrangements. The reviews are to assess progress in each subproject, identify issues and constraints, and determine necessary remedial actions and adjustments. A mid-term review will be conducted during the early third year of implementation. The mid-term review will (i) review the scope, design and implementation arrangements and identify adjustments required; (ii)

assess progress of the project implementation against performance indicators; and (iii) recommend changes in the design or implementation arrangements, if necessary

R. Financial Sustainability

50. Project outputs are public service goods with no cost recovery, and hence no financial viability assessment will be required. Roads, schools and buildings constructed under the Project will be maintained from relevant ministries ongoing recurrent budget. GON commitment will be obtained as loan assurance. As project outputs are built back with features to enhance resilience, there would be less strain on O&M budget. Experience in Nepal indicates that government departments have adequate capital budgets, which they are sometimes not able to absorb, but that recurrent budgets are generally fully utilized and sometimes insufficient. In addition, the consideration of financial sustainability is a sub-project selection criterion, and will be determined during implementation.