

FINANCIAL ANALYSIS

1. Tonga has made good progress in improving public financial management (PFM) since achieving internal self-governance in 1984, particularly in government financial accounting and reporting. Tonga's Public Financial Management Act, 2002 (amended in 2010) provides a comprehensive framework for effective fiscal financial management and for financial reporting.¹ Recent assessments show that Tongan PFM systems are well developed and recent reforms have led to improvements in quality and effectiveness.

2. The 2010 Public Expenditure and Financial Accountability (PEFA)² assessment indicates an improvement in Tonga's PFM systems over the 3 years following the 2007 PEFA assessment. For the 27 indicators, Tonga received 20 satisfactory ratings in 2010, up from 17 in 2007. However, it received unsatisfactory ratings for aspects of multiyear fiscal planning, expenditure policy and budgeting, effectiveness in collecting tax payments, competition, value for money and controls in procurement, and effectiveness of internal audit. The weaknesses in the multiyear perspective are not uncommon in thin capacity environments, where the focus is rightly placed on the annual budget. The weaknesses noted in the collection of tax payments stemmed from the timing of a set of assessments and delays in the collection of some large arrears, which are before the courts. Reflecting recent reform efforts, both the Asian Development Bank (ADB) and World Bank policy and institutional ratings for Tonga—as measured via the country performance assessments—have improved since 2010.³ The Government of Australia's assessment of national systems concluded that, overall, a moderate fiduciary and corruption risk is associated with using partner government systems and recommended their use in aid programming.⁴

3. As the leading government agency on climate change and disaster risk management policies, the Ministry of Land, Environment, Climate Change and Natural Resources (MLECCNR) will be the coordinating implementing agency for the project. The Ministry of Finance and National Planning (MFNP) will be the executing agency and be responsible for opening the project imprest account and endorsing all replenishment withdrawal applications. All the authorized signatories for the imprest account will be based in MFNP. MFNP will also oversee all procurement for the project as it chairs the project steering committee.

4. Since 2010, MFNP has the financial management capacity to administer project imprest accounts in accordance with ADB policies and guidelines. MFNP currently administers the imprest account of the Integrated Urban Development Sector Project, the Social Protection of the Vulnerable in the Pacific–Tonga subproject, and the two imprest accounts for the Nuku'alofa Urban Development Sector Project. All use the statement of expenditure procedure. The Social Protection of the Vulnerable in the Pacific Project has a ceiling of \$10,000, while the ceiling of each of the other projects is \$100,000. The audited project financial statements (APFS) of the Integrated Urban Development Sector Project for FY2009, FY2010, FY2011, and FY2012 are satisfactory, with no anomalies in the management of the imprest account. The Nuku'alofa Urban Development Project activities commenced at the end of 2012 and as with the Social Protection of the Vulnerable in the Pacific project, their first APFSs are due by 31 December

¹ Asian Development Bank. 2013. *Tonga: Economic Update and Outlook, 2012*. Manila.

² Government of Tonga. 2010. *Public Financial Management Performance Report*. Nuku'alofa (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).

³ The 2013 International Monetary Fund and World Bank Debt Sustainability Analysis upgraded Tonga's debt position from "high risk of debt distress" to "moderate risk" on the basis of the improvement in Tonga's rating from "weak" to "medium" under the World Bank's Country Policy and Institutional Assessment in 2012.

⁴ Government of Australia. 2011. *Tonga—Assessment of National Systems*. Canberra.

2013.

5. The Ministry of Infrastructure (MOI) will manage the procurement of contracts valued at approximately \$9.25 million or 50% of the total project cost. MOI is the implementing agency for the Integrated Urban Development Sector Project. All APFSs for this project were received before the due date and are acceptable to ADB. No issues have been identified with their withdrawal applications.

6. The Climate Change Trust Fund (CCTF) board, chaired by MLECCNR, will manage the other large budget under the project (\$5 million) following Public Financial Management Act procedures. The act was developed with development partner assistance and meets the fiduciary requirements for Australian Agency for International Development and World Bank to provide budget support. MFNP will be responsible for opening the CCTF endowment and operational accounts. The authorized signatories for disbursements from the fund will be the MFNP minister and secretary and the MLECCNR minister and secretary. MFNP as the CCTF manager will be responsible for preparing a monthly reconciliation of the fund.

7. MLECCNR will directly implement activities that total approximately \$1.7 million and will lead the recruitment for and manage the project management unit (PMU) consulting services totaling \$1.85 million—15% of the total project cost. MLECCNR is currently the implementing agency for the Nukualofa Urban Development Sector Project with a budget of \$12.4 million. MFNP is the executing agency for this project and is responsible for the project imprest account.

8. The financial management capacity of MFNP is assessed as adequate, based on the Public Financial and Management Performance Report and after a review using ADB's financial management assessment questionnaire and interviews. MFNP responses to the questionnaire indicate that it has defined policies and procedures in place for accounting, budgeting, and auditing activities. As per the questionnaire, MFNP maintains records of fixed assets with yearly physical inspections, including for inventory. MFNP has adequate internal controls, including an internal audit and risk committee. The existing organization structure of the MFNP Treasury Division, in charge of financial management, is adequate. MFNP has recruited a project accountant to handle all ADB projects and will recruit a full-time qualified accountant in the PMU to support MFNP and the project implementing agencies.

A. Summary of Financial Management Assessment of MFNP

9. Key findings of the financial management assessment undertaken for MFNP are described in the table.

Summary of Financial Management Assessment of MFNP

Particulars	Conclusion
Funds flow arrangement	Funds flow arrangements are reliable, predictable, and secure. MFNP has the capacity to work under the proposed investment program.
Staffing	MFNP and MLECCNR will cochair the project steering committee and be supported by the PMU to conduct all relevant project activities. Project consultants will assist the PMU at all times. MFNP, supported by the full-time project accountant based in the PMU, has the financial staff to manage projects according to ADB financial management procedures.
Accounting policies and procedures	MFNP financial management activities follow the Tonga Treasury Instructions 2010; Procurement Regulations 2010; Procurement Guidelines 2010; and Financial Management Manual (currently under review)

Particulars	Conclusion
Internal and external audits	MFNP has an internal audit department, which reports directly to the minister; this project will be included in the department's work program. MFNP is audited annually by the Tonga Audit Office, which will also audit the project's financial statements.
Reporting and monitoring	The government's financial statements are prepared in accordance with the International Public Sector Accounting Standards.
Information systems	MFNP's financial management system is computerized and meets the project requirements.

ADB = Asian Development Bank; MFNP = Ministry of Finance and National Planning; MLECCNR = Ministry of Land, Environment, Climate Change and Natural Resources; PMU = project management unit.

Source: Asian Development Bank

B. Financial Management of the Climate Change Trust Fund

10. The project will support climate change adaptation (CCA) responsive investment approaches identified and implemented by vulnerable communities through the establishment of the CCTF.⁵ The fund will initially be endowed with a capital sum of \$5 million, of which an initial sum of \$4 million will be placed in an endowment account⁶ and an initial sum of \$1 million will be placed in operational account⁷ to finance small community CCA projects of up to a maximum \$50,000 each and small to medium-scale government CCA projects of up to a maximum of \$250,000 each. Funds will only be disbursed for works, goods, and services approved by the CCTF board⁸ that meet the following criteria: (i) have a clear and demonstrable link to CCA, and (ii) project outputs and objectives align with national climate change priorities.

11. ADB's policy and institutional assessment indicates an improvement in Tonga's ratings. Tonga is performing better than the regional average under the criteria for "economic management" and "public sector management and institutions," and better than most other Asian Development Fund countries for "quality of budgetary and financial management." Weaknesses in areas related to budget credibility, external scrutiny and audit, and quality and timeliness of annual financial statements are addressed through the government's public financial management reform road map, supported by ADB technical assistance.⁹ ADB, Australia, the European Commission, and the World Bank have been providing general and sector budget support since 2010. The CCTF (to be managed by MFNP) was established in accordance with the Public Financial Management Act.

12. MLECCNR, with the support of the PMU consultants, will develop the CCTF operations manual to be agreed with ADB. It will include (i) an elaboration on the eligibility and selection

⁵ The CCTF was established in 17 May 2013; Cabinet approved the purpose and procedures of the fund, which are included in the project administration manual (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).

⁶ Under the CCTF operating principles, the endowment fund will be deposited in low risk investments. The government agreed to ensure that funds in the CCTF endowment account will be deposited in banks or financial institutions with consistent long-term debt ratings of AA- or better by Standard & Poor's and Aa2 or better by Moody's (or which have full credit support from another financial institution with such ratings).

⁷ The operational account will initially be financed through the project, plus interest and capital gains earned on the funds placed in the endowment account and money raised through other sources including bilateral and multilateral development partner contributions, and duties and taxes levied for the specific purpose of providing climate funding by the government.

⁸ CCTF board composition: MLECCNR minister (chair), MFNPP minister, representatives from MOI and Ministry of Internal Affairs, and a bilateral and/or multilateral development partner representative (resident in Tonga) as nominated by the partners present in Tonga.

⁹ ADB. 2011. *Technical Assistance for Implementing Strategic Economic Management*. Manila (TA 7959-TON).

criteria for subprojects described in the PAM; (ii) procedures and requirements for submission of applications; (iii) implementation arrangements with communities, nongovernment organizations, and government agencies; (iv) governance, technical, and financial supervision mechanisms; and (v) monitoring and reporting on the use of funds. Once approved, the manual will be used for a trial period of 2 years. At the end of the trial period, MLECCNR will make any necessary revisions and submit it for ADB approval. The revised manual will be drafted into regulations for promulgation by MFNP pursuant to the Public Financial Management Act.

13. As per the act, funds will be withdrawn from the CCTF following MFNP's existing processes. The two authorized MFNP signatories will sign checks based on a request for payment by the CCTF board. The CCTF is not expected to have a finite life and will continue operation beyond the lifespan of the project. The disbursement procedures described in the CCTF operating principles will be developed in the CCTF operations manual.

14. An independent auditor acceptable to ADB will audit the CCTF in accordance with international standards on auditing and with the government's audit regulations. Technical audits of projects funded by the CCTF will be carried out on a selective basis as recommended by the auditor general and be financed by the fund. The technical auditor will be expected to use international audit standards and will present a report to Cabinet. Cabinet will give an opinion on the accuracy of the records and financial statements of the CCTF, completeness of income of the fund, and conformity of payments with the priorities stated in these procedures. The CCTF's audited accounts and other financial statements, annual report, and any technical audits of the small-scale community initiatives financed by the CCTF will be disclosed publicly to enhance transparency and accountability.