

FINANCIAL MANAGEMENT ASSESSMENT OF IMPLEMENTING AGENCIES

A. Summary

1. A financial management assessment was carried out for both Hohhot Chengfa Heating Company (HCHC)—the project implementing agency, and Hohhot City Development, Investment, and Operation Company (HCDIO, better known as Chengfa Company) in accordance with the *Guidelines for Financial Management and Analysis of Projects of Asian Development Bank (ADB)*.¹ The assessment was based on (i) relevant information and documents submitted by HCHC and HCDIO; (ii) their responses on financial management assessment questionnaire; and (iii) information collected from the interviews with key financial staff at HCHC and HCDIO. HCDIO, which was incorporated in 2000, is owned by the Hohhot Municipal Government (HMG). HCDIO has a diversified portfolio of companies, which are mainly engaged in district heating, waste management, low income housing, and intelligent transport monitoring system business. HCDIO has 98.17% ownership share of HCHC, which was incorporated in 2006. [This information has been removed as it falls within exceptions to disclosure specified in paragraph 97, (v) of ADB's Public Communications Policy (2011)].

2. The assessment shows that financial management systems and procedures at HCDIO and HCHC are in place to perform proper financial management and reporting. Further, their accounting systems are adequate for the project loan implementation. HCHC and HCDIO have project experience with international funding organizations. They jointly set-up a project management team in the early stage of project preparation, which is responsible for procurement, disbursement, construction supervision, and all other relevant tasks for successful project implementation. As both organizations do not have ADB project experience, they are not familiar with ADB's guidelines and procedures on procurement and disbursement. HCDIO and HCHC implement accrual basis accounting and follow business accounting standards of the People's Republic of China (PRC), which are aligned with the International Accounting Standards. Their accounting procedures are aligned with the regulations and policies issued by the Ministry of Finance (MOF), which are considered effective and adequate for the project. The financial management capacities of HCDIO and HCHC are summarized in Table 1.

Table 1: Summary of Financial Management Capacity and Risk Assessment

Risks	Risk Assessment*	Proposed Mitigation
Control Risks		
HCHC and HCDIO	L	HCHC and HCDIO have significant project implementation experiences.
Accounting Policies and Procedures	L	HCHC and HCDIO have adopted new Accounting Standards for Business Enterprises approved by MOF since 2007, which is consistent with IAS on a project accounting level. HCHC and HCDIO established a complete system in budget management and asset management by applying enterprise resource planning.
		Capacity training on ADB requirements and procedures of disbursement and procurement is

¹ ADB. 2005. *Financial Management and Analysis of Projects*. Manila.

Risks	Risk Assessment*	Proposed Mitigation
		still needed to ensure all related staff at HCHC and HCDIO can understand ADB's procedures and standards in advance.
Funds flow/disbursement arrangements Use of Imprest Accounts(s) Use of Direct Payment arrangements	L	The Government of Inner Mongolia Autonomous Region has implemented a number of ADB projects. The Inner Mongolia Autonomous Region Finance Bureau has sufficient experience and capacity to manage an imprest account of an ADB project.
Staffing	L+	The accounting personnel at HCHC and HCDIO have rich working experience and are qualified with adequate financial skills. The staffing at accounting departments is assessed to be adequate.
Internal Audit	M	HCHC has no internal audit department. Yet, HCDIO has an internal audit department, which is responsible for auditing and supervising all the subsidiary companies under HCDIO, including HCHC. The audit department of HCDIO has a rich experience in project auditing.
External Audit	L	HCHC is subject to annual external audit by a certified public accountant firm designated by the Hohhot Municipal Government (HMG)-owned Assets Management Committee on a rotating basis. HMG will also conduct an audit after project completion, which will constitute a part of HMG's project acceptance.
Reporting and Monitoring	M	HCHC will report and monitor the project then HCDIO will review and confirm. The current routine practice of reporting and monitoring at HCHC is in line with ADB standards.
Information Systems	L	HCHC will use new accounting software arranged by their finance department and approved by HCDIO. The existing information system at HCDIO is satisfactory.
Overall Control Risk (before mitigation action)	M-	Implementing the mitigation actions mentioned above will reduce the control risks from moderate to low.

* H = High, M = Moderate, L = Negligible or Low

ADB = Asian Development Bank, HCDIO = Hohhot City Development, Investment, and Operation Company, HCHC = Hohhot Chengfa Heating Company, HMG = Hohhot Municipal Government, IAS = International Accounting Standards, MOF = Ministry of Finance.

B. Executing Agency

3. The Government of Inner Mongolia Autonomous Region Government (GIMAR) will be the executing agency of the project. GIMAR has implemented a number of ADB projects. IMAR Finance Bureau has sufficient experience and capacity to manage an imprest account of an ADB project.²

4. HMG will onlend the fund from GIMAR to HCDIO, and then, to HCHC. The Hohhot Finance Bureau (HFB) will coordinate with HCHC through HCDIO for the project fund disbursement. HFB will provide a natural gas subsidy to partially offset HCHC's increase in operation and maintenance costs for the natural gas-based district heating. As the timely and full payment of the subsidy is vital for the financial sustainability of the project, the project preparatory technical assistance team reviewed the fiscal capacity of HFB. The fiscal receipt and expenditure of HMG experienced a rapid growth over the past 5 years. Total receipt increased at an average annual growth rate of 17.9%, while total expenditure increased at an average annual growth rate of 17.2%. In 2013, HMG's fiscal revenue reached CNY36.01 billion (\$5.9 billion), which was 13.8% increase from 2012. In the same year, HMG's expenditure was CNY29.48 billion (\$4.8 billion), which was 7.1% increase from 2012. Once ADB project is in operation, HMG shall pay CNY247.80 million per annum, in nominal terms, for natural gas subsidies, which is equal to 0.8% of HMG's 2013 fiscal expenditure. Given the solid fiscal position of HMG, it does not seem that the timely and complete payment of natural gas subsidies would be a risk for the financial sustainability of the project (Table 2).

Table 2: Municipal Fiscal Receipts versus Expenditures
(CNY million)

Year	Gross Fiscal Receipts	Fiscal Expenditure	Fiscal Expenditures to Receipts	Domestic Debt	International Debt
			(%)		
2008	15,830.99	13,317.95	84.13	12,318.79	1,645.95
2009	20,123.71	16,516.84	82.08	18,402.20	1,645.95
2010	24,145.07	17,728.00	73.42	27,561.80	1,812.78
2011	28,521.63	25,566.80	89.64	40,061.64	2,397.53
2012	31,632.43	27,531.95	87.04	48,385.23	2,218.16
2013	36,005.11	29,483.53	81.89	65,432.11	2,035.03

Source: Hohhot Provincial Finance Department.

C. Hohhot City Development, Investment, and Operation Company (HCDIO)

5. Under the project, HCDIO will (i) provide management oversight to HCHC; (ii) sign onlending agreements with the GIMAR, through the HMG, and then, onlend to HCHC; (iii) be directly responsible for making equity contributions to the project; (iv) provide project

² ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of China for the Inner Mongolia Autonomous Region Environment Improvement*. Manila, and ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of China for the Inner Mongolia Autonomous Region Environment Improvement Project (Phase II)*. Manila.

procurement service on behalf of HCHC; and (v) provide managerial and technical support to HCHC to ensure timely implementation as well as good governance of the project. HCDIO and HCHC jointly established a project management office (PMO). The financial management assessment and the analysis of financial statements of the last 5 years were conducted for HCDIO in accordance with the *Guidelines for Financial Management and Analysis of Projects of Asian Development Bank*.³ HCDIO applies accrual basis accounting in compliance with the PRC's Accounting Standards for Business Enterprises.⁴ A computerized accounting system is in place, and the company has a complete set of accounting procedures for recording and processing transactions. A rigorous budgeting system is implemented, which is uniformly applied to HCDIO and its subsidiaries. The budget contains both financial and physical indicators that are compared to the actual performance, which is monitored on a monthly basis. The same accounting systems and procedures will be used for the project. HCDIO also has a comprehensive asset management system based on clearly defined principles, rules and guidelines.

6. According to the audited consolidated financial statements (2009–2013), HCDIO experienced a period of strong growth. Total assets value increased at an annual average growth rate of 33.6% [This information has been removed as it falls within exceptions to disclosure specified in paragraph 97, (v) of ADB's Public Communications Policy (2011)], which was mainly driven by the growth of current assets. The total owner's equity increased at an annual average growth rate of 74% [This information has been removed as it falls within exceptions to disclosure specified in paragraph 97, (v) of ADB's Public Communications Policy (2011)]. During the same period, gross revenue increased [This information has been removed as it falls within exceptions to disclosure specified in paragraph 97, (v) of ADB's Public Communications Policy (2011)] and net profits [This information has been removed as it falls within exceptions to disclosure specified in paragraph 97, (v) of ADB's Public Communications Policy (2011)]. While the enterprise was heavily leveraged in 2009 and 2010, the debt-equity ratio of HCDIO in recent years has improved after large equity injections from HMG. The financial sustainability of HCDIO mainly depends on the annual injection of additional equity by HMG.

7. The manager at HCDIO is responsible for managing the company's day-to-day business and its development under the guidance of the Board of Directors. HCDIO is composed of 10 offices and departments. HCDIO possesses ISO 9001 and ISO 14001 certification for Quality Management System and Environment Management System.

8. The finance department at HCDIO headquarter has seven accountants and each has a college degree in accounting. The Assistant to the General Manager, who is in charge of financial work, is a certified public accountant. The seven accountants are responsible for accounting work of HCDIO and also supervising and checking the works of all the subsidiaries, including HCHC. Each subsidiary of HCDIO has its own team of accountants. One accountant in the accounting division will be designated to record the disbursement and repayment transactions.

9. HCDIO has a separate audit department, which is responsible for (i) internal auditing of all the subsidiary companies and HCDIO's departments, and (ii) setting-up the internal audit rules that are applicable to HCDIO and all its subsidiaries. The audit department has four staff

³ ADB. 2005. *Financial Management and Analysis of Projects*. Manila.

⁴ Accounting Standards for Business Enterprises as issued by the MOF of the PRC are consistent with the International Accounting Standards.

members, all of whom have a bachelor and/or an advance degree, and hold professional qualification as an auditor. The head of the internal audit department directly reports to the Board of Directors on the problems identified, suggestions or recommendations. The subsidiaries, including HCHC, do not have an internal audit office. HCDIO will be responsible for internal audit of the project. HCDIO and its subsidiaries, including HCHC, are subject to annual external audit by certified public accountant firms designated by HMG-owned Assets Management Committee. In 2012, the external auditor for HCDIO was Inner Mongolia Jinfang Chartered Public Accountants. In 2013, the Inner Mongolia Xinfangyuan Certified Public Accountants Firm was designated as the external auditor for the project. The audit reports are usually released 4 months after the end of fiscal year. The audit is conducted based on national audit standards. Over the past 5 years, the audit reports did not show any significant issue on HCDIO's financial accountability. Once the project is in operation, the Hohhot Audit Bureau will audit the project annually.

10. HCDIO has installed computer software⁵ that can produce the necessary financial reports. Special system administrator and operator are in place to safeguard confidentiality, integrity and availability of data.

D. Implementing Agency

11. HCHC, a subsidiary of HCDIO is the implementing agency of the project. HCHC was incorporated in 2006 with a registered capital of CNY387.6 million. HCDIO has 98.17% ownership share of HCHC. [This information has been removed as it falls within exceptions to disclosure specified in paragraph 97, (v) of ADB's Public Communications Policy (2011)]. By 2013, the total asset of HCHC was CNY3.5 billion. HCHC is currently operating a district heating system in Hohhot, covering 32 million square meters of heating area. By 2016, the heating coverage of HCHC will increase up to 74 million square meters.

12. HCHC has 10 offices and departments. HCHC has four heating branches—Qiaokao, Sanhecun, Xinjiaying, and Jinqiao. The finance department at HCHC has six accountants, each of whom has a college degree in accounting. The accountants are responsible for account work at HCHC, including the branches. Each branch of HCHC has its own accountants responsible for the branch-level financial work and has intermediate accountant certification.

13. HCHC's financial management duties include, but not limited to (i) preparing loan withdrawal applications; (ii) recording and sorting out of financial and physical progress reports; (iii) monitoring counterpart fund utilization; (iv) preparing consolidated financial statements of all project components; and (v) preparing of progress reports and semi-annual reports to be submitted to ADB through HCDIO.

14. According to the responses on financial management assessment questionnaire, HCHC applies accrual based accounting, and strictly follows the accounting standards of the PRC. Existing accounting procedures are aligned with policies and regulations issued by the MOF. HCHC has a computerized accounting system, and follows a complete set of accounting procedures for recording and processing transactions. Internal control is effective. Authorization, transaction, recording, and asset management with clear and separate functions are well established under the existing accounting procedures. The same accounting system and procedures will be used for the project.

⁵ The name of the software is Yongyou NC.

E. Conclusion and Recommendations

15. HCDIO and HCHC have foreign project management experience, including projects funded by bilateral development cooperation organizations like the Japan Bank for International Cooperation (JBIC) and KfW, a German government-owned development bank. The first JBIC loan project was implemented in March 1998, while the second loan was implemented in June 2006. Both projects were completed on time. The third JBIC project was signed in March 2012 and is currently in implementation. HCDIO established and operates a foreign capital management office with four full-time staff. Also, HCDIO and HCHC already established a PMO for the project. The staff at the foreign capital management office will also be responsible for ADB project management, together with other PMO staff with different expertise and functions. Except for one staff that previously worked at PMO of another ADB project in IMAR and was hired during project preparation, the PMO staffs do not have previous experience in ADB projects. Thus, adequate capacity building training for staff would be helpful for smooth project implementation.

16. According to the financial management assessment on HCDIO and HCHC, it is concluded that both have sufficient financial management capacity to implement the project. For a smoother project implementation, the following are suggested:

- (i) Develop a complete manual of financial policies and procedures to guide staff in carrying out project activities and to ensure staff accountability;
- (ii) Develop training programs and execute trainings, particularly on ADB's procurement and disbursement policies and procedures; and
- (iii) Perform regular back-up of all accounting systems, and run appropriate security measures over the back-up data.

F. Financial Performance and Projections

17. Financial projection of HCHC was prepared based on the assumed operating parameters, which shows that the debt service coverage ratio and other ADB's financial covenants would be met during the project operation.

Table 3: HCHC's Financial Statements
(CNY million)

Item	Actual							Forecast					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Income Statement													
Operating Revenue	587.21	746.53	913.59	994.14	1027.81	1056.09	1085.22	1115.22	1794.19	2293.49	2356.77	2421.94	2489.08
1) Revenue From Providing Heating	521.75	625.04	734.30	794.78	942.68	970.96	1000.09	1030.09	1649.45	2109.32	2172.60	2237.77	2304.91
2) Other Revenue-Connection Fee	65.46	121.50	179.28	199.36	85.13	85.13	85.13	85.13	144.74	184.17	184.17	184.17	184.17
Less: Sales Taxes and Attached Taxes	0.00	0.00	0.00	3.80	0.00	0.00	0.00	0.00	29.77	19.70	0.00	0.00	0.00
Less: Operating Expenses	485.96	584.71	794.13	715.36	741.18	755.52	770.42	785.89	1548.17	2240.62	2280.41	2341.07	2402.43
Personnel	43.05	57.14	83.81	120.27	123.52	127.23	131.04	134.97	139.02	143.19	147.49	151.91	156.47
Power	43.49	65.28	55.73	60.67	75.80	78.07	80.41	82.83	161.33	184.68	188.90	193.20	197.58
Coal	220.01	231.07	211.94	235.64	235.64	242.71	249.99	257.49	265.22	273.17	281.37	289.81	298.50
Gas Procurement	2.58	2.48	2.32	2.49	2.88	2.97	3.06	3.15	580.46	1191.23	1228.97	1266.72	1304.47
Water	5.29	6.86	7.74	8.30	0.00	0.00	0.00	0.00	10.87	18.65	19.21	19.80	20.39
Water Treatment	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.86	3.20	3.30	3.40	3.50
Heat Procurement	14.84	47.32	39.50	42.34	57.16	58.88	60.65	62.47	113.96	151.46	156.01	160.70	165.52
Maintenance Expense	12.53	14.55	20.95	20.95	20.95	20.95	20.95	20.95	45.72	45.72	20.95	20.95	20.95
Other Production Expenses	116.24	133.57	343.32	197.71	197.71	197.71	197.71	197.71	197.71	197.71	197.71	197.71	197.71
Overhead Fee	11.77	18.44	17.36	15.52	17.20	17.72	18.25	18.80	25.25	25.51	31.01	31.94	32.90
Other Expenses	16.17	8.00	11.46	11.46	10.31	9.28	8.35	7.52	6.77	6.09	5.48	4.93	4.44
Income Before Depreciation	367.47	257.39	499.43	274.97	286.63	300.57	314.80	329.34	216.25	33.16	76.36	80.87	86.64
Depreciation	266.23	95.56	379.97	109.35	124.83	124.83	124.83	124.83	149.60	199.14	223.92	223.92	223.92
Operating Income	101.25	161.82	119.46	165.62	161.80	175.74	189.97	204.51	66.65	(165.98)	(147.56)	(143.04)	(137.27)
Add: Other Business Income													
Add: Subsidy	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	178.19	320.15	320.15	320.15	320.15
Less: Interest Expenses	(0.50)	2.72	43.47	42.42	22.00	9.37	2.17	0.00	0.00	82.28	72.66	63.03	53.41
Add: Non-operating Income	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Less: Non-operating Expenses	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Profit Before Income Tax	101.75	159.10	75.99	123.20	139.80	166.37	187.81	204.51	244.84	71.89	99.94	114.08	129.47
Less: Income Tax	0.00	0.00	0.00	30.80	34.95	41.59	46.95	51.13	61.21	17.97	24.98	28.52	32.37
NET PROFIT	101.75	159.10	75.99	92.40	104.85	124.78	140.86	153.38	183.63	53.92	74.95	85.56	97.10

Table 3: HCHC's Financial Statements
(CNY million)

Item	Actual							Forecast					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Cash Flow Statement													
Operation Activities													
Cash Subtotal from Operations Activities	27.24	(50.01)	499.73	214.62	136.02	380.30	261.32	279.00	1213.21	845.81	301.75	309.08	306.43
Investing Activities													
Cash Subtotal from Investment Activities	(243.48)	(224.34)	(186.60)	0.00	(307.06)	(149.76)	(624.54)	(778.81)	(438.87)	0.00	0.00	0.00	0.00
Financing Activities													
Equity Infusions	194.68	107.51	171.96	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Long-term Loans Borrowing	397.50	683.42	51.43	0.00	17.35	132.68	618.57	758.09	377.85	0.00	0.00	0.00	0.00
Other Cash Inflow	88.16	201.31	933.89	0.00	350.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Short-term Loans Borrowing	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Loan Interest Repayment	0.00	22.70	51.17	42.42	23.76	14.47	23.98	52.45	77.73	82.28	72.66	63.03	53.41
Loan Principal Repayment	0.00	259.38	470.47	325.42	257.12	146.95	35.91	0.00	123.75	169.48	169.48	169.48	169.48
Other Payment	435.38	416.45	803.03	0.00	0.00	350.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Cash Subtotal from Financing Activities	244.97	293.71	(167.39)	(367.84)	86.47	(378.73)	558.68	705.64	176.37	(251.76)	(242.13)	(232.51)	(222.89)

Table 3: HCHC's Financial Statements
(CNY million)

Item	Actual							Forecast					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Balance Sheet													
Assets													
Current Assets	908.01	1329.02	1094.63	1060.95	1023.40	804.01	1031.27	1239.62	2178.04	2779.44	2838.25	2912.91	2997.99
Net Fixed Assets	370.20	282.51	1604.09	2268.52	2143.69	2018.86	1894.03	1769.21	2858.21	3897.66	3673.75	3449.83	3225.92
Work in Progress	2108.38	2345.29	773.78	0.00	308.81	463.67	1110.02	1941.29	0.00	0.00	0.00	0.00	0.00
Other Assets	5.72	6.53	7.46	7.40	7.34	7.28	7.22	7.16	7.10	7.04	6.98	6.92	6.86
Total of Assets	3392.32	3963.35	3479.96	3336.87	3483.25	3293.83	4042.55	4957.28	5043.35	6684.14	6518.98	6369.66	6230.77
Liability and Equity													
Current Liabilities	871.78	1029.44	844.54	934.47	865.77	915.84	941.04	944.30	592.65	2349.00	2278.36	2212.96	2146.44
Contingency Liabilities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Long-term Debt	1433.18	1081.71	795.53	470.11	580.33	216.07	798.73	1556.81	1810.91	1641.43	1471.95	1302.48	1133.00
Equity	1087.36	1852.20	1839.90	1932.30	2037.15	2161.93	2302.78	2456.16	2639.79	2693.71	2768.67	2854.22	2951.33
Total of Liabilities and Equity	3392.32	3963.35	3479.96	3336.87	3483.25	3293.83	4042.55	4957.28	5043.35	6684.14	6518.98	6369.66	6230.77
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Financial Ratios													
Current Ratio (%)	104.16	129.10	129.61	113.54	118.21	87.79	109.59	131.27	367.51	118.32	124.57	131.63	139.67
Debt Equity Ratio (%)	131.80	58.40	43.24	24.33	28.49	9.99	34.69	63.38	68.60	60.94	53.16	45.63	38.39
Debt Service Coverage Ratio (current/current)		0.90	1.00	0.70	0.90	1.60	4.50	5.30	1.70	1.30	1.50	1.60	1.70
Quick Ratio (%)	90.37	122.63	125.35	105.59	111.40	81.63	102.87	124.97	357.43	115.74	121.94	128.91	136.86
Return on Net Fixed Assets (%)		78.03	48.34	10.42	10.41	11.99	13.58	15.19	14.40	7.49	7.89	8.69	9.62
Cost Recovery (include subsidy)	1.21	0.97	0.98	0.92	1.01	1.15	1.21	1.22	1.13	1.05	1.06	1.07	1.07
Cost Recovery(exclude subsidy)	0.78	0.86	0.69	0.92	1.01	1.15	1.21	1.22	1.03	0.92	0.93	0.94	0.95