

FINANCIAL MANAGEMENT ASSESSMENT

A. Introduction

1. The Financial Management Assessment (FMA) was prepared in accordance with ADB's *Guidelines for the Financial Management and Analysis of Projects*¹ (the Guidelines) and the publication, *Financial Due Diligence, A Methodology Note*.² The FMA incorporates a summary Financial Management Internal Control and Risk Assessment required by the Guidelines. The FMA covers the Ministry of Finance (MOF), the Ministry of Public Infrastructure, Industries and Commerce (MPIIC) and the recently established Water and Wastewater Operations division within the Palau Public Utilities Corporation (PPUC).

2. Country-level issues noted in this FMA are based on information developed through the 2009 Governance Assessment³ and 2010 Public Financial Management (PFM) Assessment⁴ undertaken by ADB, the January 2012 IMF mission⁵ in Palau and relevant updated information and findings. The ADB assessments put particular emphasis on the Governance and Anticorruption Action Plan (GACAP II) themes of PFM, procurement and anti-corruption.

B. Project Description

3. Palau is a small northern Pacific country of 20,000. Its main population center is Koror, a much smaller island and the main urban center, is connected to Airai by a bridge. Koror and Airai contain 80% of the population. Koror and Melekeok are the only urban centers with a sewerage system and treatment works while all other population centers utilize septic tanks. Water supply to Airai and Koror is sourced from a dam in Airai supplemented by river flow. Other population centers have small water reticulation schemes or no water supply network. The dispersed population makes it impractical to have a truly integrated national grid.

4. The Koror–Airai Sanitation Project (KASP) will refurbish the sewerage system on Koror which is in poor condition, increasing the health risks for Palau's population and tourists. It is a future risk to the pristine coastal environment. The impact of the project is improved environmental and public health in Koror and Airai. The outcome of the project will be improved delivery of sanitation services by PPUC. Project outputs include:

- (i) **Output 1: Effective, efficient, and sustainable sewage collection systems in Koror and Airai.** The sewerage network in Koror will be rehabilitated and augmented to (a) minimize the frequency and severity of uncontrolled sewage overflows; (b) reduce the energy requirements to operate the network; (c) improve the operation of the network through real-time monitoring of sewage system parameters at key locations within the network; and (d) enable rapid response to disruptions to sewerage services resulting from system failures. A sewerage network will be constructed at Kesebelau (Airai).
- (ii) **Output 2: Sewage treatment and disposal meets Palau's environmental standards.** Sewage collected in the Koror and Airai sewerage networks will be treated to tertiary standards at new sewage treatment plants (STPs) to be

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

² ADB. 2009. *Financial Due Diligence A Methodology Note*. Manila.

³ ADB. 2009. *Governance Assessment, Palau: Country Partnership Strategy 2009-2013*. Manila.

⁴ ADB. 2010. *Public Financial Management Assessment, Water Sector Improvement Program*. Manila.

⁵ International Monetary Fund (IMF). 2012. *Republic of Palau: 2012 Article IV Consultation, Staff Report, IMF Country Report No. 12/54*.

constructed at Malakal (Koror) and at Kesebelau (Airai). Effluent from the new STPs will meet Palau's environmental discharge quality standards for the current and projected 2036 sewer loads.

- (iii) **Output 3: Safe and hygienic public toilet facilities in Koror are available.** Three gender sensitive public toilets will be rehabilitated and connected to the sewer system while an additional three toilets will be built in key locations in the tourist precincts of Koror.
- (iv) **Output 4: Effective project management.** The project management unit (PMU), supported by project implementation assistance (PIA) consultants will provide project design and supervision, monitoring, reporting, quality and cost control, screening, contract administration services and monitoring of the gender action plan, and environmental action plan.

C. Country Issues

5. Country issues that potentially impact on the effective financial management of the proposed program include: (i) public financial management (PFM); (ii) availability of skills; and (iii) country environment.

6. Palau has made solid progress in improving PFM since achieving internal self-governance in 1981, particularly in government financial accounting and reporting – unqualified audit opinions have been issued on the government financial statements since fiscal year 2005/2006. The Office of the Public Auditor and Office of the Special Prosecutor perform their mandate effectively; Palau is an active participant in the ADB/OECD Anti-Corruption Initiative for Asia and the Pacific; and public finance legislative frameworks are reasonably sound.⁶ However, despite recent progress, further improvement is required.

1. Public Financial Management

7. The application of budget processes is not consistently applied and the quality of budget preparation and analysis prior to submission of annual budgets to Congress needs improvement. Most line ministries do not link annual budget projections to national and sectoral planning priorities. Cash planning and performance management systems are ineffective, hampering service delivery, and failing to provide a reasonable basis on which to plan, manage, or monitor expenditure (footnote 6). Revenue projections are sometimes inflated during deliberation and final approved budgets are not comprehensive. Budget execution is based on appropriations rather than cash availability, resulting in the drawdown of cash reserves and/or accumulation of arrears (footnote 5).

8. The Pacific Financial Technical Assistance Centre (PFTAC) carried out a scoping study in May 2008 to look at options for supporting budget reform.⁷ Working closely with PFTAC, ADB processed technical assistance in late 2009 to support the implementation of the PFTAC scoping study.⁸ Linked with this work, PFTAC have developed a cash management manual for Palau and is currently working closely with MOF to support the implementation of the manual and enhance cash management practices. In addition, PFTAC has provided recent support for enhancing tax administration and policy, financial sector regulation and supervision, and

⁶ ADB. 2010. *Public Financial Management Assessment, Water Sector Improvement Program*. Manila.

⁷ PFTAC. 2008. *Assessment Mission to Introduce a Medium-Term Budget in Palau and Requisite Technical Assistance Needs*. Suva.

⁸ ADB. 2009. *Technical Assistance to Palau for Implementing a Medium-Term Budget Framework*. Manila.

economic and financial statistics. In addition, ADB is supporting the design and implementation of a medium term budget framework to improve forecasting and link expenditure plans and appropriations to the actions of the medium terms development strategy. The first budget under the new framework will be presented to congress for the 2012/13 fiscal year.

9. Review of Palau's use of Compact of Free Association funding by the United States Government Accountability Office⁹ concluded that Palau's financial accountability has improved. However, it also reported that Palau still has persistent internal control problems in areas such as procurement, cash management, and equipment and property management, some of which have been recurring for many years.

10. All government audits in Palau are conducted by the public auditor or are contracted to private firms by the public auditor. There is no significant internal audit function in place in line ministries. The recent PFTAC scoping study points to this as a significant weakness that must be addressed early since, at present, heads of line ministries have no real guidance on issues such as the efficacy of their operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, or compliance with laws and regulations. In broad terms, the audit reports that have been done indicate a lack of adherence to established cash receipts and procedures, a need to strengthen expenditure controls, a need to review monthly bank reconciliations and accounts receivable, and a lack of internal control over financial reporting (footnote 3).

11. Streamlined PFM systems need to be adopted and applied consistently, including a formal and strictly adhered budget timetable; a more detailed *Integrated Planning Process* and well-costed budget submissions that allow effective scrutiny; a good cash planning system (footnote 3); a budget execution based on cash availability rather than appropriations; the establishment of Cash Management Committee which could help ensure transparent allocation of cash resources based on spending priorities, and more relevant performance measurement systems (footnote 5).

2. Availability of Skills

12. In common with many Pacific developing member countries, Palau has shortage of skills in financial management, including financial analysis, management accounting, financial reporting and audit. The state-owned Palau Community College, the only college in Palau, offers an associate degree in accounting which is basically equivalent to a bookkeeping course in other Asian countries. With a dearth of qualified local accountants and audit professionals, private sector owned businesses hire foreign accountants to handle their accounting and financial management needs. Audit engagements of international audit firms with local offices in Palau are handled by international staff auditors.

⁹ United States Government Accountability Office. 2008. *Compact of Free Association: Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self-Sufficiency*. Washington, DC.

3. Country Environment

13. **Governance.** Palau's governance performance is well above the Pacific island average on most key indicators as Table 1 below indicates, with the notable exception of government effectiveness. There is a strong perception within the community and private sector that government effectiveness is less than adequate, and there is skepticism concerning government commitment to implementing reform. First, it is unclear just how well policy statements are supported by the legislature or integrated into line agency programs and activities. Second, the tendency for economic reforms to be rejected by the Congress has been attributed to the fact that senior business leaders and members of the legislature would be the most exposed to the consequent increase in competition.¹⁰

Table 1: Governance Indicators, 2008

Country	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Palau	1.24	1.18	-0.56	n/a	0.68	n/a
Pacific Average	0.36	0.72	-0.72	-0.88	-0.15	-0.44

Source: World Bank. Governance Matters VIII: Governance Indicators for 1996-2008, June 2009.

Note: The Pacific Average has been calculated for those countries for which data are available for the particular year, from the group comprising Cook Islands, Fiji Islands, Federated States of Micronesia, Kiribati, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Timor Leste, Tonga, Tuvalu and Vanuatu. The indicators are measured in the range of -2.5 to +2.5, with a higher score indicating better governance.

14. **Procurement.** Palau has in place a procurement law,¹¹ which applies to the procurement of goods and services by the national and state governments and by most agencies of the national government.¹² Although the law designates procurement officers at the national and state levels to oversee procurement, Palau's procurement system is centralized. All procurement is processed through the MOF, and the Attorney General and his or her state counterparts must certify the form and legality of all contracts. The procurement law also contains specific provisions dealing with conflict of interest and the offering of gifts and gratuities, which apply to all procurement personnel. In addition, the Code of Ethics Act contains provisions that apply to all civil servants.

15. In relation to procurement procedures, Palau does have model tender documents and contracts with anti-competition clauses. Procurement opportunities must, by law, be announced in a newspaper of general circulation. In addition, each procurement officer must notify all eligible contractors of every procurement opportunity. Prequalification is available, and procurement must be advertised for 15 days before bidding begins. Although bidders are not present at the bid opening, the procurement law includes detailed procedures for bid opening aimed at enhancing transparency. A selection committee may be set up to evaluate bids, but the procurement officer makes the final decision. All bidders must be informed of the result and the reasons for the decision. There is a review process available to actual and prospective bidders.

16. ADB completed a procurement assessment of Palau in July 2010.¹³ The assessment concluded that Palau's procurement law is well observed among government agencies, but

¹⁰ ADB. 2005. *Country Economic Report: Republic of Palau, CER:PAL 2005-07*. Manila.

¹¹ 40 Palau National Code. Chapter 6.

¹² Semiautonomous agencies set their own procurement policies, which must at least meet the standards of the *Procurement Law and Regulations*.

¹³ ADB. 2010. *Procurement Capacity Assessment Report and Recommendations*. Manila.

does contain some ambiguity in procurement processes, particularly in evaluation methods. The assessment also noted that while there is a lack of operational guidelines and manuals, large procurement decisions are normally made by selection committees, and approved by authorized individuals with appropriate substantiation.

17. **Anti-Corruption.** The country has an independent public auditor, who is appointed by the President and confirmed by the legislature. The existence, authority and independence of the position of public auditor are specified through a provision in the Constitution. Palau is the only Micronesian country with a special prosecutor which gives the government the capacity to actually bring cases to court. However, the position of special prosecutor has been vacant for the past two years and needs to be immediately filled. The Code of Ethics Act spells out what is illegal for government officials, and the public auditor and the special prosecutor can hold them accountable for failure to observe the law.

18. The size and structure of government in Palau is as much a concern for corruption as it is for public expenditure control. With 14 full state governments to service a total population of 20,000, there have been charges laid against several governors and other state officials for mismanagement of funds. In particular, conflict of interest is potentially a serious problem since congressmen routinely have side businesses (e.g., bank, retail outlet, rental business). The Code of Ethics Act addresses conflict of interest, establishes an Ethics Commission and specifies criminal and civil penalties. Nevertheless, there is a concern that congressmen and other public officials do not abstain from discussion, voting or decision making on legislation or policies that may directly or indirectly affect their own business interests.

D. Risk Analysis

19. A summary Financial Management Internal Control and Risk Assessment was completed (footnote 1). The risk-assessment approach is based largely on International Standard on Auditing 400: *Risk Assessment and Internal Control*. The following risk assessments are based on existing circumstances, staffing and procedures, and include recommendations for risk mitigation measures.

Table 2: Financial Management Internal Control and Risk Assessment

Risk Type	Risk Description	Mitigation Measures	Risk Level ^a
Inherent Risks			
1. Country-specific risks	Weak PFM systems, particularly budget preparation and execution, cash planning and performance measurement. Shortage of skills in financial management, including financial analysis, management accounting, financial reporting and audit. Malpractice and abuse of PFM rules by employees.	Timely audit review is regularly undertaken by the Office of the Public Auditor. Ongoing efforts are underway by ADB and other development partners to strengthen PFM arrangements, including ADB's TA 7421-PAL: <i>Implementing a Medium-Term Budget Framework</i> .	M

Risk Type	Risk Description	Mitigation Measures	Risk Level^a
2. Entity-specific risks	PPUC is a newly established entity with limited ADB project experience and limited staff capability in financial management, accounting, budgeting, internal controls and financial reporting.	A parallel ADB-funded program, <i>Water Sector Improvement Program</i> (Loans 2691-PAL and 2692-PAL), will provide support to PPUC to strengthen its management and technical capabilities, including financial management, accounting, budgeting, internal controls and financial reporting.	M
3. Program-specific risks	MOF as Executing Agency and PPUC as Implementing Agency have no prior experience implementing sector programs with large contract procurement following ADB and PPUC guidelines. Lack of program management skills of staff assigned to handle the program.	A workshop on ADB project management, procurement, disbursement and reporting guidelines will be required. Under the parallel ADB <i>Water Sector Improvement Program</i> , technical assistance will be provided to support the sector programs implementation. In addition, the Program Steering Committee, Chaired by the Vice-President and Minister of Finance, will assist in mitigating the risk.	M
Overall Inherent Risk			M
Control Risks			
1. Implementing entity	PPUC has no prior ADB project experience and limited staff capability in financial management, accounting, budgeting, internal controls and financial reporting.	Under the parallel ADB <i>Water Sector Improvement Program</i> , technical support will be provided to PPUC to strengthen its management and technical capabilities, including financial management, accounting, budgeting, internal controls and financial reporting.	M
2. Staffing	Limited capability in financial management, accounting, budgeting, internal controls and financial reporting. Management and staff are not familiar with ADB current disbursement and reporting guidelines.	Under the parallel ADB <i>Water Sector Improvement Program</i> , technical support will be provided to PPUC to strengthen its management and technical capabilities, including financial management, accounting, budgeting, internal controls and financial reporting. A workshop to explain ADB current disbursement and reporting guidelines will be required.	M
3. Accounting policies and procedures	Poor financial management, accounting, budgeting and internal controls.	Under the parallel ADB <i>Water Sector Improvement Program</i> , technical support will be provided to PPUC to strengthen its management and technical capabilities, including financial management, accounting, budgeting, internal controls and financial reporting.	M
4. Procurement	Palau's procurement law does	A workshop to explain ADB current	M

Risk Type	Risk Description	Mitigation Measures	Risk Level^a
	not totally mirror current ADB requirements. Furthermore, the GOP has very limited experience of large contract procurement.	procurement guidelines will be required.	
5. Internal audit	The Office of the Public Auditor is effective in undertaking its mandate and therefore lack of a timely audit review is low.	Not applicable.	L
6. External audit	Delay in the completion of Program accounts ready for external audit.	Separate accounts and records of the bank deposit account and Program expenditures shall be maintained by the MOF within the GOP accounting system; GOP shall submit to ADB within 6 months after end of fiscal year certified copies of audited statement of deposit account and Program expenditures by independent external auditors, whose qualifications, experience and TOR are acceptable to ADB, in accordance with appropriate auditing standards.	M
7. Reporting and monitoring	Inadequate financial reporting and monitoring covering all aspects of sector financial performance.	Under the parallel ADB <i>Water Sector Improvement Program</i> , technical support will be provided to PPUC to strengthen its management and technical capabilities, including financial management, accounting, budgeting, internal controls and financial reporting.	M
8. Information systems	Inefficient financial information systems covering all aspects of sector financial performance.	Under the parallel ADB <i>Water Sector Improvement Program</i> , technical support will be provided to PPUC to strengthen its management and technical capabilities, including financial management, accounting, budgeting, internal controls and financial reporting.	M
Overall Risk			M

^a H = High, S = Substantial, M = Moderate, L = Low.
Source: Asian Development Bank.

E. Implementing Entities

20. The EA for the proposed program will be the MOF and will be responsible for the overall implementation, financial management and budget support required under the program.

1. Ministry of Finance

21. The MOF has no experience implementing ADB loan program as the *Water Sector Improvement Program* started last year.

22. **Accounting System.** The MOF maintains the GOP's centralized Financial Management System (FMS). The FMS is an on-line, interactive system for the executive and legislative branches of the government. Line ministries are given access for on-line inquiry and reporting of their accounts. Each user must have a unique ID and password to sign on to the system. The system provides a functional security feature that defines which users have access to particular financial functions.

23. The MOF integrated FMS records and classifies financial transactions at account and subaccount levels by fund, organization and cost center. An integrated general ledger and subsidiary ledger chart of accounts is used for each fund. Revenue and expenditure accounts and subaccounts are used in all funds, at all organizational levels from department, division, section and group levels as established by management. Costs and revenues are gathered by cost center and reports are provided by function, service, and program/project, as well as cost center.

24. The MOF uses the accrual method of accounting. Accounting standards are in accordance with local laws and generally accepted accounting principles (GAAP). The MOF adopts the governmental accounting and financial reporting principles established by the US Governmental Accounting Standards Board (GASB).

25. The KASP does not include an imprest account and as such there is low risk of financial risk factors from accounting payments systems.

26. **Staffing.** The MOF has limited capacity in accounting and financial management skills. Although the staffing of the Division of Finance and Accounting is complete with the hiring in 2009 of the Division Chief, vacant since 2003, annual financial statements and accounts ready for external audit are delayed. Timely completion of accounts ready for audit is a major concern. The most recent audited accounts available are for FY2009. The lack of up-to-date audited accounts seriously undermines the government's timely presentation of its financial statements and commitment to greater transparency and accountability.

27. **Budgeting.** The application of budget processes is not consistently applied and the quality of budget preparation and analysis prior to submission of annual budgets to Congress needs improvement. Most line ministries do not link annual budget projections to national and sectoral planning priorities. The MOF has very limited capacity to analyze line Ministries budget submissions effectively. Cash planning and performance management systems are ineffective, hampering service delivery, and failing to provide a reasonable basis on which to plan, manage, or monitor expenditure (footnote 4). Revenue projections are sometimes inflated during deliberation and final approved budgets are not comprehensive. Budget execution is based on appropriations rather than cash availability, resulting in the drawdown of cash reserves and/or accumulation of arrears (footnote 5).

28. **Internal Audit.** There is no internal audit function in place in the ministry. The PFTAC scoping study points to this as a significant weakness that must be addressed. All government audits in Palau are conducted by the Public Auditor or are contracted to private firms by the Public Auditor. The audit reports that have been done indicate a lack of adherence to established cash receipts and procedures, a need to strengthen expenditure controls, a need to review monthly bank reconciliations and accounts receivable, and a lack of internal control over financial reporting (footnote 3).

29. **External Audit.** The financial statements are audited annually by independent auditors. The auditors, currently the Deloitte Touche, are required to audit major US Federal Grants thoroughly as required by the Single Audit Act. The audit is conducted in accordance with the generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the US. Audit reports are required to be finalized within nine months after the close of a fiscal year. However, annual financial statements and accounts ready for external audit are delayed. The most recent audited accounts available are for FY2010. Although the audit opinion on the financial statements have been clean during the past years, reportable conditions in internal control over compliance with requirements applicable to major federal award programs were identified, some of which were considered to be material weaknesses.

30. As a loan condition, GOP shall submit to ADB within 6 months after the end of fiscal year, certified copies of audited statement of ADB loan fund deposit account and project expenditures by independent external auditors, whose qualifications, experience, and TOR are acceptable to ADB, in accordance with appropriate auditing standards.

2. Palau Public Utilities Corporation Water and Wastewater Operations

The Palau Water and Sewer Corporation was established in September 2011 through legislation (RPPL No. 8-31) called "The Water and Sewer Corporation Act". The members of the Board of Directors (BOD) were appointed by the President of Palau in October 2011. In January 2013, a new government entered into office. The new government immediately implemented policies to reduce the cost of managing and operating public utilities (electricity, water, and sewerage) through shared services and facilities. On 6 June 2013, the President signed into law the Utilities Consolidation (UC) Act¹⁴ to consolidate the delivery of electricity, water and sewerage services by a single autonomous and independent entity. The Water and Wastewater Operations of PPUC was declared operationally effective by the President on 23 July 2013 giving PPUC the mandate for the delivery of electricity, water and sewerage services.

F. Funds Flow and Disbursement

31. The proceeds of the loan will be disbursed to the GOP as the borrower according to ADB's *Simplified Disbursement Procedures and Related Requirements for Program Loans*.¹⁵ The loan proceeds will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2007, as amended from time to time) and detailed arrangements agreed upon between the GOP and ADB. The loan proceeds will finance the full foreign exchange costs, excluding local taxes and duties. Prior to withdrawal of loan proceeds, the GOP will open a deposit account at a bank acceptable to ADB. The account will be managed, operated and liquidated in accordance

¹⁴ Republic of Palau Public Law 9-4: The Utilities Consolidation Act 2013.

¹⁵ ADB. 1998. *Simplified Disbursement Procedures and Related Requirements for Program Loans*. Manila.

with terms satisfactory to ADB. The MOF will maintain records of accounts for the program. The flow of program funds is described in Figure 1 below.

G. Financial Management Plan

32. The PPUC will require consultant support to establish the finance function and to build financial management capacity. Under the parallel WSIP, the consultant will assist PPUC with the following:

- (i) Establish commercial systems and procedures including customer billing and collection;
- (ii) Establish current revenue collection, receipting, and banking procedures; implement internal financial control procedures and train staff thoroughly in their use;
- (iii) Establish financial accounting and reporting tools (including software and computer hardware) and design and implement procedures as required;
- (iv) Establish and supervise the production of routine, semi-annual, and annual financial reports and accounts required for internal and external use, including an Annual Report;
- (v) Prepare procedures for procurement of goods, works, and services including preparing bid / tender documents, tendering / bidding activities, awarding / establishing contracts and managing / administering contract performance;
- (vi) Assist in the preparation of an asset register, preparation of an asset management plan, development and implementation of procedures for asset management, asset assessment (condition and value) and recording and reporting of asset performance and levels of service; and
- (vii) Maintain cash budgets to ensure adequacy of cash to avoid disruptions in ongoing operations.

