

FINANCIAL MANAGEMENT ASSESSMENT

A. EXECUTIVE SUMMARY

1. The financial management assessment (FMA) for the additional financing of the Third Urban Governance and Infrastructure Improvement (Sector) Project¹ was conducted in accordance with the *Financial Management and Analysis of Projects* (2005) guidelines, the *Financial Due Diligence: A Methodology Note* (2009), and the *Financial Management Technical Guidance Note* (2015)² of the Asian Development Bank (ADB). The FMA considered the financial management capacity and funds flow arrangements, staffing, accounting and financial reporting systems, financial information systems, and internal and external auditing arrangements of the Local Government Engineering Department (LGED) and the Department of Public Health Engineering (DPHE) as executing agencies, the latter in particular for the water supply and sanitation components. The FMA also considered the financial management capacity of the *pourashavas* (municipalities) as implementing agencies.

2. The LGED will be responsible for overall management, supervision, and execution of the additional financing. LGED has already established the project management unit (PMU) headed by a full-time project director who is implementing the current project. The project director is supported by three project managers, one each for municipal infrastructure (from LGED), governance and institutional capacity (from LGED), and water supply and sanitation (from DPHE). LGED has considerable experiences in implementing donor-funded projects, including the current project.

3. The PMU will be responsible for all day-to-day management of the additional financing, which includes (i) preparing an overall project implementation plan and detailed work program, (ii) providing monitoring and guidance on the implementation of project works, (iii) conducting all tendering and execution of contracts, (iv) preparing the project progress report and project completion report, and (v) ensuring full compliance with the ADB's safeguards policies.

4. The project implementation units (PIUs) located within the *pourashavas* will be responsible for (i) project management and administration; (ii) procurement of goods and works; (iii) technical support; (iv) safeguards compliance; and (v) institutional capacity, governance, and community development.

5. The major risk factors identified during the assessment that need to be addressed include the following:

- (i) lack of experience of *pourashavas* in managing externally assisted projects;
- (ii) weak and inadequate financial capacity of *pourashavas* to sustain the newly developed assets under the additional financing; and
- (iii) delays in internal and external audits of *pourashavas'* financial statements, including delays in clearing the existing backlogs.

¹ ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of Bangladesh for the Third Urban Governance and Infrastructure Improvement (Sector) Project*. Manila.

² ADB. 2005. *Financial Management and Analysis of Projects*. Manila; ADB. 2009. *Financial Due Diligence: A Methodology Note*. Manila; ADB. 2015. *Financial Management Technical Guidance Note*. Manila.

6. Despite the highlighted risks, the financial management arrangements are satisfactory, considering the ongoing actions of LGED and DPHE. The existing and additional loan consultants' teams, including the management design and supervision (MDS) and governance improvement and capacity development (GICD) teams, will provide continuous support. **The overall risk assessment for the additional financing is Moderate.** The action plan for mitigating the foreseen risks consists of the following measures:

- (i) Extend full training and capacity building support with the help of MDS, GICD, and individual consultants to strengthen the financial management capacities of *pourashavas*;
- (ii) Facilitate necessary steps for revenue augmentation and sustainability of the additional financing including periodic reassessment of holdings tax demand and increase of holdings tax at the rate they are supposed to be levied and collected; and introduction of volumetric tariff and periodic revisions for recovery of operation and maintenance cost with respect to the water supply subprojects; and
- (iii) Clear existing backlogs in the audit of *pourashavas*' financial statements and conduct timely audit on a yearly basis by appointing qualified and experienced staff before commencement of the additional financing.

B. INTRODUCTION

7. This FMA focuses on funds flow arrangements, staffing, accounting policies and procedures, internal controls, financial reporting and monitoring, and internal and external audit. The FMA covers the following:

- (i) Local Government Engineering Department, in its role as the project executing agency that houses the PMU;
- (ii) Department of Public Health Engineering as another executing agency responsible specifically for water supply and sanitation subprojects; and
- (iii) *Pourashavas* as implementing agencies, and their respective PIUs located within the *pourashavas*.

8. A key aspect of the FMA is evaluating the risks associated with the project financial management arrangements. ADB's principal concern is to ensure that the funds of the additional financing are used economically and efficiently for the purpose intended. In support of this, ADB seeks assurance that the financial management systems of executing agencies and implementing agencies can report on the sources and uses of funds of the additional financing.

9. The FMA was conducted to (i) assess executing agencies' capacity to monitor, manage, and support the overall program of the additional financing; (ii) assess implementing agencies' capacity to implement and manage investments; and (iii) propose ways and means to strengthen the financial management capacity of executing agencies and implementing agencies. Specifically, the objective is to enhance competence levels to achieve the government's goals of improved access to municipal services and increased resilience to climate change impacts.

C. BRIEF PROJECT DESCRIPTION

10. The approved country operations business plan, 2017–2019³ includes a provision for the additional financing of the Third Urban Governance and Infrastructure Improvement (Sector) Project,⁴ with \$200 million allocated for development activities. The current project supports the strengthening of urban governance and improvement of urban infrastructure and service delivery in *pourashavas* (municipalities) by providing investment support to *pourashavas* based on their governance performance. The additional financing will expand the current project by supporting (i) additional priority infrastructure and governance improvements in *pourashavas* covered by the current project, and (ii) infrastructure and governance improvements in five more *pourashavas*.

11. All *pourashavas* under the current project are involved in the Urban Governance Improvement Action Program (UGIAP),⁵ a performance-based budget allocation system whereby funding for infrastructure improvements will be made available in three phases upon fulfillment of the institutional and governance criteria for each phase (entry, intermediate, and advanced). Based on an assessment of compliance with the intermediate performance criteria of the UGIAP, the five new *pourashavas* to be included under additional financing will enter the overall project (current project including additional financing) in Phase 2. The overall project will have two outputs: municipal infrastructure improved and made gender- and climate-responsive; and capacity of *pourashavas* in urban service delivery, planning, and financial management improved.

12. The FMA is based on the results of an FMA questionnaire, discussions with officials of executing agencies and implementing agencies, and information available through various reports including the annual reports of executing agencies and implementing agencies.

D. COUNTRY-LEVEL ISSUES

13. Using the existing diagnostics and available reviews, this section provides a country-level FMA focusing on the overall public financial management (PFM) set-up of the Government of Bangladesh and its functioning vis-à-vis public expenditure management outcomes.

14. Most recent PFM assessments prepared for Bangladesh is the country-level PFM based on the Public Expenditure and Financial Accountability (PEFA) assessment conducted by the government in 2015 with the support of the World Bank.⁶ Bangladesh has made positive progress in developing PFM systems since the last PEFA assessment in 2010. However, this is not reflected in the scoring due to incomplete implementation of initiatives undertaken to improve PFM, e.g., in procurement, internal audit, oversight of public corporations, and external audit. Weaknesses therefore remain, especially in control environment and tax reconciliation.

15. Table 1 shows the summary of the results for 2015. Out of the 31 indicators, Bangladesh ranked B+ (representing performance near good international practice) in only 1 indicator; B (performance ranging from good to medium) in 7 indicators; C+ and C, (performance ranging from medium to poor) in 11 indicators; and D+ and D (ineffective or

³ ADB. 2016. *Bangladesh: Country Operations Business Plan, 2017–2019*. Manila.

⁴ ADB. 2014. *Report and Recommendations of the President on a Proposed Loan to the People's Republic of Bangladesh for the Third Urban Governance and Infrastructure Improvement (Sector) Project*. Manila.

⁵ ADB. 2016. *Project Administration Manual. Appendix 6: Urban Governance Improvement Action Program (UGIAP)*. Manila.

⁶ Government of Bangladesh. 2016. *Public Financial Management Performance Report*. Dhaka.

nonfunctioning process or procedure, or no process or procedure exists at all) in the rest of the indicators.

Table 1: Summary Results by Budget Dimension and Indicators, 2015

Budget Dimension and Indicators	Dimension Ratings				Average Rating
	i	ii	iii	iv	
A. Budget Reliability					
PI-1: Aggregate expenditure outturn	B				B
PI-2: Composition of expenditure outturn	D	C	A		D+
PI-3: Aggregate revenue outturn	D	B			C
B. Transparency of Public Finances					
PI-4: Budget classification	C				C
PI-5: Budget documentation	B				B
PI-6: Central government operations outside financial reports	D	D	D		D
PI-7: Transfers to subnational governments	C	D			C+
PI-8: Performance information for service delivery	C	B	D	D	D+
PI-9: Public access to key fiscal information	D				D
C. Management of Assets and Liabilities					
PI-10: Fiscal risk reporting	D	D	C		D+
PI-11: Public investment management	D	B	D	B	C
PI-12: Public asset management	C	D	D		D+
PI-13: Debt management	B	D	A		B
D. Policy-Based Fiscal Strategy and Budgeting					
PI-14: Macroeconomic and fiscal forecasting	C	C	D		D+
PI-15: Fiscal strategy	D	A	B		B
PI-16: Medium perspective in expenditure budgeting	A	A	D	D	C+
PI-17: Budget preparation process	A	B	D		B
PI-18: Legislative scrutiny of budget	A	C	A	A	C+
E. Predictability and Control in Budget Execution					
PI-19: Revenue administration	B	D	D	D	D+
PI-20: Accounting for revenue	A	A	C		C+
PI-21: Predictability of in-year resource allocation	C	A	B	A	B+
PI-22: Expenditure arrears	D	D			D
PI-23: Payroll controls	B	B	C	C	C+
PI-24: Procurement management	B	B	B	B	B
PI-25: Internal controls on nonsalary expenditure	A	D	D		C
PI-26: Internal audit	D				D
F. Accounting and Reporting					
PI-27: Financial data integrity	D	A	D	A	C+
PI-28: In-year budget reports	A	C	C		C+
PI-29: Annual financial statements	D	D	C		D+
G. External Scrutiny and Audit					
PI-30: External audit	D	D	D	C	D+
PI-31: Legislative scrutiny of external audit reports	D	A	A	B	B

PI = performance indicators.

Note: A rating of "A" corresponds to international-level practice; "B" to good to medium performance; "C" to medium to poor performance; and "D" indicates process or procedure does not exist at all or it is not functioning effectively.

Source: Government of Bangladesh. 2016. *Public Financial Management Performance Report and Public Expenditure and Financial Accountability*. Dhaka.

16. The scores of the individual performance indicators at the country level in the 2010 and 2015 PEFA assessments were compared using the 2011 framework. There was no improvement in credibility, comprehensiveness, and transparency of budget. Performance of other dimensions in the budget cycle improved. Of 28 parameters measured in PEFA 2010, 7 performance indicators improved, 14 remained the same, and 7 deteriorated in the PEFA 2016 assessment. External scrutiny and audit remain weak in the PFM system.

17. **Review of PFM performance.** The institutional framework of PFM in Bangladesh is under transition and several improvements have been made or are being attempted. The dominant role of the Ministry of Finance in budget management has contributed to the country's strong record of fiscal discipline. The country's PFM systems have impacted PFM performance in the areas of (i) aggregate fiscal discipline, (ii) strategic allocation of resources, and (iii) efficient use of resources for service delivery.

18. The deficit targets have been met, meaning that aggregate fiscal balance has been maintained. Both revenue and expenditures have fallen short of the original budgeted amounts during the assessment period resulting in inefficient use of public funds. There is room for improvement of budget credibility. Some improvements have been made toward fiscal risk oversight. The well-functioning mechanism for debt contracting and issuance of guarantees, reporting of government-guaranteed debt, and the high quality of debt data contribute to fiscal discipline. Continued improvements in the external oversight mechanisms and the parliamentary scrutiny of government financial operations are expected to contribute to fiscal discipline.

19. Recognizing the limitations of an annual, input-oriented, and fragmented budgeting exercise, the government introduced a 3-year, medium-term budgeting framework so that the link between development strategy and resource allocation can be enhanced. However, the strategic allocation of resources is undermined by weaknesses in the linkage between the medium-term budget with sector strategies and performance indicators. Linkages are also weak between the development budget and nondevelopment budget processes. Including a systematic annual report on the financial operations of extrabudgetary funds would enhance the government's strategic allocation capabilities.

20. There is a good degree of predictability in funding for ministries but there are weaknesses in revenue and expenditure controls and in reporting and accountability mechanisms. However, the management of public resources within individual sectors and programs needs to improve significantly to raise the level of satisfactory service delivery. The current weaknesses in the procurement system could have adverse implications for the efficiency in service delivery.⁷ Significant delays in finalization of annual financial reports reduce the effectiveness of external audits and their scrutiny as accountability mechanisms and counterchecks on inefficient use of resources.

21. **Way forward.** There has been a renewed focus on PFM activities and a continued emphasis on improving PFM process and procedures. The major PFM reform project, Deepening Medium-Term Budget Framework and Strengthening Financial Accountability Project, closed in 2014. However, the development of an integrated budgeting and accounting system (iBAS++) has continued. When fully implemented, iBAS++ should strengthen control procedures, enable a comprehensive budgeting process, and address weaknesses in accounting and recording. Improvements in procurement processes are ongoing and should improve with increased e-procurement coverage. Bringing the audit of government accounts up

⁷ e-Procurement is being rolled out and is yet to be made operational and effective across the country.

to date by preparing the annual financial statements in a timely manner is an important task. Scrutiny by the Public Accounts Committee has started but is yet to reach full potential.

22. As articulated in the PFM reform strategy in 2006, the government should continue its commitment to improve function of the PFM system. In line with this, the government, with the support of the World Bank, established a trust fund, the Strengthening Public Expenditure Management Program, for PFM reform. The program, to be implemented by 2018, has three key priority areas, namely, (i) budget preparation and execution, (ii) internal and external auditing, and (iii) legislative and public oversight.

E. PROJECT FINANCIAL MANAGEMENT SYSTEM

1. Project Management Unit

23. **Major experience in managing externally financed projects.** Both LGED and DPHE have had experience in the implementation of projects funded by financing partners such as ADB, Danish International Development Agency, KfW Development Bank, International Fund for Agricultural Development, Islamic Development Bank, Japan Bank for International Cooperation, Danish International Development Agency, OPEC Fund for International Development, United Kingdom Department for International Development, and World Bank. Over the years, the management of LGED and DPHE has gained sufficient experience in complying with donor agencies' covenants and procedures in financial operation. Aside from the current project, LGED and DPHE are working on similar external donor-funded projects.

24. **Funds flow arrangements.** LGED through the PMU will manage overall project funds and have its own project accounts. DPHE will create a subaccount for recurrent administrative costs since it will work in its own office building (to maximize their technical resources).

25. **Staffing.** The finance and accounts sections of LGED and DPHE are adequately staffed at present with one accounts officer who is assisted by two accounts personnel. The existing PMU responsible for managing the current project has adequate experts to manage the financial management system. For the additional financing, PMU has indicated hiring two additional assistant accountants. Staff are being trained on ADB's financial management procedures.

26. **Accounting policy and procedures.** The policies and procedures of LGED and DPHE are well documented. Both entities keep all records of their financial transactions. They follow the cash accounting procedure in accordance with the National Accounting Standards and International Financial Reporting Standards, which are similar to the Bangladesh Accounting Standards, or the Bangladesh Financial Reporting Standards.

27. **Segregation of duties.** The organizational systems of LGED and DPHE ensure adequate segregation of duties. While the engineering and administrative departments are responsible for ordering and receiving the required equipment and services for the operation of the system, the finance and accounts sections are responsible for billing, bill payments, and managing revenue receipts under the payment management system. In the account departments as well, activities like authorization, recording, payments, and reconciliations are under different units and staff.

28. **Budgeting system.** Budget preparation is based on a bottom-up approach. The PIUs provide the actual data from the field and cost centers to the PMU, which consolidate and

forward data to LGED for further approval by the administrative ministry, then final approval by the Ministry of Finance and Ministry of Planning. At the entity level, the budget is prepared by the budget working group in accordance with set procedures.

29. **Payments.** Payments are made against invoices following adequate accounting safeguard procedures.

30. **Cash in bank.** The project director at the PMU level and the mayor, secretary, or PIU head in the implementing agency are the authorized signatories for the bank accounts. The finance and accounts section is responsible for ensuring monthly reconciliation of accounting records and bank statements. If there are variances, the finance and accounts section and the concerned bank take necessary actions to resolve the matters expeditiously.

31. **Safeguard over assets.** Fixed asset registers are available, which are in the process of being updated. Periodic verification procedures along with insurance provisions for certain assets of LGED and DPHE are provided with adequate safeguard systems.

32. **Other offices and implementing entities.** Implementation of the additional financing would be done solely by the PMU and PIUs. The oversight mechanism of the current project has functioned well.

33. **Contract management and accounting.** The LGED and DPHE maintain all records, including accounting records and contracts. The PMU of the current project has established a proven system for contract management and account monitoring.

34. **Internal audit.** Since 1995, an internal audit cell has been working at the LGED. Most staff are qualified and experienced in audit and have received regular training. The internal audit program has been developed by LGED, and compilation of rules and regulations is in place. The internal audit cell periodically conducts internal audit of ongoing projects. Dedicated audit officials for funded projects are currently lacking, and may be one of the risks in the financial management of the additional financing. The DPHE does not have an internal audit cell.

35. **External audit for entity level.** The Office of the Controller and Auditor General of Bangladesh conducts the external audit of LGED and DPHE. The Foreign Aided Project Audit Directorate (FAPAD) at the Office of the Controller and Auditor General has the constitutional mandate to conduct external audits of donor-funded projects and related accounts, including all subaccounts. Annual audit reports are typically produced within 6 months after the fiscal year. Issues are brought to the notice of management for follow-up and the necessary actions are taken to settle audit observations.

36. **External audit for project level.** For development projects, an audit is conducted by the FAPAD. This unit has expertise on loan procedures and loan negotiation documents. The unit reviews compliance with actual procedures based on the approved loan agreements, including tax payments and disbursements. LGED is experienced in managing such accounts. The Audited Project Financial Statements under the current project for FY2015 and FY2016 have been prepared on time and are unqualified.⁸

37. **Reporting and monitoring.** The reporting of LGED and DPHE is done in accordance with Generally Accepted Accounting Principles and the Bangladesh Accounting

⁸ The fiscal year of the Government of Bangladesh and its agencies ends on 30 June. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY2017 ends on 30 June 2017.

Standards. Financial statements are prepared on monthly and annual bases using a computerized accounting system called Unified Financial Management System (UFMS).

38. **Information systems.** The accounts departments of LGED and DPHE use UFMS to generate the various reports and financial systems. Reports not generated under this system are prepared using Excel.

2. Project Implementation Units

39. **Major experience in managing externally financed projects.** *Pourashavas* under the current project already have experience in implementing the first and partially the second phase of the project. The five new *pourashavas* to be included under additional financing have limited experience in implementing externally financed projects through UGIIP-II and Bangladesh Municipal Development Fund.

40. **Funds flow arrangements.** The *pourashavas* will not be engaged in funds flow since LGED will manage overall project funds.

41. **Staffing.** The *pourashavas'* finance and accounts sections are adequately staffed for the present level of operations, as each *pourashava* has one accounts officer, one accountant, and three accounts assistants. In the case of Faridpur, it has indicated additional staff requirements—one accountant and three assistants—for the additional financing, in addition to the existing staff.

42. **Accounting policy and procedures.** The *pourashavas* follow the cash accounting procedure, in accordance with the National Accounting Standards and International Financial Reporting Standards, which are similar to the Bangladesh Accounting Standards, or the Bangladesh Financial Reporting Standards.

43. **Segregation of duties.** The organizational system of the *pourashavas* ensures adequate segregation of duties. While the engineering and administrative departments are responsible for ordering and receiving the required equipment and services for the operation of the system, the finance and accounts sections are responsible for billing, bill payments, and managing revenue receipts under payment management system. In the accounts department, activities like authorization, recording, payments, and reconciliations are segregated under different units and staff.

44. **Budgeting system.** Budget preparation is the responsibility of the accounts officer and mayor. Budgets are prepared and placed before the *Paura Parishad* (municipal council) for approval.

45. **Payments.** Payments are made against invoices following adequate accounting safeguard procedures.

46. **Cash and bank.** The mayor, secretary, or equivalent officer in the implementing agency is the authorized signatory for the bank accounts. The finance and accounts section is responsible for ensuring monthly reconciliation of accounting records and bank statements. If there are any variances, the finance and accounts section and the concerned bank take necessary actions to resolve the matters expeditiously.

47. **Safeguard over assets.** Fixed asset registers are available and are in the process of being updated. Periodic verification procedures along with insurance provisions for certain assets of the *pourashavas* are provided with adequate safeguard system.

48. **Contract management and accounting.** The *pourashavas* maintain all records including accounting records and contracts.

49. **Internal audit.** There is no internal audit department in the *pourashavas*. The Standing Committee for Audit and Inspection in the *pourashavas* carries out this function as and when required. Reports are presented to the mayor informally and compliance actions are initiated to resolve any audit issue. Dedicated audit officials for funded projects are not available, and this may be one of risks to the financial management of the additional financing.

50. **External audit for entity level.** The Office of the Controller and Auditor General of Bangladesh conducts the external audit of the project *pourashavas*. The FAPAD of the Office of the Controller and Auditor General has the constitutional mandate to conduct external audits of donor-funded projects and related accounts, including all subaccounts. Annual audit reports are typically produced within 6 months of the end of the financial year. However, of the five new towns to be included under additional financing, Cox's Bazar's audit has been completed only up to FY2013, and Gopalganj's audit has been completed only up to FY2014. Under the additional financing, *pourashavas'* annual financial statements as well as the annual project financial statements have to be done on a yearly basis, and reports should be generated and issued within the agreed date. Issues are brought to the notice of management for follow-up and necessary actions are taken to settle audit observations.

51. **External audit for project level.** For development projects, an audit is also conducted by the FAPAD. This unit has expertise on loan procedures and loan negotiation documents. The unit reviews compliance with actual procedures based on the approved loan agreements, and reviews tax payments and disbursements.

52. **Reporting and monitoring.** Reporting is done in accordance with Generally Accepted Accounting Principles and the Bangladesh Accounting Standards. Financial statements are prepared on monthly and annual bases using UFMS.

53. **Information systems.** The accounts department uses UFMS to generate the various reports and financial systems. Reports not generated under this system are prepared using Excel.

F. RISK ASSESSMENT

54. The FMA reviewed two types of risks: inherent risks, i.e., risks outside the direct control of the financial management of LGED, DPHE, and the *pourashavas*; and control risks, i.e., risks concerning internal functions and control of the finance and accounting section of LGED, DPHE, and the *pourashavas*. The FMA identified key risks as presented in Table 2.

Table 2: Risk Assessment

Risk	Risk Assessment	Mitigation Measures
A. Inherent Risks		
1. Country-Specific Risks	<p style="text-align: center;">MODERATE</p> <p>Increasing unstable political situation, due to election-related issues, frequent strikes, and <i>hartals</i> (strike action), may hamper economic development and smooth implementation of development projects.</p>	The government and ADB should continue the policy dialogues through various occasions including the country partnership strategy and the country operations business plan.
2. Entity-Specific Risks	<p style="text-align: center;">SUBSTANTIAL</p> <p>LGED and DPHE do not have revenue-generating projects, while revenue-generating projects are implemented by the <i>pourashavas</i> (implementing agencies). For the water supply subprojects, introduction of volumetric tariff and regular tariff revisions for revenue mobilization are required.</p>	LGED, DPHE, and the <i>pourashavas</i> need to prepare the plan on introducing volumetric tariff and periodic increases to secure the sustainability of O&M.
3. Project-Specific Risks	<p style="text-align: center;">SUBSTANTIAL</p> <p>Financial projections of the <i>pourashavas</i> show the necessity to increase holding tax through regular reassessments and tax revisions; improve collection efficiency, which averages around 81% for taxes and 84% for water charges; and increase tariffs of revenue-generating services (e.g., water supply).</p>	The financial capacity of the <i>pourashavas</i> needs to be strengthened through (i) effective implementation of the periodic reassessment of holdings tax demand, and adequate increase of holdings tax; (ii) introduction of volumetric tariff, and periodic revisions for recovery of O&M cost of the water supply subprojects; and (iii) training programs in financial management, information and control systems. The overall project will continue to invest in capacity support to enhance municipal financial management systems.
Overall Inherent Risk	<p style="text-align: center;">SUBSTANTIAL</p> <p>While country-specific risks exist, these risks could be mitigated through concerted efforts of the government with the support of ADB. For entity- and project-specific risks at the implementing agency level, LGED, DPHE, and the <i>pourashavas</i> are required to take necessary risk-mitigating actions, especially to enhance the financial sustainability of the additional financing.</p>	
B. Control Risks (PMU)		
1. Executing Entity	<p style="text-align: center;">LOW</p> <p>The PMU of the current project will have overall control and supervision of the overall project. PMU will be assisted by MDS, GICD, and individual consultants in implementation.</p>	Not required
2. Flow of Funds	<p style="text-align: center;">LOW</p> <p>LGED has administered several ADB and other donor funds without major problems. DPHE will have a separate subaccount for office expenses only.</p>	Not required
3. Staffing	<p style="text-align: center;">MODERATE</p> <p>PMU has adequate experts for financial management of the overall project.</p>	Not required

Risk	Risk Assessment	Mitigation Measures
4. Accounting Policies and Procedures	LOW LGED and DPHE follow the relevant Bangladesh and international accounting requirements.	Not required
5. Internal Audit	SUBSTANTIAL Internal audit reports of LGED have been submitted to the chief engineer of LGED behind schedule mainly due to inadequate staff in the internal audit cell. DPHE does not have an internal audit cell and one accountant from the Office of the Controller and Auditor General office is posted in DPHE on a part-time basis for internal audit.	LGED will provide adequate staff resources for the internal audit cell.
6. External Audit	LOW External audits of LGED and DPHE are conducted annually by staff of the Office of the Controller and Auditor General with clear assignments. The additional financing is also subject to annual statutory auditing by FAPAD under the Office of the Controller and Auditor General. No delays were observed in project-based audit reports.	Not required.
7. Reporting and Monitoring	LOW Comprehensive monthly and quarterly financial management 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.	Not required
8. Information Systems	LOW Accounts are computerized under the UFMS.	Not required
Overall Control Risk	MODERATE	
	Financial management risks are moderate. Delayed submission of internal audit reports constitutes a risk to be addressed by appointing qualified staff and training of existing staff.	
C. Control Risks (PIUs)		
1. Implementing Entity	LOW PIUs will be responsible for (i) project management and administration; (ii) procurement of goods and works; (iii) technical support; and (iv) institutional capacity, governance, and community development. PIUs will be assisted by MDS, GICD, and individual consultants.	Not required
2. Flow of Funds	LOW Most of the <i>pourashavas</i> have implemented ADB and other donor funds without major problems.	Not required
3. Staffing	MODERATE Certain additional positions need to be created in the <i>pourashavas</i> .	The <i>pourashavas</i> should fill the additional positions.

Risk	Risk Assessment	Mitigation Measures
4. Accounting Policies and Procedures	LOW The <i>pourashavas</i> follow the relevant Bangladesh and international accounting requirements.	Not required
5. Internal Audit	SUBSTANTIAL Internal audit reports are submitted to the mayor by the audit committee and inspection at each <i>pourashava</i> . However, there is currently no dedicated staff for internal audit in some <i>pourashavas</i> .	The <i>pourashavas</i> should refine role assignments and address staff inadequacy, and assure a dedicated supporting arrangement for the internal audit of the additional financing.
6. External Audit	SUBSTANTIAL External audits are conducted annually by staff of the Office of the Controller and Auditor General who have clear and adequate assignments. The additional financing is also subject to annual statutory auditing conducted by FAPAD under the Office of the Controller and Auditor General. Cox's Bazar's audit is done only up to FY2013 and Gopalganj's audit is only up to FY2014.	LGED should take up the matter with the Office of the Controller and Auditor General, and ensure yearly audits of the <i>pourashavas</i> , as well as clear any existing audit backlog.
7. Reporting and Monitoring	LOW Comprehensive monthly and quarterly financial management reporting systems are in place. Routine reports are produced from the accounting system. Others are prepared in spreadsheets with figures extracted from the accounting system.	Not required
8. Information Systems	LOW LGED's computerized accounts are used in the <i>pourashavas</i> .	Not required
Overall Control Risk	MODERATE Some financial management risks are recognized. Delayed submission of internal audit reports and delay in external audits are found to present substantial risks, which need to be addressed with adequately experienced additional staff in PIUs.	

ADB= Asian Development Bank, LGED = Local Government Engineering Department, FAPAD= Foreign Aided Projects Audit Directorate, FY = fiscal year, MDS = Management Design and Supervision Consultancy, GICD = Governance Improvement and Capacity Development Consultancy, O&M = operation and maintenance, PMU = project management unit, PIU = project implementation unit, UFMS = Unified Financial Management System.
Source: Asian Development Bank.

G. STRENGTHS AND WEAKNESS

55. **Strengths.** The main strength of the existing project financial management is that executing agencies have developed significant financial management experience with externally funded projects over the last decade.

56. **Weaknesses.** Some of the main weaknesses include the following:

- (i) **Capacity.** The *pourashavas'* staff is trained and applies the basic functions of the UFMS. However, they do not possess the required skills to use current accounting software to generate automated reports; and

(ii) **Accountability.** The LGED does not undertake an internal audit of *pourashavas* at present. The *pourashavas* are supposed to have an audit and inspection standing committee that carries out internal audit and reports to their mayors. The project will support the operationalization and capacity development of the internal audit committee for each *pourashava*, and FAPAD will conduct the external audit of all project accounts. For Cox's Bazar and Gopalganj, audits are completed only up to FY2013 and FY2014, respectively. The main reason given by *pourashavas* is that the Office of the Controller and Auditor General takes up the audit of financial statements of the *pourashavas* in 1 or more years in accordance with their audit program plan. To mitigate these risks, the additional financing will have its own, dedicated financial management staff and will be audited by FAPAD on an annual basis. LGED will liaise with the Office of the Controller and Auditor General to take up the audit of *pourashavas'* financial statements on a yearly basis and to clear existing backlogs.

H. ACTION PLANS

57. LGED and ADB have agreed on an action plan to address the issues that the FMA has identified (Table 3).

Table 3: Action Plans

Area	Current Scenario	Risk	Mitigation Measure Suggested	Target Date
Managing externally assisted projects	The <i>pourashavas</i> do not have sufficient experience in managing externally assisted projects.	This may cause delays in implementing the additional financing.	Suitable training and capacity building support should be provided with the help of MDS, GICD, and individual consultants to strengthen the financial management capacities of the <i>pourashavas</i> .	June 2018
Financial capacity	The financial position of the <i>pourashavas</i> is inadequate.	Weak and inadequate financial capacity to sustain the developed assets under the additional financing.	The demand of holdings tax should be assessed periodically. The holdings tax needs to increase at the rate it is supposed to be levied and collected. In addition, volumetric tariff needs to be introduced and revised periodically to recover O&M cost in water supply subprojects.	June 2021
Internal and external audit	The annual audit of <i>pourashavas'</i> financial statements has been delayed.	This may cause delay in submission of audit reports.	The annual audit should be conducted on time by appointing qualified staff and training the existing staff. In addition, the existing backlogs in audit of <i>pourashavas'</i> financial statements should be cleared in a timely manner.	December 2017

Source: Asian Development Bank.

I. ASSURANCES AND COVENANTS

1. Right of Audit

58. The LGED, DPHE, and the *pourashavas* will ensure that contracts financed by ADB will include provisions specifying the right of ADB to audit and examine the records and

accounts of LGED, DPHE, *pourashavas*, contractors, suppliers, consultants, and other service providers as they relate to the additional financing (included in Loan Agreements, Schedule 5, Governance and Corruption).

2. Financial Management

59. FAPAD will audit PMU and PIUs annually. Audit reports shall be available within 6 months of the fiscal year-end. The PMU will build PIUs' capacity to ensure timely and rigorous reconciliations, orderly record keeping, strict adherence to financial management policies and internal controls, and orderly and timely year-end preparation and audit of annual project accounts (included in Loan Agreements, Section 4.02).

3. Governance and Anticorruption

60. The government will ensure the following: (i) the overall project is carried out in compliance with all applicable government anticorruption regulations and ADB's Anticorruption Policy (1998, as amended to date); (ii) all PMU and PIU staff actively participate in government's anticorruption regulations and ADB's Anticorruption Policy trainings; (iii) a project website is developed and maintained to disclose audited annual project accounts, project progress, and procurement activities; and (iv) procurement plans and activities are discussed in public *pourashava* meetings (included in Loan Agreements, Schedule 5 Website, and Governance and Corruption).

4. Financial Sustainability

61. The government shall require each *pourashava* with water and sanitation subprojects to adopt a water tariff reform plan as part of an overall operation and maintenance (O&M) and debt service plan. The first water and sanitation tariff revision shall be adopted before the completion of civil works. Advanced UGIAP performance criteria require holding tax collection to be at least 85%. Fulfillment of this requirement shall be a core condition to receive funding under phase 3 of the overall project. The *pourashavas* with metered piped water supply systems shall carry out a public awareness campaign throughout the project on the need for metering and tariff changes. Under the advance UGIAP performance criteria, a tariff collection efficiency of at least 80% should be achieved (included in Loan Agreements, Schedule 5 Counterpart Funds and O&M).

J. CONCLUSIONS

62. The FMA indicates that there are financial management risks. Consequently, the project has proposed a series of targeted mitigation measures to increase transparency, internal controls, and reporting. Given the scale of the planned investments and expected increase in O&M costs for the *pourashavas* in the coming years, officials of executing agencies and implementing agencies should give more attention to strengthening financial management capacity, improving their own revenue, and making available the required resources to mitigate any financial risk. Positive findings are that the executing agencies have a sound record in implementing externally funded projects and programs and implementing agencies have experience with international donor projects.