

**PROJECT INFORMATION DOCUMENT (PID)  
IDENTIFICATION/CONCEPT STAGE**

Report No.: PIDC86745

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| <b>Project Name</b>                    | Improving Quality and Efficiency of Public Sector Audit               |
| <b>Region</b>                          | LATIN AMERICA AND CARIBBEAN   |
| <b>Country</b>                         | Nicaragua   |
| <b>Lending Instrument</b>              | IPF   |
| <b>Project ID</b>                      | P161359   |
| <b>Borrower Name</b>                   | Government of Nicaragua, Ministry of Finance and Public Credit (MHCP) |
| <b>Implementing Agency</b>             | Nicaragua Comptrollers' General Office                                |
| <b>Environment Category</b>            | C - Not Required  |
| <b>Date PID Prepared</b>               | 09-Aug-2016   |
| <b>Estimated Date of Approval</b>      | 15-Nov-2016   |
| <b>Initiation Note Review Decision</b> | The review did authorize the preparation to continue                  |

**I. Introduction and Context**

**Country Context**

1. Nicaragua has witnessed an impressive reduction in both extreme and overall poverty over the last ten years. Major progress has been made in improving service delivery to the poorest and results are beginning to show. Public expenditures in infrastructure and reforms in social service delivery have been targeted to rural areas and poorer households. Preliminary estimates indicate that extreme poverty in Nicaragua decreased from 17.2 percent in 2005 to 8.3 percent in 2014. Preliminary results also suggest that the overall poverty rate fell from 48.3 percent in 2005 to 29.6 percent in 2014. Despite positive trends in poverty, almost three out of ten individuals still lived with a per capita consumption lower than the general poverty line in 2014. Poverty remains largely a rural problem. Inequality, measured using the Gini coefficient, has improved somewhat, falling from 0.40 in 2005 to 0.38 in 2014 and remains below the LAC region's average. Nicaragua has also made progress in improving social indicators, in particular in health and education, though challenges remain.

2. Reducing vulnerability to exogenous shocks and increasing productivity remain key challenges. Sound macroeconomic policies have allowed for moderate and steady economic growth, but increasing productivity is needed to accelerate convergence in income levels with the rest of the region. Real GDP growth averaged about 3.5 percent since 2000. Despite being hit hard by the global financial crisis of 2008, it has been able to recover to its pre-crisis trend. Growth has since moderated to around 4.5 percent and 4.7 percent in 2013 and 2014 respectively and is expected to be about 4.0 percent for 2015. However, the country is heavily dependent on food exports to the US and Venezuela, and on oil imports and associated financing from Venezuela. Fluctuations in commodity prices could increase the current account deficit, while further repercussions could come from slowing global growth and donor countries' aid budgets. On the

other side, climate shocks such as hurricanes, severe storms, floods and droughts occur frequently. These events threaten the life, health and economic activity of the population and the infrastructure of the country.

3. The Government's strategy, National Plan for Human Development (PNDH) 2012-2016 continues its emphasis on reducing inequality by increasing poverty-related spending and boosting investment in social sectors and rural infrastructure. This includes building on the proven models to further expand access and to achieve more efficiency in the delivery of basic services. Governance issues are addressed in the PNDH from different angles. Nicaragua still faces a variety of challenges with respect to good governance. While the most high profile aspects relate to the checks and balances, other issues such as government effectiveness, regulatory quality and the control of corruption are critical for accelerating and broadening the gains from economic growth.

4. Improving transparency and accountability in the public sector is crucial to help build broader consensus around development strategies. While there has been good progress in the area of budget openness and public financial management, there is need to further develop better linkages between spending and outcomes that allow for a more transparent evaluation of public programs. In addition, Nicaragua still has significant weaknesses in the area of spending oversight both for central and municipal governments, as well as state owned enterprises. There is thus a need to strengthen the country's institutions of oversight in order to improve transparency and accountability. The Comptroller's General Office (CGR) is key amongst such institutions, and its role in the transparency and accountability agenda is critical. Accordingly, the strengthening of the state capacity for an accountable public administration is one of the strategic areas (lineamiento estrategico) included in the updated PNDH and the CGR's audit of the Nicaragua's general budget is listed as one of the indicators. Therefore, efforts are needed to strengthen its capacity to efficiently fulfill its mandate. An analysis of the capacity of the CGR to fulfil its mandate is included below.

## **Sectoral and Institutional Context**

### **Public Financial Management Context**

5. During the last years, the Government has shown its genuine commitment to strengthen the public financial management systems, including the implementation of a Medium-Term Budget framework, a Treasury Single Account, and the ongoing upgrade of the integrated financial management system. At the request of the Ministry of Finance and Public Credit (MHCP), the WB and IDB carried out a joint assessment of Public Financial Management (PFM) systems following the PEFA Framework in 2014. The evaluation showed that there had been progress in some areas, but also uncovered weaknesses in others including internal control, internal and external audit.

6. Overall, the preparation of the annual budget follows an orderly process that allows for its approval by the National Assembly before the beginning of the fiscal year. However, the time assigned to spending entities to prepare budget proposals continues to be tight; and there might be delays in communicating budget ceilings. Policies and priorities are broadly reflected in the budget, which itself is based on a Medium-Term Budget framework. Budget coverage is adequate and classifiers are consistent with international statistical standards .

7. Budget execution is carried out through the SIGFA system and expenditures are subject to

budget controls incorporated in it; these effectively limit expenditures to actual cash availability and approved budget allocations. However, commitments and accruals are recorded only at the time the invoice is available rather than at the time of the approval of the expenditure. This weakens the controls over budget execution. As a result, there is no adequate mechanism to ensure that arrears are being monitored from the moment an obligation is legally generated; and therefore, accruals may not be promptly recorded in the system. This practice weakens budgetary controls and it would also affect the usefulness of in-year budget execution reports.

8. Internal control and internal audit are generally transaction based. Internal control rules and procedures consist of a basic set of rules for processing and recording transactions, which are generally complied with, but controls may be deficient in some important areas, as the establishment and design of internal controls does not necessarily follow a comprehensive risk assessment. In addition, the Technical Standards on Internal Controls (NTCI) for the public sector have not been adjusted to reflect changes on the PFM modernization framework, mainly as it relates to budget execution controls. Existing Internal Audit function is limited to a transactional approach and does not focus on the adequacy and effectiveness of the internal control system.

9. In-year budget execution reports and annual budget reports are prepared in a timely manner, but there is no independent audit of the annual financial statements, as these are not prepared. The annual budget execution report produced by the MoF is submitted to the Congress and to the Auditor General's Office and disseminated to the general public within a six-month period. Auditor General's Office reviews the budget execution report with a two-year delay though. Therefore, they are not aligned with the formulation of the budget and it is not used either by the National Assembly or by the Executive Branch to support discussion on the budget. The Legislative Assembly exercises its scrutiny role at the time of budget approval, but scrutiny of budget execution reports is quite limited while no annual financial statements are made available.

10. The modernization of the PFM system in Nicaragua is defined as a strategic line of action in the 2012-2016 PNDH. As such, there are important on-going reforms and/or strengthening efforts supported by different development organizations such as the IDB, World Bank, EU and SECO. Some of those reforms include: Public debt management, implementation of a Medium-Term Expenditure Framework; modernization of the treasury system through the implementation of the Treasury Single Account (CUT), e-payments, and monthly cash flow planning; implementation of an e-procurement platform for central government, and the most important, the modernization of the Integrated Financial Management System (SIGAF) that would allow the integration of key PFM processes in the whole public sector on a gradual basis.

#### Supreme Audit Institution Context

11. The System of Control of the Public Administration and oversight of the State's Goods and Resources (Sistema de Control de la Administracion Publica y de Fiscalizacion de los Bienes y Recursos del Estado) is governed by the Comptroller's General Office. As such, the CGR was created as an independent body with administrative and functional autonomy. Overall, the CGR has a solid and well established legal and institutional framework. It is headed by a Superior Council, and has nearly 465 staff. Technical work is anchored in its Direccion General Juridica and the Direccion General de Auditoria. The CGR has firmly committed to the transparency and accountability agenda in the country as expressed in its Institutional Development Strategic Plan (2011-2015), one of whose objectives is to increase the coverage of the oversight of public institutions and the strengthening of the internal control systems. In an effort to embark on a more

structured strengthening plan, the CGR went through an external evaluation following the SAI PMF methodology with the support of IDB and INTOSAI, which was completed in July, 2015.

12. The SAI PMF report identifies important capacity issues. These include the lack of up to date audit standards, constraints in human and financial resources, and a limited approach and coverage of external audit, which is almost exclusively focused on the review of the budget execution reports and compliance issues, partly because of the lack of financial statements. Following the completion of the SAI PMF review, the CGR requested IDB's support to prepare a comprehensive action plan that includes nine broad strategic areas, some of which have been prioritized by CGR to improve its performance. One of those prioritized areas is related to the updating and effective implementation of high-quality professional auditing standards based on the International Standards for Supreme Audit Institutions (ISSAIs), for which initial steps are being taken with IDB support, mainly in relation to the revision and update of the government auditing standards (NAGUN) and related Audit Manual (Manual de Auditoria Gubernamental), which are expected to be approved by early May, 2016; and the development of an on-line training module.

13. However, the issuance and approval of revised audit standards would not be enough to ensure the provision of high-quality audit in the public sector. Audit work is currently done manually requiring the use of excessive human and economic resources that are not available; and thus limiting significantly the coverage of the public sector. Beyond coverage, the lack of comprehensive audit standards, qualified staff and tools to support the overall audit process (planning, risk assessment, documentation, etc- considerably affect the quality and usefulness of the audit work.

14. Additionally, the successful implementation of PFM reforms calls for a stronger and better equipped CGR that can efficiently fulfill its mandate. For instance, the implementation of the new financial management system (SIGAF) will enable the Ministry of Finance, and decentralized entities to produce timely and comprehensive financial statements, which according to the existing framework should be subject to external audit from the CGR. Thus, there is an urgent need for the CGR to strengthen its capacity to deliver high quality audits following a more efficient and effective approach. The proposed Project would contribute to this high level objective. A strong CGR with sufficient capacity to satisfactorily audit these financial statements would provide the conditions for enhancing transparency and accountability in the management of public resources in the country.

15. The Nicaragua SAI is a signatory of the IDI (OLACAEFS Initiative for the Implementation of ISSAIs under IDI's 3i Program. As stated and required by the 2014 IDI (OLACEFS's Declaracion de Compromisos (Statement of Commitments), the CGR is making the efforts to advance in the implementation of ISSAIs. The proposed project will actually allow the CGR to comply with the ISSAI implementation at level 2 and level 4 (financial, performance and compliance audit) of the ISSAI framework, as laid out in the IDI's 3i Program. Training on ISSAIs will use the framework and other training material developed as part of the 3i Program, and will involve ISSAI facilitators certified by IDI.

#### **Relationship to CAS/CPS/CPF**

16. The FY2013-2017 CPS supports the Government's program in two key areas: (i) improving social welfare by improving access to quality basic services, in particular by poor rural

households; and (ii) raising incomes by improving productivity, competitiveness and diversification. Consistent with the Government's strategy, the CPS identifies transparency and accountability in the public sector as a cross-cutting area that is crucial to help build broader consensus around development strategies.

17. During the CPS period, the transparency agenda supported by the Bank, focused on regulatory quality, government effectiveness, and voice and accountability. On government effectiveness, the primary outcome under the CPS is related to support provided for upgrading of the Public Financial Management System (SIGAF) and improving the efficiency of expenditures in the social sectors. Overall, support in the area of governance and transparency, including the PFM agenda, is coordinated with the IDB and other development partners. Within the specific objectives, the CPS has also supported analytical and advisory work to strengthen dialogue in key areas of engagement, one of those being the joint IDB-WB PEFA assessment carried out in 2014. It is intended that this dialogue would result in the preparation of a country action plan to strengthen the PFM environment. The Proposed Project to strengthen CGR's capacity is fully aligned with the CPS's focus on transparency and accountability.

## **II. Project Development Objective(s)**

### **Proposed Development Objective(s)**

The project development objective is to improve the quality and efficiency of public sector audit, thereby strengthening external oversight over the management of public resources in Nicaragua.

### **Key Results**

### C. Key Outputs

Key outputs for Component 1. i) 1,000 CGR auditors from different levels and internal auditors of nearly 249 public institutions trained on updated NAGUN based on ISSAIs; ii) a core team of 20 CGR auditors trained on Performance Audit; iii) 30 CGR auditors trained to provide training on ISSAIs.

Key outputs for Component 2. i) SIAG (Integrated Governmental Audit System) adapted, installed, and functioning; and, ii) Audit supervisors, ➤( encargados ➤( and auditors trained in the use of the systems.

Key outputs for Component 3. i) Code of Ethics updated; ii) 250 auditors trained in the use of the updated Code of Ethics; and iii) quality control system designed, implemented and tested in three pilot audits with independent review.

### D. Key Results/Outcomes

21. Project outcomes include:

➤(ç The CGR ➤( s capacity strengthened to carry out and deliver high quality audits in the Nicaragua Public sector in accordance with revised audit standards based on ISSAIs, through professional auditors trained and qualified, an integrated audit system implemented to support the overall audit process; and a quality control system in place.

➤(ç CGR uses its strengthened capacity to carry out, during the life of the Project, at least two pilot audits using the system and revised standards, which quality control would be performed by an independent party, either a partner SAI or an international independent consultant.

➤(ç Having in place strengthened capacity would allow the CGR to gradually increase not only the number of audits, and therefore the coverage of the public sector, but the quality and overall value-added to the accountability and transparency in Nicaragua.

## III. Preliminary Description

### Concept Description

Description of the Proposed Project

22. The Project consists of the following parts:

a) Development and implementation of a training strategy for CGR ➤( s auditors and staff from the internal audit units (an operational arm of the CGR) on the deployment of the updated auditing standards and audit manual. Considering that the CGR is currently working on the design of the on-line training modules on the updated NAGUN based on ISSAIs and related audit manual, which would be available in their institutional training platform, the Project would finance consulting services, training materials and logistics, and travel costs for:

i) a train-the-trainers course led by an international expert (certified ISSAI facilitator) to guide the on-line learning and deliver face-to-face sessions to train 30 CGRs auditors (future trainers on

ISSAIs);

- ii) deployment of the on-line training and face-to-face sessions in different regions to train nearly 1,000 CGR auditors and internal auditors working in public sector entities in the application of the new standards ; and,
- iii) provision of specialized training to a selected group of CGR officials on performance audit through a knowledge exchange arrangement with the Mexican Auditoria Superior de la Federacion (ASF) in the framework of an existing OLACEF's Internship Program on Performance Audit.

b) Adaptation and implementation of the Integrated Governmental Audit System (SIAG) . Building on the existing cooperation arrangements among the SAIs in the region, through OCCEFS, the Nicaragua CGR would have access and the right to adapt and use an integrated government audit system currently used by other SAI in the region. To this end, the Nicaragua CGR intends to amend an existing cooperation agreement with the Guatemala CGR to specifically set out the arrangements to use SIAG. The system would support the planning, conducting, monitoring and supervision of the audit work in the public sector, and help in the assignment of auditors. It would also facilitate the recording and maintenance of the documentation gathered during the audit process and which would support the key findings, results and conclusions of the audit process, including the audit reports. These improvements would all be aligned to the new audit standards and manuals. The implementation of the SIAG will not only create the conditions for compliance with the new standards, but would also allow for a more efficient audit process, which is currently manual and thus demands the use of more resources and time. The adaptation and implementation of the SIAG would require the financing of consulting services, goods and travel costs for CGR officials, as well as officials from partner SAIs to facilitate the knowledge exchange. Specific activities include:

- i) Agree and sign the amendment to the Cooperation Agreement with the Guatemala CGR for the use and adaptation of the SIAG
- ii) Review of the system features and functionalities to identify and define adjustments needed to respond to CGR needs, including the preparation of a comprehensive work plan to complete the adaptation.
- iii) Adaptation of existing functionalities, and development of any new additions to SIAG up to the implementation and readiness for deployment and operation.
- iv) Training of audit supervisors and encargados on the use of the system.
- v) Performance of two pilot audits (financial and compliance) using SIAG and the updated NAGUN based on ISSAIs. These activities would allow CGR to: i) verify the operation of the system, and ii) verify overall compliance with ISSAIs, including quality arrangements. Quality control of the pilot audits would be carried out with the support of an external reviewer potentially from a partner SAI.

c) Design and implementation of a quality control system in compliance with ISSAI No. 40. Delivering high quality audits is a critical factor that may affect the SAI's reputation and credibility and ultimately, its ability to fulfill its mandate. The Nicaragua SAI is therefore committed, as part of its strategy, to establish and maintain a quality control system relevant to conducting audits of a high quality in the public sector environment. An effective quality control system would help CGR to have reasonable assurance that i) its staff comply with professional standards, and any legal or regulatory requirement, including relevant ethical requirements (e.g. integrity, independence, objectivity and competence); and ii) the reports issued by the CGR are appropriate to the circumstances. To support this, the Project would finance consulting services, workshops and travel costs for:

- i) The design of a quality control system which is appropriate to its mandate and circumstances and which responds to their risks of quality, including the definition and implementation of the policies and procedures built into the performance of the CGR and the production of the CGR's reports.
- ii) Update the Code of Ethics in accordance with ISSAI 30 and training of nearly 250 auditors.
- iii) Pilot and assess the operation of the quality control system in three financial audit engagements through an independent international expert.
- iv) Project management, M&E and audit. The CGR will secure the financing of key positions within the Unidad de Apoyo Administrativo (UAA/CGR) required for project implementation. Under such arrangements the Grant would i) partially finance a Procurement Specialist or a Project Coordinator within the CGR's Unidad de Apoyo Administrativo (UAA/CGR) that would support and facilitate the interaction among different units within CGR, and the interaction with partner SAIs, as well as overall project monitoring; and ii) single project financial audit.

NOTE. Supervision resources have been allocated in the form of a BETF.

#### IV. Safeguard Policies that Might Apply

| Safeguard Policies Triggered by the Project    | Yes | No | TBD |
|--|-----|----|-----|
| Environmental Assessment OP/BP 4.01            |     | x  |     |
| Natural Habitats OP/BP 4.04                    |     | x  |     |
| Forests OP/BP 4.36                             |     | x  |     |
| Pest Management OP 4.09                        |     | x  |     |
| Physical Cultural Resources OP/BP 4.11         |     | x  |     |
| Indigenous Peoples OP/BP 4.10                  |     | x  |     |
| Involuntary Resettlement OP/BP 4.12            |     | x  |     |
| Safety of Dams OP/BP 4.37                      |     | x  |     |
| Projects on International Waterways OP/BP 7.50 |     | x  |     |
| Projects in Disputed Areas OP/BP 7.60          |     | x  |     |

#### V. Financing (in USD Million)

|  |       |                       |               |
|--|-------|-----------------------|---------------|
| Total Project Cost:                                  | 0.497 | Total Bank Financing: | 0             |
| Financing Gap:                                       | 0     |                       |               |
| <b>Financing Source</b>                              |       |                       | <b>Amount</b> |
| Supreme Audit Institutions Capacity Development Fund |       |                       | 0.497         |

#### VI. Contact point

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